Davis Polk
CLIENT NEWSLETTER

October 9, 2009

Investment Management Regulatory Update

SEC Rules and Regulations

- SEC Adopts Interim Final Temporary Rule Requiring Money Market Fund Disclosure

Industry Update

- Rep. Kanjorski Releases Private Fund Investment Advisers Registration Act
- Rep. Kanjorski Releases Investor Protection Act
- FINRA Releases Proposed Amendment to Communications Rules
- SEC Establishes New Division of Risk, Strategy, and Financial Innovation
- Pay-to-Play Developments (New York and Federal)
- Treasury Department's Guarantee Program for Money Market Funds Expires as Planned

SEC Rules and Regulations

SEC Adopts Interim Final Temporary Rule Requiring Money Market Fund Disclosure

In the wake of the Treasury Department's decision to end its Guarantee Program for Money Market Funds (the "**Guarantee Program**"), as discussed in *Treasury Department's Guarantee Program for Money Market Funds Expires as Planned*, the SEC has adopted Rule 30b1-6T, an interim final temporary rule under the Investment Company Act of 1940 (the "**Investment Company Act**") that requires money market funds whose "market-based net asset value per share" drops below $0.9975 to notify the SEC promptly of the decline and subsequently to provide the SEC with certain "weekly portfolio and valuation information." The information required by the SEC under the rule is essentially the same as that provided to it and the Treasury Department by money market funds that participated in the Guarantee Program. Information provided to the SEC pursuant to Rule 30b1-6T will remain confidential "to the extent permitted by law."

In the release accompanying the rule, the SEC noted that it is still considering the reforms to the regulation of money market funds that it proposed in June 2009 (as reported in the *July 1, 2009 Investment Management Regulatory Update*) and indicated that, while such reforms are being finalized, it needs to continue "to monitor money market funds."

The rule took effect on September 18, 2009 and will remain in effect until it expires, by its terms, on September 17, 2010. The SEC is seeking comments on the rule, and the deadline for submitting comments is October 26, 2009.

- See a copy of the rule

Industry Update

Rep. Kanjorski Releases Private Fund Investment Advisers Registration Act

On October 1, 2009, Congressman Paul E. Kanjorski (D-PA), Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, introduced a

discussion draft of the Private Fund Investment Advisers Registration Act of 2009 (the "**PFIARA**"). The PFIARA draws heavily from the Treasury Department's earlier proposed legislation of the same name (the "**Treasury Proposal**"). Indeed, as described more fully below, the most controversial difference between the two bills might prove to be the PFIARA's special treatment of advisers of venture capital funds; the PFIARA, as proposed, carves-out advisers of such funds from the registration requirements that would be imposed upon advisers to other private funds.

Like the Treasury Proposal, the PFIARA would also generally require all advisers to private funds to register with the SEC. Currently, an investment adviser who, during the course of the preceding 12 months, has had fewer than 15 clients and who neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company or business development company is exempted from the SEC registration requirements otherwise imposed by the Investment Advisers Act of 1940 (the "**Advisers Act**"). A fund is generally considered one "client." Therefore, many advisers to private funds, such as private equity and hedge funds, are able to rely on this so-called "private investment adviser" exemption and are not required to register with the SEC, although a significant number do so voluntarily.

The PFIARA would eliminate the ability of advisers to private funds to rely on the "private investment adviser" exemption. It accomplishes this, as did the Treasury Proposal, by mandating that advisers to "private funds" register with the SEC if their assets under management exceed $30 million. Both the PFIARA and the Treasury Proposal define "private funds" as any investment fund that would be an investment company under the Investment Company Act but for the exemptions provided by Section 3(c)(1) or 3(c)(7) thereunder and either (i) is organized or created under the laws of the United States or any state or (ii) has ten percent or more of its outstanding securities owned by U.S. persons.

Unlike the Treasury Proposal, which did not distinguish between advisers to hedge funds and other private funds, the PFIARA would exempt advisers to "venture capital funds" from SEC registration. This means that such advisers would not be subject to the provisions of the Advisers Act that would otherwise require them to, among other things, implement a comprehensive compliance program, adopt a code of ethics and an insider trading policy, comply with certain custody procedures, advertising restrictions and document retention obligations, disclose and report specified information on Form ADV, or that would otherwise subject them to SEC examinations. Advisers to "venture capital funds" would, however, be subject to the anti-fraud provisions of the Advisers Act and would further be required under the PFIARA to maintain certain records and provide the SEC with "such annual or other reports as the [SEC] determines necessary or appropriate in the public interest for the protection of investors." Importantly, the PFIARA does not define the term "venture capital funds," leaving that difficult and nuanced task to the SEC.

Like the Treasury Proposal, the PFIARA would retain the registration requirement for an adviser to a private fund whose clients are all residents of the state in which the investment adviser maintains its principal office and who does not offer advice regarding securities listed or traded on any national securities exchange. These advisers are currently exempt from the Advisers Act's registration requirements. It further retains the registration requirement set forth in the Treasury Proposal for an adviser to a private fund who is registered with the Commodity Futures Trading Commission (the "**CFTC**") as a commodity trading advisor and whose "business does not consist primarily of acting as an investment adviser, as defined in Section 202(a)(11)" of the Advisers Act. Presently, such advisers are not required to register with the SEC.

Like the Treasury Proposal, the PFIARA's registration exemption for a "foreign private adviser" is narrower than current SEC guidance. Under both bills, an investment adviser who (i) has <u>no place of business</u> in the United States, (ii) has for the preceding 12 months had fewer than 15 clients in the United States and assets under management attributable to clients in the United States of less than $25 million (or such higher amount as the SEC may determine by rulemaking) and (iii) neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company or business development company is exempt from registration. Current SEC

guidance provides that an offshore adviser, meaning an adviser with a principal place of business outside the United States, with fewer than 15 U.S. clients is not required to register—regardless of the dollar amount of its assets attributable to U.S. clients.

The PFIARA would expand the Treasury Proposal's controversial new books and records requirements, which are intended to provide the federal government with systemic risk data. Both bills would require registered investment advisers to maintain and file with the SEC records and reports detailing, for each "private fund" advised by that adviser: (i) its assets under management; (ii) its use of leverage (including off-balance sheet leverage); (iii) its counterparty credit risk exposure; (iv) its trading and investment positions; (v) its trading practices; and (vi) other information that the SEC and Federal Reserve deem necessary or appropriate to protect the public interest and/or investors or for the assessment of systemic risk. The PFIARA would also grant the SEC the rulemaking authority to require such additional information from "private fund" advisers as the SEC determines necessary. In addition, both bills make clear that all records of "private funds" (as opposed to simply the records required to be kept by law) would be subject to periodic and special examination by the SEC.

The PFIARA would also expand the list of entities with which the SEC may share systemic risk information. It would authorize the SEC to share such information with not only the Federal Reserve, but also with other entities identified by the SEC as having "systemic risk responsibility." Any shared records would be required to be kept confidential to the extent permitted by applicable law.

The Treasury Proposal's grant of rulemaking authority to the SEC to establish public disclosure requirements on advisers to "private funds" remains unchanged in the PFIARA. Neither bill provides details about the nature of any such disclosures.

Both the Treasury Proposal and the PFIARA contain broad grants of authority to the SEC to craft appropriate rules to implement the intent of the legislation. They both, for example, explicitly permit the SEC to "ascribe different meanings to terms (including the term 'client') used in different sections of [the Advisers Act]" and to establish "different requirements for different classes of persons or matters." The PFIARA would further amend Section 211 of the Advisers Act to endow the SEC with sweeping powers to come up with new rules, to amend existing rules and to rescind rules, regulations and orders "as are necessary or appropriate to the exercise of the functions and powers conferred upon the [SEC] elsewhere in this title." Additionally, the PFIARA authorizes the SEC to "classify persons and matters within its jurisdiction based upon, but not limited to—(A) size; (B) scope; (C) business model; (D) compensation scheme; or (E) potential to create or increase systemic risk." Ultimately, these amendments increase the likelihood that the SEC would withstand a legal challenge to any new rule that it may promulgate pursuant to the PFIARA based on the ground that the rule exceeded the scope of the SEC's authority.

Finally, each bill requires the CFTC and the SEC to issue joint rules, within six months of the bill's enactment and after consultation with the Federal Reserve, regarding the collection of systemic risk data from investment advisers registered under both the Advisers Act and the Commodity Exchange Act.

- See the Davis Polk client memorandum entitled *Representative Kanjorski Releases Investor Protection, Private Fund Investment Adviser Registration and Federal Insurance Office Proposals*
- See a copy of the PFIARA
- See the Davis Polk client newsflash entitled *Private Fund Investment Advisers Registration Act*, which discusses the Treasury Proposal in detail
- See a copy of the Treasury Proposal

Rep. Kanjorski Releases Investor Protection Act

Accompanying his release of the PFIARA, Chairman Kanjorksi also released a discussion draft of a bill entitled the Investor Protection Act of 2009 (the "**IPA**"). As with the PFIARA, the IPA modifies a prior

version released by the Treasury Department this past summer. Among other new provisions, the IPA would require the SEC to apply the same standard of conduct for a broker-dealer that is providing investment advice to a retail customer as applies to an investment adviser under the Advisers Act. Additionally, the IPA would require the SEC to impose an annual assessment on all registered investment advisers to help cover the costs incurred by the SEC in inspecting and examining registered investment advisers pursuant to the Advisers Act.

- See the Davis Polk client memorandum entitled *Representative Kanjorski Releases Investor Protection, Private Fund Investment Adviser Registration and Federal Insurance Office Proposals*
- See a copy of the IPA
- See a copy of the Davis Polk client newsflash entitled *Investor Protection Act of 2009*, which discusses the Treasury Department's proposed legislation in detail
- See a copy of the Treasury Department's proposed legislation

FINRA Releases Proposed Amendment to Communications Rules

The Financial Industry Regulatory Authority ("**FINRA**") is seeking comment on proposed new rules (the "**Proposed Rules**") related to its member firms' communication with customers and the public. Among other changes, the Proposed Rules would modify the communication categories now in effect, reducing the six existing categories to three: "institutional communications," "retail communications" and "correspondence." Of particular note, "retail communications" is defined to include all communications, including most advertisements and sales literature (presently considered separate categories), made available to more than 25 retail investors. The Proposed Rules would generally continue the existing review and approval requirements, as modified for the new categories, while adding an exemption from review and approval for "retail communications" that are "solely administrative."

In addition, the Proposed Rule requires firms to file "retail communications" pertaining to all types of closed-end investment funds within ten days of their first use. Currently, with respect to non-continuously offered closed-end funds, firms need only file advertisements and sales literature that are used during the fund's initial public offering period. According to the Regulatory Notice accompanying the Proposed Rule, FINRA's motivation in suggesting that filings be done beyond the initial offering period was its belief "that investors deserve the same protections concerning retail communications about [non-continuously offered] closed-end funds . . . as those that are distributed during the IPO."

- See the Davis Polk memorandum entitled *FINRA Proposes Amendments to Communications Rules, Including New Pre-Filing Requirements for Structured Products Communications*
- See the Regulatory Notice accompanying the Proposed Rules
- See the text of the Proposed Rules

SEC Establishes New Division of Risk, Strategy, and Financial Innovation

On September 16, 2009, the SEC announced the establishment of a new Division of Risk, Strategy, and Financial Innovation. The new division will combine the SEC's Office of Economic Analysis ("**OEA**") and the Office of Risk Assessment ("**ORA**"). According to the SEC, the new division will provide the SEC "with sophisticated analysis that integrates economic, financial, and legal disciplines."

In addition to assuming the functions previously performed by the OEA and ORA, the new division's responsibilities will include "(1) strategic and long-term analysis; (2) identifying new developments and trends in financial markets and systemic risk; (3) making recommendations as to how these new

developments and trends affect the Commission's regulatory activities; (4) conducting research and analysis in furtherance and support of the functions of the Commission and its divisions and offices; and (5) providing training on new developments and trends and other matters."

University of Texas School of Law Professor Henry T. C. Hu will head the newly established division. Professor Hu is known for his work on topics such as the regulation of derivatives markets, hedge funds, corporate governance and the "decoupling" of ownership of debt and equity securities from economic interests.

- See the SEC's press release

Pay-to-Play Developments (New York and Federal)

New York

As previously reported in the *June 8, 2009, July 1, 2009* and *August 5, 2009 Investment Management Regulatory Updates*, pay-to-play arrangements remain a hot topic of investigation and reform. Notably, on September 23, 2009, New York State Comptroller Thomas P. DiNapoli adopted an executive order and associated interim policy (the "**Interim Policy**") designed to ban pay-to-play practices by investment advisers seeking to manage New York State Common Retirement Fund ("**NYCRF**") monies. Under New York law, the State Comptroller is the sole trustee and manager of the approximately $117 billion NYCRF.

The Interim Policy follows in the wake of a long-running investigation by New York State Attorney General Andrew M. Cuomo's Office into kickback schemes and other pay-to-play practices involving New York State and City pension funds. On September 17, 2009, Attorney General Cuomo announced settlement agreements with four private equity firms—HM Capital Partners I, Levine Leichtman Capital Partners, Access Capital Partners and Falconhead Capital—pursuant to which the firms agreed to pay over $4.5 million to the State of New York to be returned to the NYCRF and to adopt Cuomo's Public Pension Fund Reform Code of Conduct (the "**Code of Conduct**"). See the *June 8, 2009 Investment Management Regulatory Update* for a summary of the Code of Conduct, which has now been signed by seven firms. Additionally, on October 6, 2009, Attorney General Cuomo announced that Raymond Harding, the former chair of the New York Liberal Party, and Saul Meyer, a founding partner of Aldus Equity, pled guilty to felony securities fraud charges for their participation in pay-to-play kickback schemes at the NYCRF and the New York State Comptroller's office. Harding admitted to receiving $800,000 in sham placement fees relating to NYCRF's investments. Meyer admitted to paying $300,000 to Hank Morris, the top political adviser to former New York State Comptroller Alan Hevesi, to secure an investment for Aldus from NYCRF and to recommending that NYCRF make certain investments based on political pressure from David Loglisci, the former NYCRF chief investment officer.

The Interim Policy prohibits NYCRF, "directly or indirectly, from engaging, hiring, investing with, or committing to" an outside investment adviser if that adviser, or certain employees of that adviser (each a "**covered associate**"), has made a political contribution to the New York State Comptroller, or to a candidate for that position, in the past two years. Under the Interim Policy, the term "investment adviser" includes both SEC-registered investment advisers, advisers required to be registered with the SEC and unregistered investment advisers who rely on the exemption available under Section 203(b)(3) of the Advisers Act for any investment adviser that does not hold itself out to the public as an investment adviser and has fewer than 15 clients.

The Interim Policy is similar in many respects to the SEC's proposed Rule 206(4)-5 under the Advisers Act (the "**Proposed Rule**"), released on August 3, 2009. See the *August 5, 2009 Investment Management Regulatory Update* for a summary of the Proposed Rule. For example, like the Proposed Rule, the Interim Policy provides for a *de minimis* exception, permitting contributions of $250 or less to the New York State Comptroller, or a candidate for that position, for whom the covered associate making the

contribution is entitled to vote. Both the Proposed Rule and the Interim Policy contain a "catchall" provision that prohibits the investment adviser and any covered associate from engaging indirectly in pay-to-play practices, which, if done directly, would result in a violation of the Proposed Rule or Interim Policy, respectively.

The Interim Policy also requires that investment advisers provide NYCRF with a "political contribution representation" (the "**Representation**") in the form of a letter certifying that neither the adviser nor any covered associate has made a prohibited contribution after the effective date of the Interim Policy within the two-year period immediately preceding the date of the Representation. If an investment adviser makes a material misstatement or omission in its Representation, NYCRF is entitled to terminate its relationship with the investment adviser. Such termination may take the form of, among other things, (i) the termination of an investment management agreement or advisory contract, and recoupment of any fees paid thereunder; (ii) the termination of NYCRF's obligation to make future capital contributions; or (iii) the immediate redemption of NYCRF's investment.

The Interim Policy will become effective on the 45th day after September 23, 2009, the date on which the Executive Order was signed, and will remain in effect "until such time as the SEC adopts a final rule pertaining to political contribution." We will continue to monitor any developments with respect to the Interim Policy, the Proposed Rule and other pay-to-play investigations and regulations.

- See the Interim Policy press release
- See the Interim Policy
- See the settlement announcement
- See the announcement of the guilty pleas

Federal

On October 6, 2009, the comment period expired for the SEC's proposed rule to curb pay-to-play practices. For a more detailed discussion of the proposed rule, see the *August 5, 2009 Investment Management Regulatory Update*. Numerous individuals, placement agents, public officials, investment managers, brokerage firms and pension fund representatives, among others, submitted comments. For further analysis regarding the SEC's proposed pay-to-play rule, please see Davis Polk's October 6, 2009 comment letter to the SEC.

Treasury Department's Guarantee Program for Money Market Funds Expires as Planned

On September 19, 2009, the Treasury Department announced the expiration of its Guarantee Program, the details of which were discussed in the *October 8, 2008 Investment Management Regulatory Update*. The Treasury Department created the Guarantee Program in September 2008 to stabilize the money market industry after the net asset value of the Reserve Primary Fund fell below $1 per share following the collapse of Lehman Brothers. Key to the Treasury Department's decision to allow the Guarantee Program to expire was its belief that "the risk of catastrophic failure of the financial system has receded."

Under the Guarantee Program, the Treasury Department earned approximately $1.2 billion in participation fees while incurring no losses.

- See the Treasury Department's press release

Davis Polk

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

John G. Crowley	212 450 4550	john.crowley@davispolk.com
Nora M. Jordan	212 450 4684	nora.jordan@davispolk.com
Yukako Kawata	212 450 4896	yukako.kawata@davispolk.com
Leor Landa	212 450 6160	leor.landa@davispolk.com
Danforth Townley	212 450 4240	danforth.townley@davispolk.com
Joseph J. Cipolla	212 450 4911	joseph.cipolla@davispolk.com

© 2009 Davis Polk & Wardwell LLP

Notice: This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have any questions about the matters covered in this publication, the names and office locations of all of our partners appear on our website, davispolk.com.