

## Investment Management Regulatory Update

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## Litigation

### Insider Trading Charges Brought Against Hedge Fund Manager Raj Rajaratnam, Galleon Management and Others

On October 16, 2009, federal prosecutors and the SEC charged hedge fund manager Raj Rajaratnam, a principal at the hedge fund advisory firm, Galleon Management, L.P. (“**Galleon**”), along with five others—including a hedge fund consultant, a hedge fund general partner and three high-level corporate executives and insiders—with engaging in an insider trading scheme that allegedly generated more than \$33 million in illicit gains. In addition to the individuals charged, the SEC also charged Galleon and a New York-based hedge fund. Following the initial charges, federal prosecutors and the SEC, on November 5, 2009, announced charges against several additional individuals and entities in connection with the alleged insider trading scheme. The case marks a new Government initiative to aggressively investigate trading practices at hedge funds. Davis Polk is representing a client in connection with these investigations.

At an initial press conference, the Director of the SEC’s Division of Enforcement, Robert Khuzami, highlighted the involvement of hedge funds and hedge fund personnel in this case as particularly of concern because of the “dominant role” of hedge funds in today’s markets. In particular, Mr. Khuzami noted that hedge funds account for a tremendous amount of trading volume and “operate as intermediaries . . . [that perform] a role historically played by more highly-regulated broker-dealers.” According to Mr. Khuzami, the SEC is “committed to pulling back the curtain on hedge fund operations and taking a close look at their activity,” with particular scrutiny of hedge funds’ trading activity.

The United States Attorney for the Southern District of New York, Preet Bharara, (the “**U.S. Attorney**”) also held a press conference on October 16, 2009 to announce the first set of criminal charges against six individuals, including Mr. Rajaratnam, arising out of their involvement in the alleged insider trading scheme. In an accompanying press release, the U.S. Attorney noted that this is the first time in history that court-authorized wiretaps were used to target significant insider trading. In a statement, the U.S. Attorney alluded to the fact that wiretaps will continue to be utilized in pursuing insider trading activity, cautioning “Wall Street insiders who are considering breaking the law . . . to ask themselves one important question: Is law enforcement listening?”

While this case alleges knowingly illegal conduct, it nonetheless highlights the importance of treating material, non-public information carefully and avoiding situations in which trading might occur—even innocently—in circumstances when one or more persons in an organization may possess, or have access to, material, non-public information. Moreover, given the SEC’s increased focus on hedge fund insider trading, investment advisers to hedge funds should consider revisiting their firms’ compliance policies and procedures with respect to material, non-public information and insider trading—especially in regard to the use of company executives as sources of information.

- ▶ [See a copy of the SEC’s October 16, 2009 press release announcing the charges](#)
- ▶ [See a copy of Mr. Khuzami’s remarks](#)
- ▶ [See a copy of the SEC’s November 5, 2009 press release](#)
- ▶ [See a copy of the U.S. Attorney’s October 16, 2009 press release](#)
- ▶ [See a copy of the U.S. Attorney’s November 5, 2009 press release](#)
- ▶ [See a copy of the U.S. Attorney’s remarks](#)

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### SEC Appeals Mark Cuban Insider Trading Decision

On October 13, 2009, the SEC filed an appeal in its insider trading case against Dallas Mavericks owner Mark Cuban. As discussed in greater detail in the [August 5, 2009 Investment Management Regulatory Update](#) and the Davis Polk client newsflash, [SEC v. Cuban: A New Decision Casts Doubt on a Key SEC Position on Insider Trading](#), in July 2009, a federal district court in the Northern District of Texas dismissed the SEC’s complaint against Cuban. Notwithstanding the fact that the SEC alleged that Cuban traded the stock of a company, of which he was the largest shareholder, on the basis of material, nonpublic information that he received from the company while having orally promised to keep the information confidential, the court ruled that the SEC’s complaint was fatally defective. According to the court, Cuban’s oral agreement to maintain the confidentiality of the company’s information, without an agreement not to trade, was an insufficient basis upon which to ground insider trading liability.

- ▶ [See a copy of the SEC’s notice of appeal](#)

## Industry Update

### House Financial Services Committee Approves Private Fund Investment Advisers Registration Act

On October 27, 2009, the House Financial Services Committee approved the Private Fund Investment Advisers Registration Act, H.R. 3818, (the “**PFIARA**”) by a vote of 67-1. This bipartisan vote came after a full committee markup of the Discussion Draft of the Private Fund Investment Advisers Registration Act of 2009 (the “**Discussion Draft**”), which, as reported in the [October 9, 2009 Investment Management](#)

**Regulatory Update**, was introduced by Congressman Paul E. Kanjorski (D-PA) on October 1, 2009 and drew heavily upon the Treasury Department's earlier proposed legislation of the same name (the "**Treasury Proposal**," and together with the Discussion Draft, the "**Earlier Versions**").

Key provisions of the PFIARA include:

- *Registration requirement for private fund advisers.* The PFIARA would generally require all advisers to private funds to register with the SEC. It would accomplish this by eliminating the "private investment adviser" exemption, contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). Section 203(b)(3) allows investment advisers who, among other things, have had fewer than 15 clients over the preceding 12 months and who do not hold themselves out generally to the public as investment advisers, to avoid registering with the SEC.
- *Definition of "private fund."* The PFIARA defines the term "private fund" as any investment fund that would be an investment company pursuant to the Investment Company Act of 1940 but for the Section 3(c)(1) or 3(c)(7) exemptions thereunder. We note that, unlike the Earlier Versions' definition of the term, the PFIARA does not require that a fund be formed under U.S. laws or have 10% or more of its securities owned by U.S. persons to be deemed a "private fund." As discussed in greater detail below, certain books and records requirements and registration exemptions contained in the PFIARA are keyed-off of the "private fund" definition.
- *Registration exemption for certain private fund advisers.* The PFIARA calls for the exemption from registration with the SEC of any investment adviser to "private funds" so long as each "private fund" advised by the adviser has assets under management in the United States of less than \$150 million. Advisers claiming the exemption would, however, be required to keep such records and make such reports to the SEC "as the [SEC] determines necessary or appropriate in the public interest or for the protection of investors." This exemption is a significant departure from the Earlier Versions, which generally required an adviser to a "private fund" that managed \$30 million in aggregate total assets to register with the SEC. As currently drafted, the new exemption's assets-under-management threshold applies on a fund-by-fund basis, not on the aggregate amount of an adviser's assets under management across funds. Read literally, this exemption appears inconsistent with the spirit of the PFIARA, as it seems to allow an investment adviser to a "private fund" to avoid SEC registration despite having a very significant amount of total assets under management, provided that each "private fund" advised by it has, individually, less than \$150 million in assets in the United States. However, the benefit of the exemption to those advisers who take advantage of it will be tempered by the recordkeeping and reporting requirements to be established by the SEC.
- *Registration exemption for advisers to "venture capital funds."* Retaining an exemption introduced in the Discussion Draft, the PFIARA would exempt from SEC registration advisers to "venture capital funds," while continuing to leave the difficult and nuanced task of defining "venture capital funds" to the SEC.
- *"Foreign private fund adviser" registration exemption.* Under the PFIARA and the Earlier Versions, an investment adviser who (i) has no place of business 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. The PFIARA's exemption from registration with the SEC for a "foreign private fund adviser" is narrower than current SEC guidance, which 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.

- *Registration exemption for advisers to small business investment companies.* The PFIARA also provides a registration exemption for investment advisers that solely advise licensed small business investment companies regulated by the Small Business Investment Company Act of 1958.
- *Modifications to certain current registration exemptions.* The PFIARA eliminates two current registration exemptions for advisers to certain “private funds.” First, the exemption currently available to an adviser 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 is eliminated. Second, the PFIARA eliminates the registration exemption currently available to commodity trading advisors under Section 203(b)(6) of the Advisers Act for commodity trading advisors managing “private funds.”
- *Mid-sized private fund advisers.* With respect to advisers of an undefined class of “mid-sized private funds,” the PFIARA does not provide an exemption, but instead instructs the SEC to ensure that “registration and examination procedures with respect to the investment advisers of such funds . . . reflect the level of systemic risk posed by such funds.”
- *Books and records requirements.* The PFIARA would retain the Discussion Draft’s expansive books and records requirements, which are intended to provide the federal government with systemic risk data. For each “private fund” advised by a registered investment adviser, the PFIARA would require the adviser to maintain and file with the SEC records and reports detailing the fund’s: (i) assets under management; (ii) use of leverage (including off-balance sheet leverage); (iii) counterparty credit risk exposure; (iv) trading and investment positions; and (v) trading practices. The adviser would also be required to maintain and file any other information that the SEC and the Federal Reserve deem necessary or appropriate to protect the public interest and/or investors or for the assessment of systemic risk. The PFIARA makes 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 grant the SEC the rulemaking authority to require such additional information from an adviser to a “private fund” as the SEC determines necessary and to set different reporting requirements for different classes of advisers to “private funds,” based on the type and size of the funds advised.
- *Information sharing and disclosure.* The Discussion Draft provided an expansive list of entities with which the SEC may share systemic risk information and authorizes 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.” The PFIARA retains this expanded information-sharing authority and clarifies the extent to which such information will be kept confidential. The PFIARA, like the Earlier Versions, also allows the SEC to establish public disclosure requirements on registered investment advisers with respect to any “private fund” advised by that adviser. Neither the PFIARA nor the Earlier Versions provide details about the nature of any such disclosures.
- *SEC rulemaking authority.* Both the Earlier Versions and the PFIARA contain broad grants of authority to the SEC to craft appropriate rules to implement the intent of the legislation. They all, for example, explicitly permit the SEC to establish “different requirements for different classes of persons or matters” and to “ascribe different meanings to terms . . . used in different sections of [the Advisers Act].” The PFIARA introduces a new, very specific limitation on this broad authority, stating that the SEC “shall not ascribe a meaning to the term ‘client’ that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.” As explained during the markup, this language was introduced to prevent advisers from being subject to an irresolvable conflict of interest that might arise from managing a pooled investment vehicle with the interest of each individual investor in mind.

- The PFIARA retains amendments to Section 211 of the Advisers Act that would 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.” The SEC would also be authorized 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.
  - *Joint CFTC/SEC rulemaking.* The PFIARA requires the CFTC and the SEC to issue joint rules, after consultation with the Federal Reserve, regarding the collection of systemic risk data from the investment advisers registered under both the Advisers Act and the Commodity Exchange Act. While the Earlier Versions required that such joint rules be issued within six months of enactment, the PFIARA expands this period to 12 months.
  - *Required study.* The PFIARA also introduces several new sections not included in the Earlier Versions. The PFIARA introduces a requirement that the Comptroller General conduct a study to assess the annual costs on industry members and their investors due to the legislation’s registration and ongoing reporting requirements. Further, the PFIARA would require that the findings and determinations made in carrying out this study be presented to Congress, in the form of a report from the Comptroller General, within the two-year period beginning on the date of the PFIARA’s enactment.
  - *Transition period.* If enacted, the PFIARA will not take effect immediately. Instead, there would be a one-year transition period before its provisions would become effective. During this transition period, advisers who will be required to register would need to prepare themselves to operate as registered investment advisers by appointing a chief compliance officer and preparing and making effective the necessary compliance policies and procedures, among other things. Under the PFIARA, an investment adviser that would be required to register pursuant to the legislation would be permitted, at the adviser’s discretion, to register with the SEC during this transition period, and the SEC would be required to prescribe rules and regulations to enable such an optional registration.
  - *Adjustment for inflation to the “qualified client” determination.* Finally, the PFIARA introduces a new section requiring a periodic adjustment for inflation when the SEC grants exemptions under Section 205(e) of the Advisers Act. Section 205(e) allows the SEC to exempt persons or transactions from the prohibition on investment advisory contracts that provide the investment adviser with compensation on the basis of a share of capital gains upon, or capital appreciation of, the client’s funds. Such exemptions may be granted on the basis of certain factors, such as financial sophistication. The PFIARA requires that, where the SEC utilizes “a dollar amount test” in connection with such factors, this dollar amount must be adjusted for inflation no later than one year after enactment of the PFIARA and every five years thereafter. Accordingly, this provision would apply the inflation adjustment to the \$750,000 assets under management and \$1.5 million net worth tests for determining a client’s status as a “qualified client” under Rule 205-3 of the Advisers Act.
- ▶ [See a copy of the adopted amendments approved by the House Financial Services Committee](#)
  - ▶ [See a copy of the Discussion Draft](#)
  - ▶ [See a copy of the Treasury Proposal](#)

## House Financial Services Committee Approves Investor Protection Act

Following approval of the Private Fund Investment Advisers Registration Act (the “PFIARA”), the House Financial Services Committee approved the Investor Protection Act of 2009, H.R. 3817, (the “IPA”) by a party-line vote of 41-28. As with the PFIARA, the IPA modifies a discussion draft circulated by Rep. Paul E. Kanjorski in October 2009 (the “IPA Discussion Draft”). See the [October 9, 2009 Investment Management Regulatory Update](#) for more detail on the IPA Discussion Draft. Among other new provisions, the IPA modifies the IPA Discussion Draft’s proposed uniform standard for broker-dealers and investment advisers, requires the SEC to establish a limit on the value of client funds under the custody of an investment adviser and authorizes the SEC to provide the Financial Industry Regulatory Authority (“FINRA”) with enforcement and rulemaking authority under the Investment Advisers Act of 1940 (the “Advisers Act”) with respect to FINRA members or persons associated with its members. The IPA also modifies the assets-under-management threshold at which an investment adviser will be required to register with, and be subject to examination by, state regulators. Additionally, the IPA alters the test governing the extraterritorial reach of the antifraud provision of the Advisers Act to clarify that jurisdiction extends to violations committed by a foreign adviser involving foreign investors.

- ▶ See the Davis Polk client newsflash entitled [Investor Protection Act Passes House Financial Services Committee](#), which discusses the IPA in detail
- ▶ See a copy of the adopted amendments approved by the House Financial Services Committee
- ▶ See a copy of the IPA Discussion Draft

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## New Developments Regarding Pay-to-Play Arrangements

As previously reported in the [June 8, 2009](#), [July 1, 2009](#), [August 5, 2009](#) and [October 9, 2009 Investment Management Regulatory Updates](#), pay-to-play practices have been, and continue to be, the focus of much debate and increased regulation. Most recently, California enacted a law geared toward enhancing the regulation of placement agents and investment firms in relation to California’s public pension funds. Additionally, the California Public Employees’ Retirement System (“CalPERS”), the nation’s largest public pension fund, announced that it is in the process of conducting a “special review of the fees paid by its external managers to placement agents and their related activities.” Finally, in New York, State Attorney General Andrew M. Cuomo, along with several New York State Senators, announced proposed legislation that would, among other things, “institutionalize” 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.

We discuss each of these developments below.

### **California Assembly Bill No. 1584**

In mid-October 2009, California Governor Arnold Schwarzenegger signed into law California Assembly Bill No. 1584, crafted by Assembly member Ed Hernandez (the “Hernandez Bill”). Key provisions of the Hernandez Bill, which, according to its terms, took effect immediately upon the bill’s enactment, include the following:

- *Two-year postemployment restriction on receiving compensation.* The Hernandez Bill generally prohibits certain former high-ranking employees and board members of California’s public pension systems from subsequently being paid by any person to represent that person, in connection with influencing, amongst other things, any action involving the awarding of a contract or the purchase of goods or property, before the public pension system with which the former

employee or board member was associated. This prohibition lasts for a period of two years after such former employee or board member ceased to be associated with the public pension system.

- *Disclosure of payments requirements.* The board of each public pension system must establish, by June 30, 2010, policies mandating the disclosure of payments to placement agents in connection with pension and retirement system investments in or through external asset managers. A failure of an external asset management firm or a placement agent to make the required disclosures will result in the imposition of a penalty in the form of a bar on solicitation of new investments from the public retirement system for a period of five years, with the possibility of reduction. The Hernandez Bill also requires a placement agent, before acting as such with respect to a potential pension or retirement system investment, to disclose to the board of the pension or retirement system all gifts bestowed upon any member of the board, as well as any campaign contributions made by it to elected members of the board, during the prior 24-month period.
- *Conflicts of interest.* The Hernandez Bill prohibits board members of California's pension and retirement systems from directly or indirectly selling or providing investment products to California's retirement systems. The prohibition applies to board members in their personal capacity as well as in their capacity as an "agent or partner or employee of others."

### ***CalPERS Embarks on Special Review of Placement Agent Fees***

On October 14, 2009, CalPERS announced that it will begin a special review of placement agent fees paid by its external managers to placement agents. Subsequent to its adoption in May 2009 of a new placement agent policy (as discussed in greater detail in the [June 8, 2009 Investment Management Regulatory Update](#)), CalPERS requested information from the external managers of funds to which it had previously allocated capital. Responses to these requests led to the revelation that certain investment funds paid over \$50 million in fees to a placement agent, ARVCO Financial Ventures LLC, headed by a former CalPERS board member. According to CalPERS, this discovery prompted its decision to conduct the special review.

### ***New York State Attorney General Announces Proposed Pay-to-Play Legislation***

On October 8, 2009, New York State Attorney General, Andrew Cuomo, announced proposed legislation entitled "Taxpayers' Reform for Upholding Security and Transparency" ("TRUST"), which would codify Cuomo's Code of Conduct and provide for enhanced civil, criminal and administrative penalties for violations of its provisions.

Key provisions of TRUST include the following:

- *Creation of a board of trustees.* TRUST would replace the sole trustee of the New York State Common Retirement Fund with a board of trustees comprised of 13 members.
- *Ban on placement agents.* TRUST would prohibit investment firms from using placement agents in dealing with New York's public pension funds, although incidental assistance (e.g., marketing and due diligence) by consultants would not be prohibited.
- *Campaign contributions.* TRUST would generally prohibit investment firms from doing business with a public pension fund for two years after the firm makes a campaign contribution to a board member (or candidate for that position). A *de minimus* exception with respect to certain contributions in the amount of \$300.00 or less would apply.
- *Increased disclosure.* Among other disclosure provisions, TRUST would require investment firms to report any payments made to third parties in connection with public pension fund matters as

well as any apparent or actual conflicts of interest that it faces with respect to the public pension fund.

- *Conflicts of interest.* Pursuant to TRUST, an investment firm would be required to promptly cure any conflicts of interest or “terminate its relationship with the [public pension fund] as promptly and responsibly as legally possible.”
- *Enhanced penalties.* TRUST would provide for additional civil, criminal and disciplinary penalties and sanctions for violating its provisions.

We will continue to monitor developments with respect to pay-to-play investigations and regulations.

- ▶ [See a copy of the Hernandez Bill](#)
- ▶ [See a copy of the CalPERS press release](#)
- ▶ [See a copy of TRUST](#)
- ▶ [See a copy of the TRUST news release](#)

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## SEC No-Action Letter Allows for Greater Outsourcing of Recordkeeping by Investment Advisers

The SEC’s Division of Investment Management recently issued a no-action letter to Omgeo LLC, a joint venture between The Depository Trust & Clearing Corporation and certain subsidiaries of Thomson Reuters, (“**Omgeo**”) that would allow registered investment advisers to fulfill their recordkeeping requirements under the Investment Advisers Act of 1940 (the “**Advisers Act**”) with respect to trade confirmations by utilizing Omgeo’s proposed electronic recordkeeping service (the “**Recordkeeping Service**”). Omgeo sought the no-action letter on behalf of those registered investment adviser clients currently participating in Omgeo’s electronic trade confirmation services (“**Omgeo Clients**”) that will utilize the Recordkeeping Service (“**Participating Omgeo Clients**”).

Pursuant to Rule 204-2(a)(7) under the Advisers Act, all registered investment advisers are required to make and keep originals of all written communications received relating to the placing or execution of any order to purchase or sell any security. Such written communications include trade confirmations. Further, Rule 204-2(b)(3) under the Advisers Act requires registered investment advisers that maintain custody of client assets to make and keep copies of confirmations of all transactions effected by or for the account of any such client. For some time, the Division of Investment Management has provided no-action relief that permits Omgeo Clients to treat certain electronic trade confirmations as original communications for purposes of Rule 204-2(a)(7) and satisfying the requirement under Rule 204-2(b)(3) to make and keep copies of confirmations of all transactions effected by or for the account of a client. Currently, to comply with Rule 204-2(a)(7) or 204-2(b)(3), as applicable, Omgeo Clients that receive electronically transmitted trade confirmations must download or print a copy of each electronic confirmation and store the record consistent with the requirements for electronic storage specified in Rule 204-2(g) under the Advisers Act and for the retention period specified in Rule 204-2(e) under the Advisers Act.

Under the Recordkeeping Service, as described in Omgeo’s request letter, Participating Omgeo Clients would rely on Omgeo to maintain and preserve, on their behalf, copies of electronically transmitted trade confirmations provided through existing Omgeo services. Participating Omgeo Clients would continue to receive electronically transmitted trade confirmations but would not be required to download and print out copies of the confirmations. Instead, Omgeo would retain an electronic copy of the trade confirmation for five years and make that copy available to the Participating Omgeo Client or to the SEC staff promptly upon request. In this way, Participating Omgeo Clients would rely on Omgeo to assist them with compliance with Rule 204-2(g).

The Division of Investment Management's response notes that, based on the facts presented by Omgeo, it would not recommend enforcement action under Rules 204-2(a)(7), 204-2(b)(3) and 204-2(g) against Participating Omgeo Clients. In reaching this conclusion, the staff relied on representations by Omgeo with respect to the Recordkeeping Service, including a number of representations relating to easy access to, and availability of, all information to the SEC.

- ▶ [See a copy of the no-action letter and the incoming letter from Omgeo](#)

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### Bulldog Investors Loses Hedge-Fund Advertising Case

In September 2009, the Massachusetts Superior Court ruled against the investment fund group Bulldog Investors ("**Bulldog**") in Bulldog's suit on First Amendment grounds against William F. Galvin, the Massachusetts Secretary of the Commonwealth. As previously reported in the [April 14, 2008 Investment Management Regulatory Update](#), Galvin had instituted an enforcement action against Bulldog, on the basis that Bulldog had violated Massachusetts' securities laws by soliciting an unaccredited investor, and had fined Bulldog \$25,000. Bulldog then filed a motion for preliminary injunction in the Massachusetts Superior Court alleging that the enforcement action amounted to a violation of Bulldog's First Amendment rights. This motion was denied in December 2007. Nevertheless, Bulldog instituted another action in the Massachusetts Superior Court seeking an order to the effect that its First Amendment right to free speech had been violated. In finding that neither the securities laws in question nor the Commonwealth's enforcement action against Bulldog violated Bulldog's First Amendment rights, the court applied the test of commercial speech regulation from the leading case, *Central Hudson Gas & Elec. v. Public Service Comm'n* 447 U.S. 557 (1980). The court reasoned in part that the ban on general advertising of unregistered securities encourages disclosure via public filings, which in turn enhances security valuation as well as information accuracy and accessibility. The court thus found that the Massachusetts' securities regulation challenged by Bulldog advanced a material government interest and that the regulation constitutes a proportional means of securing that interest. The court further stated that the regulation in fact serves to expand speech and not to restrict it, "by ensuring that any public offer to sell securities is accompanied by full disclosure of all material information."

- ▶ [See a copy of the Superior Court Decision](#)

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### SEC Clarifies Interpretation of Sections 13(d) and 13(g) of the Exchange Act

The SEC's Division of Corporation Finance recently released Compliance and Disclosure Interpretations ("**Interpretations**") pertaining to Section 13(d) and 13(g) of the Securities Exchange Act of 1934 (the "**Exchange Act**"), Regulation 13D-G, promulgated thereunder, and related Schedules 13D and 13G. These Interpretations are presented in a question-and-answer format and serve to update the section of the July 1997 Manual of Publicly Available Telephone Interpretations entitled "Regulations 13D and 13G and Schedules Thereunder."

Section 13(d) of the Exchange Act and Regulation 13D-G thereunder require any person who beneficially acquires five percent or more of a voting equity security registered under Section 12 of the Exchange Act to publicly disclose certain information about its ownership. The rules create a two-part disclosure regime depending on the acquirer's ownership percentage and whether it has an intent to change or influence "control" of the issuer. Investors holding voting equity securities with the purpose or effect of changing or influencing the control of the issuer, and most non-U.S. investors holding more than 20 percent of a class of such securities, must report on Schedule 13D. Investors who can certify that their holding does not have a control purpose or effect may report on Schedule 13G, which is significantly less burdensome than Schedule 13D.

Certain notable Interpretations are summarized below.

- Inadvertent breaches of the five percent beneficial ownership threshold trigger a 13D or 13G reporting obligation. If, for example, a customer instructs a broker to procure less than five percent of the outstanding class of registered voting equity securities of a company and such broker accidentally purchases more than five percent, the customer will still be required to file a Schedule 13D or 13G. According to the SEC, an absence of intent to acquire more than five percent beneficial ownership is not a factor when considering reporting obligations under Sections 13(d) and 13(g).
  - The 10-day filing window that begins after a securities holder crosses the five percent beneficial ownership threshold commences on the trade date, not the settlement date.
  - A Schedule 13D filer that later develops a passive investment intent cannot switch to a Schedule 13G filing unless the filer was initially eligible to report on Schedule 13G.
  - If a holder of more than five percent of a class of voting equity securities delegates its authority to both vote and dispose of such securities to an investment adviser, the holder will still be required to report its beneficial ownership of the securities so long as it may rescind the authority vested in the adviser and regain voting or investment power over the securities within 60 days.
- ▶ [See a copy of the Interpretations](#)

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### SEC and CFTC Release Joint Report on Harmonization of Regulation

As reported in the October 20, 2009 Davis Polk Client Newsflash [SEC and CFTC Release Joint Report on Harmonization of Regulation](#), the SEC and the CFTC have released a joint report reviewing the key elements of their regulatory schemes and providing recommendations for regulatory harmonization (the “**Joint Report**”). The Joint Report, issued in response to a request in Treasury’s White Paper on Financial Regulatory Reform (the “**White Paper**”), contains recommendations to strengthen the agencies’ oversight and enforcement, enhance market efficiency and investor protection and improve inter-agency coordination and cooperation. Recommendations included in the Joint Report include suggestions for additional actions by the two agencies as well as several requests to Congress for the enactment of additional legislation. The Joint Report also explores certain areas without providing recommendations, suggesting either disagreements between the two agencies or a belief that differences in the regulatory schemes are warranted by the differences between securities and futures.

- ▶ [See a copy of the joint report](#)

## SEC Rules and Regulations

### SEC Removes References to NRSRO Ratings from Certain Investment Company Act Rules and Reopens Comment Period Regarding Additional NRSRO References in Investment Company Act and Investment Advisers Act Rules

On October 5, 2009, the SEC issued a release (the “**Adopting Release**”) adopting certain amendments proposed last year to remove references to ratings of Nationally Recognized Statistical Rating Organizations (“**NRSRO**”) from its rules, including rules under the Investment Company Act of 1940 (the “**Investment Company Act**”). In a companion release (the “**Companion Release**”), the SEC reopened the comment period on other amendments proposed last year to remove such references from the

Investment Company Act and the Investment Advisers Act of 1940 (the “**Advisers Act**”), among other statutes.<sup>1</sup>

Specifically, the SEC adopted amendments to Rules 5b-3 and 10f-3 under the Investment Company Act and reopened the comment period on additional amendments to Rule 5b-3 and Rule 3a-7 under the Investment Company Act and Rule 206(3)-3T under the Advisers Act. Generally, these rules allow investment companies, or advisers, as applicable, to rely on the ratings of securities provided by NRSROs as a proxy for such securities’ creditworthiness and liquidity.

The approved amendments, described in the Adopting Release, eliminate the availability of exemptions from certain requirements based upon a relevant security or instrument’s sufficiently high rating from one or more NRSROs. In so doing, the amendments require that the relevant security or instrument be assessed by an independent certified public accountant, in the case of Rule 5b-3, or by the registered fund’s board of directors, in the case of Rule 10f-3. According to the Adopting Release, the SEC believes that the adopted amendments will “reduce reliance on credit ratings . . . consistent with the protection of investors.”

In the Companion Release, the SEC is seeking additional public comment on other previously proposed amendments that would remove references to ratings from NRSROs from certain rules and forms under the Advisers Act and the Investment Company Act, among other statutes. Except with respect to Rule 3a-7, the previously proposed amendments substitute alternative requirements—generally a subjective determination about a relevant security or instrument’s creditworthiness or liquidity—designed to achieve the same purpose as the rating currently being referenced. In contrast, the amendments to Rule 3a-7 would entirely eliminate an exemption that currently allows issuers of certain structured finance vehicles to make sales of these securities to the general public without being deemed an “investment company” under the Investment Company Act, provided the securities are highly rated by at least one NRSRO.

Although additional comments are being sought and must be received by the SEC on or before December 8, 2009, the Companion Release notes that in several areas the SEC is considering taking additional, broader action that may affect those rules that are discussed in the Companion Release.

- ▶ [See a copy of the SEC’s summary of rules and forms affected by the SEC’s rulemaking actions](#)
- ▶ [See a copy of the SEC release adopting amendments to rules under the Investment Company Act](#)
- ▶ [See a copy of the SEC release reopening the comment period for proposed amendments to rules under the Advisers Act and the Investment Company Act](#)

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<sup>1</sup> The Adopting Release and the Companion Release are part of a series of releases issued on October 5, 2009 and October 7, 2009 by the SEC with respect to NRSROs. This series of releases corresponds to actions taken by the SEC’s Commissioners at an open meeting held on September 17, 2009 and contains additional rulemaking actions not discussed here. The rule release corresponding with additional action taken at the September 17, 2009 open meeting has not yet been issued.

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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

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