

Investment Management Regulatory Update

Industry Update

- Senate Passes Restoring American Financial Stability Act
- Recent Developments Regarding the EU Directive on Alternative Investment Fund Managers
- California Attorney General Charges ex-CalPERS Executives in Pay-to-Play Scheme
- SEC's Donohue Discusses Current Initiatives of the Division of Investment Management

Litigation

- CFTC Settles Price Manipulation Charges Against Hedge Fund Moore Capital Management, LP
- State of New York Charges Investment Adviser with Misleading Clients Regarding Madoff Investments
- Court Rules That Principal of Sham Hedge Fund, Whose Only "Compensation" Consisted of Misappropriated Investor Funds, Is Appropriately Deemed an Investment Adviser
- SEC Charges Registered Investment Adviser in Connection with Fraudulent Valuation Practices

Industry Update

Senate Passes Restoring American Financial Stability Act

On May 20, 2010, the Senate passed the Restoring American Financial Stability Act (the "**Senate bill**"). The Senate's legislative efforts follow those in the House, which on December 11, 2009, passed the Wall Street Reform and Consumer Protection Act of 2009 (the "**House bill**"). The House bill was described in the [January 7, 2010 Investment Management Regulatory Update](#) and in the Davis Polk Client Memorandum [Summary of the Wall Street Reform and Consumer Protection Act Passed by the House of Representatives, December 11, 2009](#). For a summary of the entirety of the Senate bill and a side-by-side comparison of the Senate bill with the House bill, please see the Davis Polk Client Memoranda [Summary of the Restoring American Financial Stability Act, Passed by the Senate on May 20, 2010](#) and [Side-by-Side Comparison Chart – Key Senate and House Bill Issues](#).

The Senate and the House are expected to reconcile the differences between the two bills through a conference process that is to begin this week. Reports indicate that Congress aims to produce a final bill for President Barack Obama's signature prior to the Fourth of July weekend.

The following update briefly summarizes certain portions of the Senate bill.

Regulation of Advisers to Hedge Funds and Others

- *Elimination of "private investment adviser" exemption.* The Senate bill, like the House bill, requires many investment advisers to private funds to register with the SEC by, among other things, eliminating the "private investment adviser" exemption contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). Currently, this exemption from registration is available to 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.

- *Definition of “private funds.”* The Senate bill defines the term “private fund” to be any fund that would be an investment company but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the “**Investment Company Act**”). This definition is identical to that adopted in the House bill.
- *Significant registration exemptions.* The Senate bill sets forth registration exemptions for advisers to venture capital funds and private equity funds. The inclusion of the private equity fund adviser exemption maintains one of many key differences between the Senate bill and the House bill, which does not provide an exemption for advisers to private equity funds. The bills leave to the SEC the difficult task of defining the terms “venture capital fund” and “private equity fund.”
- *Family offices.* The Senate bill carves-out family offices from the definition of the term “investment adviser,” placing such entities outside the purview of the Advisers Act, and requires the SEC to define the term “family offices,” for purposes of the carve-out, in a manner consistent with its prior exemptive orders pertaining to such entities.
- *Recordkeeping and reporting.* The Senate bill includes recordkeeping and reporting provisions that remain broadly similar to the House bill. Both would impose extensive recordkeeping and reporting obligations on registered investment advisers with respect to any private funds that they manage.
- *Disclosure of client identity.* The Senate bill modifies the current Advisers Act prohibition limiting the SEC’s ability to require investment advisers to disclose the identity, investments or affairs of their clients by adding an exception enabling the SEC to require the disclosure of such information insofar as such disclosure is sought “for purposes of assessment of potential systemic risk.” The House bill, however, removes this prohibition altogether.
- *Proprietary information.* The Senate bill provides enhanced protections to proprietary information provided to the government. For example, proprietary information is excised from FOIA’s coverage. The Senate bill’s definition of the term “proprietary information” is identical to that found in the House bill; both cover, among other things, non-public information about an adviser’s trading strategies, computer hardware or software containing intellectual property, and trading data. However, it is unclear how these protections will apply if the “proprietary information” is requested by the Office of Financial Research. The Senate bill expressly subjects any data submitted to the Office of Financial Research to FOIA, and requires data other than “confidential data” (an undefined term) to be published.
- *Custody of client assets.* The Senate bill allows the SEC to promulgate rules to require registered investment advisers to take steps to safeguard client assets over which the adviser has custody. This differs from the House bill, under which the SEC would generally be required to adopt a rule requiring investment advisers to use a qualified custodian to custody any client accounts with more than \$10 million worth of client funds or securities. The extent to which the legislation will require additional changes to the SEC’s custody rules, which were amended subsequent to the passage of the House bill, is unclear. See the [January 7, 2010 Investment Management Regulatory Update](#) for a discussion of the recent amendments to the custody rules.
- *“Public” disclosure.* The Senate bill (unlike the House bill) does not grant the SEC the authority to issue rules requiring registered investment advisers to provide reports, records and other documents containing non-proprietary information to investors, prospective investors, counterparties and creditors of any private fund advised by that adviser.

The Volcker Rule

The “Volcker Rule” in the Senate bill generally prohibits insured depository institutions, bank holding companies and any company treated as a bank holding company for purposes of the Bank Holding Company Act, as well as their subsidiaries, from engaging in proprietary trading and investing in or

sponsoring hedge funds or private equity funds. While there is no Volcker Rule in the House bill, there are strong indications that the Volcker Rule will be present in some form in the final bill.

This overview focuses on the aspects of the Volcker Rule that affect sponsoring or investing in such private funds. For a summary of the Volcker Rule's limits on proprietary trading, see the Davis Polk Client Memorandum [*Summary of the Restoring American Financial Stability Act, Passed by the Senate on May 20, 2010.*](#)

- *Generally.* The Volcker Rule, as it appears in the Senate bill, would prohibit Covered Entities (as defined below) from sponsoring or investing in hedge funds or private equity funds, which are generally defined as entities that are exempt from registration as an investment company pursuant to Section 3(c)(1) or 3(c)(7) of the Investment Company Act or a similar fund as determined by regulators.
- *Covered Entities.* The Volcker Rule's prohibition with respect to sponsoring or investing in a hedge fund or private equity fund would apply to insured depository institutions, any company that controls an insured depository institution, any company that is "treated as a bank holding company" for purposes of the Bank Holding Company Act, or any subsidiary of such an institution or company (together, "**Covered Entities**").
- *Prohibition on "sponsoring" a fund.* Covered Entities would be prohibited from, among other things, serving as a general partner, managing member or trustee of a fund; selecting or controlling a majority of the directors, trustees or management of a fund; or sharing any variation of the same name with a fund.
- *Ability to advise a fund.* Covered Entities may provide investment advisory services to hedge funds and private equity funds.
- *Foreign exemption.* Foreign institutions and their foreign affiliates may invest in or sponsor private equity funds or hedge funds so long as the investment or activity is conducted solely outside the United States.
- *Other exemptions.* The Volcker Rule provides two narrow exceptions to the prohibition on sponsoring or investing in hedge funds and private equity funds. Sponsoring or investing in small business investment companies and certain "public welfare" investments are not prohibited.
- *Limitations on transactions and relationships.* The Volcker Rule bans covered transactions as defined in Section 23A of the Federal Reserve Act (including credit transactions, asset purchases or guarantees) between a Covered Entity that serves as an investment adviser to a hedge fund or private equity fund, and any such hedge fund or private equity fund.
- *Systemically important nonbank financial companies.* Under the Volcker Rule, any systemically important nonbank financial company that sponsors or invests in hedge funds or private equity funds (other than pursuant to certain narrow exceptions) will be subject to additional capital requirements and additional quantitative limits to be adopted by the Federal Reserve.
- *Rulemaking.* Within a maximum of fifteen months of enactment, regulators must implement the Volcker Rule via notice-and-comment rulemaking, taking into account any recommendations of the Financial Stability Oversight Council resulting from the Council's study on the impact of the Volcker Rule.
- *Transition.* Two years after the issuance of final regulations, Covered Entities may not retain any investment or relationship prohibited under such regulations, subject to a total of three 1-year extensions by application to regulators.

Investor Protections

The Senate bill would also introduce additional changes with respect to the regulation of broker-dealers and investment advisers.

Certain particularly significant changes are discussed below.

- *Fiduciary duty study.* The Senate bill requires the SEC to study the effectiveness of existing standards of care for broker-dealers and investment advisers for providing personalized investment advice and recommendations about securities to retail customers. If the study concludes that gaps or overlaps exist, the SEC is required to promulgate rules within two years of the enactment of the Senate bill. Notably, this provision represents a sharp break with the House bill, which requires the SEC to impose a fiduciary duty on broker-dealers providing investment advice about securities to retail customers.
- *Short sales.* The Senate bill does not contain the House bill's requirement that institutional investment managers provide the SEC with daily reports regarding short sales.
- *Mandatory arbitration.* The Senate bill authorizes the SEC to conduct rulemaking to reaffirm or prohibit the use of mandatory arbitration agreements between broker-dealers and their clients and investment advisers and their clients. The corresponding provision in the House bill only authorizes the SEC to promulgate rules limiting or prohibiting mandatory arbitration.

We will continue to monitor legislative developments in this area.

- ▶ [See a copy of the Senate bill](#)
- ▶ [See a copy of the House bill](#)

Recent Developments Regarding the EU Directive on Alternative Investment Fund Managers

Recently, both the Economic and Monetary Affairs Committee of the European Parliament (the "**Parliament**") and the Economic and Financial Affairs Council (the "**Council**") of the European Union ("**EU**") released separate draft proposals embodying their positions on the controversial Directive on Alternative Investment Fund Managers (the "**Directive**") set forth by the European Commission (the "**Commission**"). See the [May 8, 2009 Investment Management Regulatory Update](#) for an overview of the Directive. These two draft proposals, along with the European Commission's draft, must now be reconciled in a process known as "trilogues," that reportedly may result in final legislation by July 2010.

This article focuses on how the Directive (as modified by either the Council draft or the Parliament draft) would regulate the marketing of alternative investment funds by U.S. and other non-EU alternative investment fund managers (collectively, "**Non-EU Managers**") to investors in the EU. In both drafts, the regulations focus on the location of the manager and not on the location of the fund for this purpose.

Council Draft

Under the Council draft, a Non-EU Manager may market alternative investment funds pursuant to each individual member state's regulatory regime; provided that the Non-EU Manager complies with certain disclosure requirements of the Directive (as modified by the Council draft), including, but not limited to, those pertaining to leverage, remuneration and portfolio companies.

If a Non-EU Manager uses leverage on a "systematic basis" (as defined by the Commission), the Non-EU Manager must disclose to regulators in each EU member state certain details regarding the leverage position of each of its alternative investment funds, including any leverage embedded in financial derivatives and the five largest sources of borrowed cash or securities for each fund.

In addition, under the Council draft, a Non-EU Manager must prepare an annual report, which will be made available to investors and the relevant regulators of the EU member states, for all of the alternative investment funds it manages, which sets forth (i) the total remuneration paid by the Non-EU Manager, (ii) the number of beneficiaries and (iii) the aggregate amount of remuneration broken down by members of staff who had a material impact on the risk profile of each fund.

Also, a Non-EU Manager must disclose to the investors of each alternative investment fund it manages, among other things, the fund's investment strategy and associated risks, its valuation procedures and methodology, all fees and expenses directly or indirectly borne by the investors and any preferential treatment afforded to an investor.

Finally, pursuant to the Council draft, a Non-EU Manager that manages any fund which acquires a "controlling influence" (i.e., 50% or more) of an unlisted company must disclose to the target company, among other things, the manager's identity and conflicts of interest policy.

Parliament Draft

Under the Parliament draft, Non-EU Managers can market funds in EU member states only if they comply with **all** of the provisions of the Directive (as modified by the Parliament draft). Notwithstanding the fact that such Non-EU Managers would be subject to the same regulatory framework as EU alternative investment fund managers ("**EU Managers**"), unlike EU Managers, they would not be able to market alternative investment funds on a "passport" basis throughout the EU.

The Parliament draft also includes disclosure requirements with regard to leverage, remuneration and portfolio companies that are generally more onerous than the Council provisions. In addition, the Parliament draft subjects Non-EU Managers seeking to market alternative investment funds in the EU to additional requirements, such as requiring an annual independent valuation of the assets in the funds.

The Parliament draft requires a Non-EU Manager seeking to market alternative investment funds in the EU to obtain the agreement of regulators in its domicile (e.g., the SEC for a U.S. alternative investment fund manager) to supervise such Non-EU Manager's compliance with the Directive. Whether a non-EU regulator would be willing to agree to monitor and ensure compliance with the laws of a foreign jurisdiction is unclear (and seems unlikely) and could pose a considerable practical difficulty for Non-EU Managers seeking to market alternative investment funds in the EU.

Finally, pursuant to the Parliament draft, the domicile of the Non-EU Manager (and the domicile of the alternative investment fund being marketed, if different from that of the Non-EU Manager) must, among other things, enter into a cooperation and tax transparency agreement with the regulator of the EU member state in which the alternative investment fund is being marketed.

- ▶ [See a copy of the Directive](#)
- ▶ [See a copy of the Parliament draft](#)
- ▶ [See a copy of the Council draft](#)

California Attorney General Charges ex-CalPERS Executives in Pay-to-Play Scheme

On May 5, 2010, the California Attorney General's Office announced that it charged Alfred Villalobos, a former California Public Employees' Retirement System ("**CalPERS**") board member, his company, ARVCO Capital ("**ARVCO**"), and Federico Buenrostro, the former CEO of CalPERS, with engaging in "fraudulent and unlicensed securities broker-dealer activities" in violation of California's securities laws.

According to the California Attorney General's press release and its complaint, after leaving CalPERS, Villalobos cultivated relationships with, and lavishly entertained, key CalPERS executives and members of its board of directors, resulting in the CalPERS board approving investments in securities from which

Villalobos's company, which operated without a broker-dealer license, reaped over \$40 million in commissions. The complaint also alleges that ARVCO failed to disclose certain key facts to the full board, including, among others, the following: that ARVCO was a party to placement agent agreements with various investment firms, which agreements were entered into for the purpose of assisting in sales of securities to CalPERS; the amount of commissions that ARVCO received by virtue of these placement agent agreements; gifts and gratuities given to CalPERS decision-makers; and that Buenrostro had a standing job offer from ARVCO, which he accepted while still with CalPERS. According to the California Attorney General's complaint, ARVCO's activities were further concealed with the help of Buenrostro, who signed disclosure forms purportedly acknowledging that ARVCO's placement agent agreements and commissions associated therewith were disclosed to CalPERS.

The California Attorney General is seeking recovery of the more than \$40 million in commissions collected by Villalobos and ARVCO, the imposition of civil penalties and a permanent order preventing Villalobos and ARVCO from violating state securities laws.

- ▶ [See a copy of the press release](#)
- ▶ [See a copy of the complaint](#)

SEC's Donohue Discusses Current Initiatives of the Division of Investment Management

In a recent speech at the Massachusetts Society of CPAs' Investment Company InfoShare Program, Andrew J. Donohue, director of the SEC's Division of Investment Management (the "**Division**"), discussed some of the Division's current regulatory initiatives.

Money Market Funds

Donohue emphasized the crucial role that money market funds play in the U.S. economy. He asserted that the SEC's regulation of the industry seeks to strike a balance between safety and funds' ability to generate attractive yields for their investors, and he addressed the SEC's January adoption of new rules pertaining to money market funds. These rules, according to Donohue, "represented strong action by the SEC to make money market funds a more transparent and safe investment." Included among the rules are requirements that money market funds make monthly portfolio updates available on their websites and file more detailed monthly portfolio reports with the SEC that will later be disclosed to the public. He explained that the new rules also establish maturity and liquidity standards, helping to ensure that money market funds will be less exposed to market risks and that investors will be able to redeem their investments in such funds upon request.

Nevertheless, Donohue expressed his belief that "[the new rules] were only a first step in a continuing effort to improve the regulation of money market funds." According to Donohue, additional regulations pertaining to money market funds are likely, and the SEC will continue policy discussions about the ability of such funds to sustain themselves in times of deep financial distress.

Advisers Act Custody Rule

Donohue also briefly discussed recent changes made to the rules governing investment advisers' custody of client assets, changes intended to protect investors from investment advisers misappropriating and misusing their assets. Donohue encouraged registered investment advisers to adapt their compliance programs to protect client assets and urged auditors to "be vigilant" in looking for fraudulent use of client assets.

Sophisticated Products

Donohue reiterated his longstanding concern regarding investment companies' use of derivatives. According to Donohue, investment companies' shift over the past two decades to investment strategies

involving participating in a wide range of derivative transactions presents many different types of risks and challenges, including “market, liquidity, leverage, counterparty, legal and structure risks” and the need to clearly and effectively relate these risks to shareholders through enhanced financial reporting and disclosure.

With respect to funds’ financial statement reporting of derivatives, Donohue noted that recent changes made by the Financial Accounting Standards Board (“**FASB**”) require funds to disclose how and why they utilized derivatives during the financial reporting period. Donohue urged funds “to approach this disclosure thoughtfully with a mind towards informing shareholders as to how derivatives were actually used during the period to meet the objectives of the fund.”

Private Investments

Noting that many mutual funds invest in non-registered investment vehicles, such as private equity funds, Donohue expressed concern with respect to related disclosure and transparency issues. Non-registered investment vehicles generally do not provide the same level of transparency to their investors as do mutual funds, remarked Donohue; therefore, a mutual fund that chooses to invest in such vehicles should take care to procure “any additional material information [that] may be necessary so that its prospectus and shareholder reports are not misleading.”

Regulation S-X

Donohue also mentioned that he has asked Division staff to compare the SEC’s accounting and reporting rules to those of generally accepted accounting principles. Observing that the last time that the SEC made significant changes to its financial reporting rules was in 1982, he indicated that its rules may be in need of change, especially considering the considerable evolution of investment companies since that time.

IFRS and Investment Companies

Donohue concluded by discussing the SEC’s continuing goal of harmonizing U.S. accounting standards established by FASB with the International Financial Reporting Standards (“**IFRS**”) established by the International Accounting Standards Board (“**IASB**”). He asserted that the benefits of achieving this goal include an increased ability to compare companies on a global basis, simplified accounting for companies whose operations span the globe and “easier access to foreign capital and improved liquidity, leading to a reduced cost of capital.”

Donohue noted that while operating companies generally are inclined to support this goal, investment companies generally are not, arguing that IFRS standards are not directly addressed to the investment company industry and could, therefore, imprecisely portray “the nature of a fund’s investment activity.” Donohue challenged the industry to reexamine IFRS and noted that several recent FASB pronouncements that affect investment companies have been consistent with IFRS.

In closing, Donohue urged managers of investment companies to provide feedback to the SEC and the Division on the issue of whether IFRS’ standards are sufficient for investment companies.

- ▶ [See a copy of Donohue’s remarks](#)

Litigation

CFTC Settles Price Manipulation Charges Against Hedge Fund Moore Capital Management, LP

Recently, the U.S. Commodity Futures Trading Commission (the “**CFTC**”) settled charges it brought against hedge fund Moore Capital Management, LP and certain of its affiliates (collectively, “**Moore Capital**”) for allegedly attempting to manipulate the price of certain futures contracts.

According to the CFTC’s order, from November 2007 through May 2008, a former Moore Capital portfolio manager frequently used a practice called “banging the close,” whereby the portfolio manager placed buy orders in the last seconds before the market closed in an attempt to push the settlement prices of platinum and palladium futures artificially upward. The CFTC also found that Moore Capital failed to properly supervise the portfolio manager’s trading and failed to have adequate policies and procedures in place to detect violations of the Commodity Exchange Act. The CFTC order also noted that Moore Capital’s policy requiring reporting of violations to compliance was deficient in that it lacked adequate guidance or means to ensure such reporting. As an example supporting its finding, the order mentions a Moore Capital execution clerk who, as a result of feeling intimidated by the particular portfolio manager, failed to report his concerns to compliance.

Moore Capital was ordered to pay a civil penalty of \$25 million and agreed to the imposition of several additional settlement conditions which primarily relate to the enhancement of Moore Capital’s compliance procedures. Additionally, until two years from the date of the order, Moore Capital has agreed not to trade platinum or palladium futures and options during the last fifteen minutes of the trading period each day.

- ▶ [See a copy of the CFTC’s press release](#)
- ▶ [See a copy of the CFTC’s order](#)

State of New York Charges Investment Adviser with Misleading Clients Regarding Madoff Investments

On May 11, 2010, New York State Attorney General Andrew M. Cuomo filed a lawsuit in state court against Ivy Asset Management, LLC (“**Ivy**”), a registered investment adviser and a subsidiary of BNY Mellon, and its former executives Lawrence Simon and Howard Wohl (collectively, the “**Defendants**”). The complaint charges the Defendants with, among other things, “committ[ing] egregious breaches of fiduciary duty” and violating New York State’s Martin Act due to their failure to disclose to their clients, or otherwise misleading clients with respect to, material facts and their concerns regarding investing with Bernard L. Madoff.

Ivy’s business includes managing funds of funds, and assets of high net worth individuals, as well as providing other investment advisory services. Simon served as president and chief executive officer of Ivy from 1984 to 2005 and vice chairman from 2006 to 2008. Wohl co-founded Ivy and served as its vice president and chief investment officer from 1984 to 2005 and vice chairman from 2006 to 2008.

According to the complaint, by the late 1990s, the Defendants developed grave concerns regarding Madoff, with whom they had been investing since 1987, as evidenced by, among other things, an e-mail wherein Wohl wrote “[investing with Madoff] remains a matter of faith . . . [and] doesn’t justify any investment.” Nevertheless, the Defendants continued to invest many of their clients’ funds with Madoff for years, allegedly concealing material facts from these clients and affirmatively misleading them as to what the Defendants knew about Madoff. Indeed, according to the complaint, the Defendants went so far as to invest their own money with Madoff in certain of their fund-of-funds in order to foster the false impression

that the Defendants had confidence in Madoff. Additionally, certain other of the Defendants' advisory clients allegedly were told not to invest with Madoff.

The complaint sets forth several facts regarding Madoff's operation purportedly known by the Defendants but concealed from, or misrepresented to, certain of their clients, including the following:

- Madoff was not making the trades he claimed to make. First, the trading volume of certain options was insufficient to support the level of trading in these options that Madoff claimed to engage in on behalf of his clients. Second, the confirms sent by Madoff to the Defendants reflected prices paid for securities well below those reported by Bloomberg. On this latter point, the complaint cites an internal memorandum prepared by the Defendants wherein Ivy's chief of investment management stated, "[t]his is a clear example of our inability to make sense of Madoff's strategy, and one where his trades for our accounts are inconsistent with the independent information that is available to us."
- Madoff misappropriated client funds to make subordinated loans to his market-making business and lied about there being no relationship between his money management operation and his market-making business.
- Madoff reported fictional returns, as evidenced by the fact that a Madoff investor with a portfolio ostensibly dissimilar to most of Madoff's other clients consistently received nearly identical returns to Madoff's other clients.

The complaint alleges that, as a result of the Defendants' fraud, investors, including dozens of New York union pension and welfare plans, lost more than \$227 million in the aftermath of the revelation of Madoff's Ponzi scheme. Meanwhile, according to the complaint, Ivy made more than \$40 million in fees, and Simon and Wohl built the reputation of their practice, allowing them to each receive \$100 million upon selling Ivy to The Bank of New York.

Cuomo's complaint demands, among other things, that the Defendants pay all restitution, disgorgement and damages caused by their allegedly fraudulent acts, punitive damages and plaintiff's costs.

- ▶ [See a copy of the complaint](#)

Court Rules That Principal of Sham Hedge Fund, Whose Only "Compensation" Consisted of Misappropriated Investor Funds, Is Appropriately Deemed an Investment Adviser

In a recent decision, the U.S. Court of Appeals for the Eleventh Circuit affirmed the sentence imposed on Manyu Ogale, the principal of a sham hedge fund, Den Haag Capital, LLC, finding that Ogale qualified as an investment adviser and that, therefore, the lower court was correct in applying the investment adviser enhancement called for by federal sentencing guidelines in connection with Ogale's conviction for wire fraud. *United States v. Ogale*, No. 09-11780, 2010 U.S. App. Lexis 9636 (11th Cir. 2010) (per curiam).

The Investment Advisers Act of 1940 (the "**Advisers Act**") defines an investment adviser as "any person who, *for compensation*, engages in the business of advising others, either directly or indirectly or through publications or writings as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities," subject to certain exceptions. The federal sentencing guidelines look to this definition for purposes of the investment adviser sentencing enhancement.

Ogale argued that he should not be considered an investment adviser and, therefore, should not receive the investment adviser sentencing enhancement. Among other contentions, Ogale asserted that he could not be considered an investment adviser because he received no compensation from investors. Indeed, noted Ogale, the only money that he received was investors' initial investments in his fund, the entirety of

which it appears he misappropriated for personal use. “[I]l-gotten gains are not compensation,” argued Ogale.

The court was not persuaded. Noting that “the receipt of any economic benefit qualifies as compensation under the [Advisers Act],” the court concluded that Ogale’s use of investor funds to pay his own personal expenses constituted an economic benefit to him and, thus, qualified as compensation for Advisers Act purposes.

SEC Charges Registered Investment Adviser in Connection with Fraudulent Valuation Practices

Recently, the SEC charged Morgan Asset Management, Inc. (“**Morgan Asset Management**”), its broker-dealer affiliate, Morgan Keegan & Company, Inc. (“**Morgan Keegan**”) and several of these entities’ associated persons, including a Morgan Asset Management portfolio manager, James C. Kelsoe, Jr., with engaging in fraudulent valuation practices with respect to several registered funds (the “**Funds**”) managed by Morgan Asset Management.

The Funds’ boards of directors were responsible for pricing the Funds’ securities according to the Funds’ valuation policies and procedures. Each Fund’s board of directors delegated this responsibility by contract to Morgan Keegan. Morgan Keegan, along with Joseph Thompson Weller, its controller and head of its fund accounting department, managed a “Valuation Committee” whose role was to oversee the Funds’ accounting procedures and evaluate the Funds’ security prices.

Included in the Funds’ valuation policies and procedures was a requirement to obtain dealer quotes to validate the prices assigned to securities. Dealer prices could only be overridden when there was “a reasonable basis to believe that the price provided [did] not accurately reflect the fair value of the portfolio security.” Upon the overriding of a dealer’s price, a portfolio manager was required to provide documentation substantiating such a determination to the Valuation Committee for their review.

According to the SEC’s allegations, Morgan Keegan and Weller failed to fulfill their responsibilities “to price the Funds’ securities in accordance with their valuation policies and procedures.” Adequate oversight was lacking due to Morgan Keegan (i) leaving pricing decisions to lower-level employees, (ii) not requesting a basis for or documentation supporting Kelsoe’s price adjustments and (iii) giving Kelsoe excessive discretion in determining which dealer quotes to use and which to ignore.

In his position as the Funds’ portfolio manager, Kelsoe was given authority to re-price quotes from broker-dealers in “good faith.” However, contrary to the valuation policies, Kelsoe allegedly did not provide any substantiation with regard to his price adjustments, and fund accounting did not document which securities were subject to such adjustments. In fact, according to the SEC, Kelsoe was screening and manipulating the dealer quotes he received and did not relay to fund accounting price quotes that would have required the securities’ prices to be reduced. Without the proper oversight from Morgan Keegan, the SEC charged, Kelsoe ultimately was able to artificially inflate the net asset value of each Fund.

As a result of the conduct described above, among other securities law violations, Morgan Asset Management and Kelsoe are charged with violations of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)(7) promulgated thereunder, which prohibit fraudulent or deceptive practices by an investment adviser and require investment advisers to adopt policies to prevent such violations. In addition, Morgan Asset Management, Morgan Keegan, Kelsoe and Weller were charged with willfully aiding and abetting and causing violations of Rule 38a-1 promulgated under the Investment Company Act of 1940 which requires a registered investment company to adopt written policies and procedures reasonably designed to prevent federal securities law violations.

- ▶ [See a copy of the charges](#)

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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