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Breaking News on Enforcement

Side Pocket Arrangements, Valuation Under SEC Investigation

According to a recent news report, the specialized asset management unit of the SEC's Division of Enforcement is investigating potential abuses of side pockets by hedge funds during the financial crisis, a period that saw many fund managers increasingly opt to utilize such arrangements. Reportedly, the Division of Enforcement is currently involved in two such investigations that may be brought to the Commission for approval in the next six months. The valuation of the assets in the side pocket arrangements is among the issues reported to be the focus of the asset management unit's probe. It is reported that the scope of the SEC's investigation into this issue extends to an examination of a variety of third-party service providers, including the targeted hedge funds' administrators and auditors. The directors of offshore hedge funds are also of interest, notes the report.

Davis Polk will continue to monitor events in this area.

- ▶ [See The Wall Street Journal Article *SEC Probes 'Side Pocket' Arrangements*](#)

Litigation

Court Rules Whistleblower Protections of the Sarbanes-Oxley Act Applicable to Employees of Privately Held Mutual Fund Advisers

On March 30, 2010, U.S. District Judge Douglas P. Woodlock of the U.S. District Court, District of Massachusetts, denied two motions to dismiss filed by Fidelity Investments and Fidelity Management (collectively, "**Fidelity**"), the defendants in two separate (but joined) unlawful retaliation cases, holding that the whistleblower provision of the Sarbanes-Oxley Act, Section 806 ("**Section 806**"), applies to

employees of privately held investment advisers to mutual funds. Fidelity's business includes providing investment advice to the Fidelity family of mutual funds (the "**Funds**").

Among other things, Section 806 generally says that "[no public company, including a mutual fund], or any officer, employee, contractor, subcontractor or agent of such company, may discharge, demote . . . or in any other matter discriminate against an employee" who acts as a whistleblower.

One plaintiff, Jackie Hosang Lawson, worked for Fidelity from 1993 until 2007, eventually being promoted to Senior Director of Finance. In her brief opposing Fidelity's motion to dismiss her unlawful retaliation suit, she listed seven different "protected activities" under Section 806, including alerting her supervisors to various concerns with regard to improper retention of 12b-1 fees, the methodology used in allocating various expenses and errors in profitability models. Lawson alleges that in retaliation for such protected activities she was, among other things, verbally abused, her work was sabotaged and she was warned for violating Fidelity's rules on insubordination.

The other plaintiff, Jonathan M. Zang, worked for Fidelity from 1997 until he was terminated in 2005, most of that time as a portfolio manager. Zang alleges he was retaliated against and his employment terminated without severance as a result of his performing a "protected activity," which was informing his supervisors of inaccurate disclosures relating to the way portfolio managers were compensated.

Fidelity moved to dismiss their unlawful retaliation claims on the grounds that the plaintiffs were not covered employees under Section 806. While Fidelity did not dispute that an employee of the Funds would be subject to Section 806, Fidelity argued that the plaintiffs were employed by the privately held companies that served as the Funds' investment advisers—not the Funds themselves—rendering Section 806 inapplicable to them. In response, the plaintiffs contended that the protections of Section 806 apply to employees of privately held companies in certain circumstances, including where that private company serves as an investment adviser to mutual funds.

Thus, the initial question before the court was whether the term "employee" in Section 806 refers only to an employee of a public company or also to an employee of "any officer, employee, contractor, subcontractor or agent of such company." Through the use of statutory interpretation and review of the legislative history, the court ultimately decided that the purpose of the statute is to protect whistleblowing activity that relates to fraud against a public company's shareholders; therefore, the statute is just as applicable to related entities of a public company as it is to the public company itself.

Having determined that Section 806 protects employees of related entities of public companies, the court then turned to the question of whether the plaintiffs were employed by such a company (i.e., a "contractor, subcontractor or agent" of a public company). The court observed that the plaintiffs' employers, the Fund's investment advisers, performed various administrative tasks and made fundamental investment decisions for the Funds pursuant to investment advisory contracts. The court concluded, therefore, that their employers could be deemed "contractors, subcontractors or agents" of the Funds and that the plaintiffs were covered employees under Section 806.

In closing, the court noted that if it held otherwise, "reporting of fraud involving a mutual fund's shareholders [would] go unprotected for the simple reason that no 'employee' exists for this particular type of public company."

- ▶ [See a copy of the court's decision](#)

Charles Schwab Charged with Investment Company Act Violation

On March 30, 2010, the U.S. District Court for the Northern District of California granted a motion for summary judgment against Charles Schwab Corp., two of its subsidiaries, Charles Schwab & Co. Inc. and Charles Schwab Investment Management Inc., and its chief executive officer, Charles R. Schwab (collectively, “**Schwab**”), finding that Schwab violated Section 13(a) of the Investment Company Act of 1940 (the “**Investment Company Act**”) by changing the treatment of certain mortgage-backed securities held by its Schwab YieldPlus mutual fund (the “**Fund**”) for purposes of the Fund’s industry concentration policy without a shareholder vote. In re Charles Schwab Corp. Securities Litigation, C-08-01510-WHA (N.D. Cal., S.F. Div.). The charges were brought, along with other claims, by the Fund’s investors as part of a class action lawsuit that accuses Schwab of mismanaging the Fund.

The court noted that among other abuses that the Investment Company Act seeks to address are those related to a manager employing a bait-and-switch approach with respect to the investment policy of a mutual fund (i.e., luring investors into a fund premised on one investment policy and unilaterally, and without notice, changing it). Section 8(b) and Section 13(a) of the Investment Company Act are meant to address such abuse. Section 8(b) requires a mutual fund to include certain information in its registration statement, including its industry concentration policy, and Section 13(a) requires a mutual fund to obtain a vote of a majority of its shareholders before deviating from any of its fundamental policies, including those pertaining to industry concentration limits.

The court noted that the Fund’s 1999 registration statement stated that the Fund’s concentration policy limited the Fund’s ability to commit more than 25% of its assets to any particular industry. In 2001, Schwab amended the Fund’s registration statement, without a shareholder vote, to say that the Fund would treat uninsured privately-issued mortgage-backed securities as a stand-alone industry and to say in the Fund’s Statement of Additional Information (the “**SAI**”) that this change implicated the Fund’s industry concentration policy. Thus, observed the court, after this change, the Fund could invest a maximum of 25% of its assets in uninsured privately-issued mortgage-backed securities. In 2006, however, the Fund’s managers amended the Fund’s registration statement and SAI again on this issue to state that uninsured mortgage-backed securities issued by private lenders “are not part of any industry for purposes of [the Fund’s] concentration policies. This means that [the Fund] may invest more than 25% of its total assets in [uninsured] privately- issued mortgage-backed securities.” Schwab did not send a notice to the Fund’s shareholders advising of this change.

According to the plaintiffs, over 50% of the Fund’s assets came to consist of uninsured privately-issued mortgage-backed securities. After the value of these securities plummeted in the wake of the financial crisis the plaintiffs filed suit, contending, among other things, that Schwab unlawfully changed the Fund’s concentration policy by failing to have the change to the industry classifications utilized by the Fund ratified by the Fund’s shareholders.

In contesting the plaintiffs’ motion for summary judgment on the issue, Schwab contended that changes to the industry classifications used for purposes of the Fund’s concentration policy did not require a shareholder vote, a position similar to that advocated by the Investment Company Institute (the “**ICI**”) in the *amicus curiae* brief that it filed in this case. The ICI advocated the position that a fund’s industry concentration policy is distinct from the manner in which the fund defines the industries underlying such policy. Further, because Sections 8(b) and 13(a) of the Investment Company Act specifically reference a fund’s industry concentration policy—not the industry classifications it uses in connection therewith—shareholder approval is required for changes to the former, but not the latter.

Notably, the SEC filed an *amicus curiae* brief supporting the plaintiffs’ position, arguing that the Fund’s concentration policy and its industry classifications must be read together, especially in light of the fact that the Fund’s 2006 SAI noted that the change to the Fund’s classification of uninsured privately-issued mortgage-backed securities was “for purposes of [the Fund’s] concentration policy.” According to the

SEC, “[c]hanging what constitutes an industry changes the . . . concentration policy because . . . the concentration policy cannot be implemented without a determination of what is an industry.”

In ruling in favor of the plaintiffs, the court articulated its own rationale. First, the court asserted that the 2001 change to the Fund’s treatment of uninsured privately-issued mortgage-backed securities was a “mere clarification” of a vague definition that would have required a vote had its effect been to allow the Fund to exceed its stated 25% industry concentration limit. In the opinion of the court, the 2001 clarifying change established a “bright line” that was subsequently relied upon by investors in purchasing shares of the Fund; therefore, the 2006 amendment, which changed this “bright line” in a manner that allowed the Fund to invest more than 25% of its assets in uninsured privately-issued mortgage-backed securities required a shareholder vote.

- ▶ [See a copy of the court order](#)
- ▶ [See a copy of the ICI *amicus curiae* brief](#)
- ▶ [See a copy of the SEC *amicus curiae* brief](#)

SEC Censures and Fines Adviser for Due Diligence Lapses

Recently, the SEC settled an administrative action against Yosemite Capital Management, LLC (“**Yosemite**”), a registered investment adviser, and its managing director, Paul H. Heckler, finding that Heckler and Yosemite violated Section 206(2) of the Investment Advisers Act of 1940 (the “**Advisers Act**”) by failing to disclose to clients that they had encountered substantial problems when attempting to perform the due diligence that had been promised to clients.

In 2007, Yosemite placed \$3.25 million of four clients’ funds through a feeder fund, Ashton Investments LLC (“**Ashton**”), into supposed bridge loans arranged by Norman Hsu and Next Components, Ltd. (“**Next**”). Heckler’s clients’ funds were not, however, put towards any bridge loans. Instead, they became part of a \$60 million Ponzi scheme run by Hsu and Next.

According to the SEC, Heckler’s promised diligence process met with significant setbacks and exposed numerous red flags—none of which were disclosed to Heckler’s clients. The setbacks and red flags detailed in the administrative proceeding include the following:

- Ashton had no offices, so Heckler met Ashton representatives at local restaurants.
- Heckler’s attempts to obtain financial records for Hsu, Next and Ashton were rebuffed by Ashton’s representatives.
- When Heckler requested a disclaimer in the loan agreement, he was told that it was unnecessary because the investment was not risky.
- One Ashton representative told Heckler that the short-term loans would be insured up to \$10 million in case of default, but another representative later told Heckler there was no such insurance.
- Heckler was told that he could not contact Hsu’s lawyers or accountants because Hsu was a very private person.
- The only written information that Heckler received about Ashton and Hsu were business cards from Ashton’s representatives that listed their position as “Representative” [sic], a brochure that was riddled with spelling errors and emails that summarized a few of the loans, but contained no identifying information.

In settling the dispute with the SEC, Heckler and Yosemite agreed to be censured and to cease and desist from causing any violations or future violations of Section 206(2) of the Advisers Act. Additionally,

Heckler agreed to pay a civil penalty of \$26,000, and Yosemite agreed to pay about \$79,000 in civil penalties, disgorgement and interest.

- ▶ [See a copy of the SEC's order](#)

Industry Update

SEC's Donohue Discusses Key Regulatory Initiatives of the Division of Investment Management

In a recent speech at the Practising Law Institute's Investment Management Institute 2010, Andrew J. Donohue, director of the SEC's Division of Investment Management (the "**Division**"), discussed some of the Division's current regulatory initiatives and concerns.

Derivatives

Donohue reiterated his long-standing concern regarding investment companies' use of derivatives. Conceding that derivative instruments can play a role in "efficient portfolio management and risk mitigation," Donohue nevertheless expressed his belief that they pose "significant additional risk" to investment companies and implicate investor protection issues. According to Donohue, the increasing use of derivatives by investment companies for purposes other than hedging or risk management raises issues with respect to the "literal terms" of the Investment Company Act of 1940 (the "**Investment Company Act**") and two of its core premises: limiting the "speculative character" of investment company interests by placing limits on borrowing and the issuance of senior securities and assuring "full disclosure of investment strategies and risks."

Donohue noted that, in light of these concerns, the Division is considering a variety of questions regarding investment companies' use of derivatives, including the following:

- Are certain means of obtaining leverage through derivatives consistent with the limits on leverage contained in Section 18 and the policy considerations set forth in Section 1(b) of the Investment Company Act?
- Do certain techniques of increasing an investment company's leverage violate Section 48 of the Investment Company Act, which prohibits doing indirectly what one is not permitted to do directly?
- How should derivatives be factored into portfolio concentration and diversification requirements applicable to investment companies?
- Do investment companies that utilize derivatives possess sufficient risk management systems and procedures and appropriate expertise?
- Does the current regulatory framework applicable to investment companies adequately address funds' pricing and liquidity determinations with respect to derivatives?
- Are the risks posed by derivatives adequately captured under the currently applicable disclosure regime?
- Has the SEC offered sufficient guidance regarding Investment Company Act leverage limits?
- Are funds' directors equipped with the expertise to sufficiently oversee funds' use of derivatives, particularly collateralized debt obligations, collateralized mortgage obligations and swaps?

Donohue emphasized that regulators must take an active role in understanding and overseeing how derivatives are used by various financial operators. Concluding his remarks on derivatives, Donohue said, "Our goal with respect to derivatives is not simply to react to recent market events, but rather, . . . to

develop a complete picture of the current landscape in this area and develop an appropriate regulatory approach.” (Notably, subsequent to Donohue’s speech, news reports indicate that the SEC’s Office of Compliance Inspectors and Examinations is conducting widespread examinations of mutual funds’ use of derivatives.)

Money Market Funds

Donohue also addressed the SEC’s recent amendments to Rule 2a-7, which were implemented to reduce the risks associated with money market funds through new requirements related to liquidity, maturity, and quality of fund portfolios. See the [March 2010 Investment Management Regulatory Update](#) for more detail on the amendments to Rule 2a-7. Notwithstanding these recent amendments, Donohue expressed his belief that further reform of money market funds remains necessary. In addition to further exploring the creation of a private liquidity bank to stabilize money market funds experiencing liquidity problems, Donohue suggested that additional reforms focused on lowering institutional investors’ incentive to redeem when a money market fund “breaks the buck” should be considered. Donohue also cautioned industry participants that opposition to further reforms may impact the government’s willingness to provide future assistance to funds facing problems with liquidity.

Collective Investment Trusts

Donohue concluded his speech by mentioning his concerns regarding the increasing popularity of collective investment trust platforms, especially for retirement funds. With collective investment trusts becoming simultaneously more pervasive and more varied, the Division is considering whether their exclusion from registration under the Investment Company Act might, in some cases, run counter to its policies and prevent investors from receiving appropriate protections.

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

New Developments Regarding Pay-to-Play Practices

As previously reported in several Investment Management Regulatory Updates, including, among others, the [January 7, 2010](#), [March 9, 2010](#) and [April 6, 2010 Investment Management Regulatory Updates](#), pay-to-play practices have been and continue to be, the subject of much scrutiny. Recently, on April 15, 2010, the SEC announced that it settled charges against private equity firm, Quadrangle Group LLC and one of its funds, Quadrangle GP Investors II, L.P. (collectively “**Quadrangle**”), for their involvement in a pay-to-play scheme involving the New York State Common Retirement Fund (the “**NYCRF**”). Additionally, New York State Attorney General Andrew M. Cuomo recently announced agreements with several institutions and individuals stemming from his office’s ongoing investigation of pay-to-play practices, and California has proposed new legislation for regulating placement agents.

Each of these developments is discussed below.

SEC Settles Charges With Quadrangle in Pay-to-Play Scheme

According to an SEC press release discussing its settlement with Quadrangle, the NYCRF invested \$100 million with Quadrangle in return for a Quadrangle executive facilitating the distribution of a film produced by former New York State Deputy Comptroller, David Loglisci, and his brother. The SEC also alleged that the Quadrangle executive agreed to pay Henry Morris, a political advisor to, and chief fundraiser for, Alan Hevesi, who was then the New York State Comptroller, over \$1 million in “finder” fees.

The SEC’s release sets forth the factual basis for its charges against Quadrangle, detailing, among other things, communications between Loglisci, his brother, the Quadrangle executive and a Quadrangle affiliate, GT Brands (“**GT**”), concerning Quadrangle’s assistance with a DVD distribution deal for Loglisci’s brother. The SEC alleges that the Quadrangle executive contacted GT and, over the course of their contact, repeatedly urged GT to take care with its treatment of Loglisci’s brother because Quadrangle

was seeking an investment from the NYCRF through Loglisci. Contrary to its decision after initial talks with Loglisci's brother, GT ultimately offered him a distribution deal.

Further, according to the SEC, although Quadrangle was already interacting with Loglisci, it retained Morris as a "placement agent," and once it informed Morris that the GT distribution deal was moving forward, Loglisci agreed to have the NYCRF make an investment with Quadrangle.

Quadrangle settled the SEC's charges and agreed to be permanently enjoined from violation of section 17(a)(2) of the Securities Act of 1933. Notwithstanding this settlement, the release indicates that the SEC's investigation of Quadrangle is ongoing.

New York Attorney General Announces Additional Agreements Resulting From its Ongoing Pay-to-Play Investigation

On April 15, 2010, the New York Attorney General's Office (the "**NYAG**") announced that it entered into agreements with two firms and three unlicensed brokers pursuant to which New York State and the NYCRF stand to be repaid a total of nearly \$12 million. A significant portion of the payments represents a disgorgement of management and placement fees received by the parties. The agreements are the result of the NYAG's ongoing investigation of pay-to-play practices over the last two years. These agreements, together with previously announced agreements with other firms and individuals, bring the total to be returned to the NYCRF and New York State to over \$130 million.

The five signatories have also agreed to comply with the New York Attorney General's Public Pension Reform Code of Conduct, which prohibits, among other things, the use of placement agents in soliciting state pension fund investments and also prohibits a state pension fund from investing with a firm within two years of such firm's campaign contribution to the New York State Comptroller or other elected trustee.

Susan Lerner, Executive Director of good government group, Common Cause, has praised and pledged support for the NYAG's work, saying that "Attorney General Cuomo's sweeping investigation into the public pension fund has uncovered conflicts of interest, improprieties, and outright criminal acts by those we trust with our money."

California Proposes Legislation to Mitigate Placement Agents' Influence on Pension Funds

On April 7, 2010, the California State Assembly's Committee on Public Employees, Retirement and Social Security (the "**Committee**") voted for a bill ("**AB 1743**") whereby placement agents would be required to: register with the California Secretary of State as lobbyists under the California Political Reform Act of 1974; report gifts, fees and other compensation on a quarterly basis; and adhere to gift limits and restrictions and reporting requirements on campaign contributions. Additionally, while AB 1743 would allow investment managers to pay flat fees to placement agents for securing business with the state's pension funds, it would prohibit contingency fees—which are typically about one percent of the total investment won. The Committee voted 4-1 in favor of AB 1743, with one Committee member abstaining. After a subsequent unanimous vote of 7-0 in the California State Assembly's Elections Committee, the bill now moves on to the state's full Assembly for approval.

- ▶ [See a copy of the SEC's press release](#)
- ▶ [See a copy of the NYAG's press release](#)
- ▶ [See a copy of AB 1743, as amended](#)

SEC and Other Federal Regulators Release Online Form Builder for Model Consumer Privacy Notices

As reported in the *December 4, 2009 Investment Management Regulatory Update*, the SEC and seven other federal regulatory agencies (the “**Agencies**”) have released model consumer privacy notice forms designed to facilitate consumers’ understanding of how financial institutions collect and share information about their customers. More recently, the Agencies released an Online Form Builder that enables financial institutions to download and create their own customized privacy notices. The Online Form Builder, which is available on the Federal Reserve System’s website, provides instructions and links to four versions of the model form that vary depending on what options the institution provides for consumers with respect to opting-out of having their information shared with third parties. The use of a properly constructed model form allows a financial institution to obtain a legal “safe harbor” and satisfy the disclosure requirements set forth in Section 503 of the Gramm-Leach-Bliley Act.

- ▶ [See a copy of the SEC press release announcing the Online Form Builder](#)

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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