Investment Management Regulatory Update

January 27, 2014

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SEC Releases Additional Rule 506 "Bad Actor" Guidance

On January 3, 2014, the Division of Corporate Finance of the Securities and Exchange Commission (the "**SEC**") issued additional Compliance and Disclosure Interpretations ("**C&DIs**") regarding the "bad actor" rules adopted by the SEC. For details on previously posted C&DIs regarding the bad actor rules, please see the December 11, 2013 Client Newsflash, ***SEC Issues Guidance on Rule 506 "Bad Actor" Provisions***.

The bad actor rules are codified as Rules 506(d)–(e) under the Securities Act of 1933, as amended (the "**Securities Act**"), and became effective on September 23, 2013. Under Rule 506(d), if one of an enumerated list of covered persons in relation to an offering of securities is subject to a "disqualifying event" that occurred on or after September 23, 2013, then the issuer is generally disqualified from relying on Rule 506 of Regulation D. In addition, pursuant to Rule 506(e), if a covered person is subject to a matter that would have been a disqualifying event had it occurred on or after September 23, 2013, then the issuer must furnish to each purchaser, a reasonable time prior to selling securities in reliance on Rule 506, written disclosure of such matter.

The additional C&DIs provided guidance on a number of bad actor rule topics including:

Beneficial Ownership. The bad actor rules include as covered persons beneficial owners of 20% or more of an issuer's outstanding voting equity securities, calculated on the basis of voting power. The C&DIs clarified certain aspects of the bad actor rules that pertain to 20% beneficial owners, including that:

- an equity holder that becomes a 20% beneficial owner upon the completion of a sale of securities is not a 20% beneficial owner "at the time of the sale" (and therefore such equity holder is not a covered person under the rules), but such an equity holder could be a covered person if sales of securities are made while it was otherwise a 20% beneficial owner;
- the term "beneficial owner" should be interpreted as such term is interpreted in Rule 13d-3 under Securities Exchange Act of 1934 (i.e., "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares, or is deemed to have or share: voting power, which includes the power to vote, or to direct the voting of, such

security; and/or investment power, which includes the power to dispose, or to direct the disposition of, such security"); and

- in respect of equity holders who have entered into a "voting agreement" (whereby equity holders have formed a group that beneficially owns the shares beneficially owned by the group's members), a party to the agreement (the "**Voting Party**") will be deemed to beneficially own the interests of other parties to the agreement if the Voting Party has the "power to vote or direct the vote" of interests beneficially owned by other parties. Furthermore, according to the C&DIs, the bad actor rules apply to the group if the group itself is a 20% beneficial owner, but if a party to a voting agreement becomes a 20% beneficial owner because it is a Voting Party that is deemed to beneficially own the interests of other parties to the agreement, then such a person would be considered a covered person.

Court Order *in Lieu of Waiver*. The C&DIs explained that a self-executing statement of a court or regulator that a regulatory event should not result in disqualification under Rule 506 (as contemplated by Rule 506(d)(2)(iii)) does not waive the disclosure obligation set forth in Rule 506(e). Instead, the C&DIs stated, Rule 506(d)(2)(iii) permits an issuer to rely on such a statement to avoid Rule 506 disqualification when a court or regulator advises the SEC "that Rule 506 disqualification should not arise [as] a consequence of a disqualifying event that occurred on or after September 23, 2013." However, the C&DIs clarified that a regulator may determine that an order issued prior to September 23, 2013 would not have triggered disqualification under Rule 506(d) because the order was not "a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct," in which case, the issuer would have no disclosure obligation under Rule 506(e) in respect of such event.

- **See a copy of the C&DIs**

IM Guidance Update Clarifies Exclusion from Investment Company Act for Charitable Investment Funds

In December 2013, the Division of Investment Management of the SEC issued an IM Guidance Update to clarify that the exclusion from regulation under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") that is provided to an investment fund (a "**Charitable Investment Fund**") maintained by a charitable organization (such as a 501(c)(3) corporation) for the collective investment of certain permitted assets of charitable organizations ("**Permitted Assets**"), as set forth in Section 3(c)(10)(B) of the Investment Company Act, also extends to a Charitable Investment Fund that is a separate legal entity from the charitable organization that operates such fund, so long as the Charitable Investment Fund is "organized and operated for the purpose of earning investment returns for the investing charitable organizations" and such returns are used exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes ("**Permitted Purposes**").

The exclusion from regulation as an "investment company" is provided to Charitable Investment Funds by Section 3(c)(10) of the Investment Company Act, which excludes funds "organized and operated exclusively for [Permitted Purposes]" and maintained by a charitable organization "exclusively for the collective investment and reinvestment of [Permitted Assets]."

According to the IM Guidance Update, a Charitable Investment Fund might be formed as a separate legal entity to protect it against the liabilities of the charitable organization that maintains such fund and uses the proceeds from its investments for Permitted Purposes. Therefore, according to the IM Guidance Update, a Charitable Investment Fund that is a separate legal entity from the charitable organization that maintains it may not be "organized and operated exclusively for Permitted Purposes" (since its purpose would also be to produce investment proceeds for the investing charitable organizations), but the IM Guidance Update would deem such a fund to satisfy the 3(c)(10) exclusion if it otherwise satisfied the requirements of the exclusion and any applicable no-action letters issued by the SEC staff regarding Charitable Investment Funds.

- See a copy of the IM Guidance Update

Industry Update

SEC's National Examination Program Releases its Examination Priorities for 2014

On January 9, 2014, the National Examination Program (the "**NEP**") published its examination priorities for 2014 (the "**Exam Priorities**"). The NEP identified several market-wide priorities that address issues relevant to nearly all SEC registrants, as well as specific priorities for each of the NEP's distinct program areas, including, among other programs, the program applicable to investment advisers and investment companies.

According to the Exam Priorities, the NEP will focus examinations on several key risk areas applicable to the entire market, including:

- **Fraud Detection and Prevention**. The NEP will seek out fraudulent and unethical behavior by market participants through the continued use and enhancement of its quantitative and qualitative tools and techniques, including the NEP's Quantitative Analytics Unit, which, according to the Exam Priorities, is "a team of specialists with post-graduate degrees in fields such as computer science and mathematics that is able to evaluate risks in the algorithms, models, and software of the most sophisticated investment firms."
- **Corporate Governance, Conflicts of Interest and Enterprise Risk Management**. The NEP will initiate meetings with senior management and boards of SEC registrants (and their affiliates) to discuss and assess registrants' management and mitigation of any conflicts of interest and their legal, compliance, financial and operational risks.
- **Technology**. The NEP may conduct examinations on registrants' governance and supervision of information technology systems, operational capability, market access, the security of information and registrants' ability to respond to system outages.
- **Dual-Registrants**. The NEP will also focus on dually registered investment advisers and broker-dealers and the attendant conflicts of interests raised by such businesses, and will examine how the different supervisory structures and legal standards of conduct that govern investment advisers and broker-dealers, respectively, affect investors.
- **Rule 506(c)**. The NEP will assess the use of Rule 506(c), which, as discussed in the July 29, 2013 Davis Polk Client Memorandum, ***Private Offering Reform: Analysis and Implications***, eliminated the prohibition on widespread advertising and other forms of "general solicitation" or "general advertising" in private offerings under Rule 506 of Regulation D of the Securities Act. According to the Exam Priorities, the staff will be particularly focused on issuers' general solicitation practices and the verification of accredited investor status, as well as the level of due diligence conducted by broker-dealers and investment advisers in Rule 506(c) offerings.
- **Retirement Vehicles and Rollovers**. The NEP will examine investment advisers' sales practices regarding the rollover of employer-sponsored 401(k) plan investments into more expensive investments and whether such investment advisers' misrepresent their credentials or the benefits of IRAs (or other alternatives). In addition, according to the Exam Priorities, the NEP will examine broker-dealers and investment advisers "for possible improper or misleading marketing and advertising, conflicts, suitability, churning, and the use of potentially misleading professional designations" in connection with so-called "IRA rollovers" resulting from a customer's or client's change of employment.

The NEP also identified specific examination priorities for investment advisers and investment companies, including certain "core" focus areas and certain new and emerging focus areas.

Core Focus Areas. According to the Exam Priorities, the NEP's core focus areas will include an emphasis on: (i) the custody and safety of client assets, including compliance with Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended, (ii) conflicts of interest inherent in certain business models, including (A) undisclosed compensation arrangements (and how such arrangements may affect investment recommendations), (B) the allocation of investment opportunities, (C) the adequacy of controls and disclosure in situations in which an investment adviser manages funds with similar investment objectives but where one fund pays performance fees and the other fund does not, (D) risk controls and disclosure related to illiquid and leveraged investments and (E) "higher risk products" targeted to retail investors (and in particular, elderly investors), and (iii) the accuracy and completeness of advisers' investment objectives and advertised performance (including as it relates to marketing efforts arising from changes in advertising practices that have resulted from the Regulation D amendments).

New and Emerging Issues and Initiatives. According to the Exam Priorities, in addition to the core focus areas, the NEP intends to focus on certain areas based on recent changes and developments in the industry, including "changes in financial conditions, products or investment strategies offered, technology, regulation, business combinations, and business practices." Specifically, according to the Exam Priorities, the NEP will focus on: (i) advisers that have been registered with the SEC for more than three years but have not yet been examined by the NEP (which is a focus separate from the "Presence Exam Initiative," which focuses on newly registered advisers, as discussed in the ***March 25, 2013 Investment Management Regulatory Update***), (ii) whether advisers are adhering to their fiduciary and compliance obligations in connection with wrap-fee programs (and advisers' monitoring processes in respect of such wrap-fee programs), (iii) whether advisers using quantitative trading models have in place policies and procedures that are designed to prevent market manipulation, ensure proper testing of the models, ensure proper books and records are maintained and ensure a current inventory of an adviser's proprietary models is maintained, (iv) the examination of newly registered investment advisers in connection with the Presence Exam Initiative, (v) payments to distributors and intermediaries, including a focus on the disclosure of such payments to a fund's board and the board's oversight of such payments and (vi) risks related to changing interest rates and the impact such changing interest rates may have on bond funds.

In addition, according to the Exam Priorities, the NEP will also seek to review certain "policy topics," including: (i) how money market funds manage stress events, which may affect their ability to maintain stable share prices, (ii) the use of "alternative" investment strategies, including as it relates to (A) leverage, liquidity and valuation policies and practices, (B) whether adequate compliance personnel, back-office support and board oversight are in place for such strategies and (C) whether applicable regulations are being followed as it relates to the marketing of such funds, and (iii) whether securities lending arrangements comply with applicable SEC exemptive orders and no-action letters.

According to the NEP, the focus areas identified in the Exam Priorities are not exhaustive, although the NEP expects to use a significant portion of its resources to focus examinations on the issues identified in the Exam Priorities.

- **See a copy of the Exam Priorities**

CFTC Provides Guidance on Cross-Border Application of Swap Regulations and Provides Temporary Relief for Non-U.S. Swap Dealers from Swap Data Reporting Requirements

On December 20, 2013, just ahead of the expiration of the Commodity Futures Trading Commission's (the "**CFTC**") exemptive order delaying the applicability of some CFTC swap regulations for non-U.S. swap dealers and foreign branches of U.S. swap dealers, the CFTC issued a press release and summary

table announcing comparability determinations that will allow certain non-U.S. swap dealers and foreign branches of U.S. swap dealers to comply with local law instead of CFTC requirements in cases where substituted compliance is available under the CFTC's cross-border guidance. According to the CFTC's press release, the CFTC's actions also extend to non-U.S. major swap participants ("**MSPs**") and foreign branches of U.S. MSPs.

Contemporaneously with issuing the press release, the CFTC published no-action letters 13-75 and 13-78 providing temporary relief for non-U.S. swap dealers in certain jurisdictions from compliance with swap data reporting rules under Parts 45 and 46 and certain internal business conduct rules under Part 23 of the CFTC's regulations. While the CFTC deferred the decision to make a comparability determination with respect to such swap data reporting requirements, as it continues to review the issue, its reporting no-action relief will allow non-U.S. swap dealers that do not have a U.S. ultimate parent to delay reporting transactions with non-U.S. persons for several months. Where the CFTC did not provide for comparability or timing relief, firms will need to comply with the relevant requirements immediately.

For further discussion of the CFTC's press release, summary table and the no-action letters, including charts we have prepared summarizing the comparability determinations and the timing relief, based on the press release, summary table and the two no-action letters, please see the December 22, 2013 Client Newsflash, ***CFTC Announces Cross-Border Substituted Compliance Determinations, Provides Limited Phase-In for Some Swap Requirements***.

- **See a copy of the CFTC's press release**
- **See a copy of the CFTC's summary table**
- **See a copy of CFTC No-Action Letter 13-75**
- **See a copy of CFTC No-Action Letter 13-78**

Notes from Europe: European Regulatory Developments

UK: AIFMD Transitional Arrangements Update

On December 19, 2013, the United Kingdom's Treasury ("**HM Treasury**") published an update on the transitional arrangements relating to the Alternative Investment Fund Managers Directive (the "**AIFMD**"). Broadly, under the transitional arrangements in place in the United Kingdom (the "**UK**"), alternative investment fund managers ("**AIF Managers**") who managed an alternative investment fund ("**AIF**") prior to July 22, 2013 or, in relation to third country AIF Managers (i.e., an AIF Manager whose registered office is not located in a European Economic Area ("EEA") State), marketed that AIF in a EEA State prior to July 22, 2013, need not comply with the UK's implementation of the AIFMD until July 22, 2014.

In light of concerns raised by the AIF industry, HM Treasury is intending to amend the Alternative Investment Fund Managers Regulations 2013 to provide that, if a transitional AIF Manager's application for authorization or registration is submitted without sufficient time for the UK Financial Conduct Authority ("**FCA**") to determine the application by July 22, 2014 (the end of the transitional period), that AIF Manager will be able to continue managing AIFs until the FCA has made such a determination. The requirement to submit an application before July 22, 2014 will remain in place and all AIF Managers will, in any event, be required to comply with all relevant AIFMD requirements from July 22, 2014, even if the FCA has not yet determined an AIF Manager's application.

HM Treasury noted that it is in the process of determining certain details, in particular the status of AIF Managers whose applications are yet to be determined after July 22, 2014, but it has stated that it intends to make an amending statutory instrument to this effect in early 2014. HM Treasury is nonetheless encouraging all transitional AIF Managers to submit their applications for authorization or registration in a

timely manner. The FCA has a statutory deadline of three months from the receipt of a complete application for authorization to make a determination as to whether or not to grant authorization, although it can, upon notice to the applicant, extend the deadline by up to three additional months depending on the specific circumstances of the application.

- See a copy of the HM Treasury's update

European Commission Adopts Delegated Regulation on Determining Whether an AIF Manager is Managing an Open-Ended or Closed-Ended AIF

On December 20, 2013, the European Commission published the text of a delegated Regulation it has adopted supplementing the AIFMD with regard to regulatory technical standards ("**RTS**") for determining whether an AIF Manager is managing an open-ended or closed-ended fund. This distinction is important as certain requirements imposed on AIF Managers under the AIFMD, including, for example, as it relates to liquidity management and valuation, differ depending on whether the AIF being managed is open-ended or closed-ended.

The RTS set out the criteria for determining whether an AIF Manager is managing an open-ended AIF and closed-ended AIF, as follows:

- an AIF Manager of an open-ended AIF is an AIF Manager that manages an AIF the shares or units of which are, at the request of any of its shareholders or unit-holders, repurchased or redeemed prior to the commencement of its liquidation phase or wind-down, directly or indirectly, out of the assets of the AIF and in accordance with the procedures and frequency set out in its rules or instruments of incorporation, prospectus or offering documents; and
- an AIF Manager of a closed-ended AIF is an AIF Manager that manages an AIF other than an open-ended AIF.

The definition of a closed-ended fund is different, however, for the purposes of the transitional provisions of the AIFMD. Under such provisions AIF Managers that managed closed-ended funds (i) before July 22, 2013 that do not make additional investments after July 22, 2013 or (ii) whose subscription period for investors closed prior to July 22, 2013 and are constituted for a period of time that expires no later than July 22, 2016, are permitted to continue to manage such funds without authorization under the AIFMD (although in respect of (ii) above, AIF Managers will need to comply with the annual report requirement and, where relevant, the requirements in relation to the acquisition of control of non-listed companies and issuers and the restrictions on asset-stripping). For these purposes, in order to reflect the fact that when the AIFMD was originally adopted there was no harmonized definition in the European Union of the legal structure of a closed-ended fund, the RTS defines a closed-ended fund as an AIF "whose shares or units are, at the request of any of its shareholders or unitholders, repurchased or redeemed prior to the commencement of its liquidation phase or wind-down, directly or indirectly, out of the assets of the AIFs after an initial period of at least five years during which redemption rights are not exercisable."

The delegated Regulation will enter into force on the twentieth day following that of its publication in the Official Journal of the Europe Union.

- See a copy of the delegated Regulation

Davis Polk

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