Investment Management Regulatory Update

March 24, 2014

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SEC Rules and Regulations

SEC Staff Responds to Questions About Form PF

On February 12, 2014, the Division of Investment Management of the Securities and Exchange Commission (the "SEC") issued additional responses (the "**Responses**") to frequently asked questions regarding Form PF. For details on previously posted SEC responses to frequently asked questions regarding Form PF, please see the ***September 26, 2013 Investment Management Regulatory Update***, the ***May 16, 2013 Investment Management Regulatory Update***, the ***March 25, 2013 Investment Management Regulatory Update***, the ***December 20, 2012 Investment Management Regulatory Update***, the ***August 22, 2012 Investment Management Regulatory Update*** and the ***July 16, 2012 Investment Management Regulatory Update***.

Investment advisers registered or required to register with the SEC under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), that advise one or more private funds (i.e., 3(c)(1) or 3(c)(7) funds) and that have at least $150 million in private fund assets under management ("**private fund advisers**") are required to file Form PF with the SEC for the purpose of reporting systemic risk information to the SEC. Additionally, private fund advisers that are also registered with the Commodity Futures Trading Commission (the "**CFTC**") as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**") and are required to file Form PF under the Advisers Act must file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are private funds. Such CPOs and CTAs may file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are not private funds. Please see the ***November 18, 2011 Investment Management Regulatory Update*** for a discussion of the final Form PF rules and the ***June 19, 2012 Investment Management Regulatory Update*** for a discussion of the initial Form PF deadlines.

The Responses provided guidance on a number of Form PF topics including, among other things:

Reverse Repos. The Responses clarified that the amount of cash borrowed via Reverse Repos should be reported as the short value of Repos for purposes of reporting the exposures in Questions 26 and 30. According to the SEC, a "Reverse Repo"—which takes place when a reporting fund sells a security with an agreement to repurchase such security at a later date at a previously agreed upon price—is considered a borrowing. The Responses distinguish a "Reverse Repo" from a "Repo," which is an arrangement where a reporting fund purchases a security together with an agreement to sell such security at a later date at a predetermined price. A Repo, unlike a Reverse Repo, is not considered a borrowing.

Reported Borrowings. The Responses also clarified that responses to Question 46(a), which requires an adviser to provide the aggregate dollar amount of borrowings by, and cash financing available to, the reporting fund for each qualifying hedge fund, should include the borrowings reported in Question 43, which asks the value of the fund's secured and unsecured borrowings.

The Responses noted that the adviser is not required to complete Question 12 for any reporting fund with respect to which it is answering Question 43 in Section 2b. In the event that the adviser answers Question 43 with respect to a reporting fund, the Responses state that each part of Question 12 should be left blank. Likewise, the Responses noted that the adviser is not required to complete Question 13 for any reporting fund with respect to which it is answering Question 44 in Section 2b. In the event that the adviser answers Question 44 with respect to a reporting fund, the Responses state that each part of Question 13 should be left blank.

Private Equity Fund. The Responses explained that the leverage and shorting characteristics in the definition of "hedge fund" are not limited to actual or contemplated use, but extend to potential use as well. For example, a private fund that would be categorized as a private equity fund but for the fact that the fund documentation allows the fund to either employ large amounts of leverage or to short assets—even if such private fund does not in fact intend to employ such measures—must be treated as a hedge fund for reporting purposes. The Responses further explain that if a private fund is held out to investors as a type of fund other than a hedge fund, the adviser may include a note in Question 4 indicating the category of private fund that the adviser believes better describes the fund and why the reporting fund meets the definition of a hedge fund.

Parallel Managed Accounts. The Responses clarified that the Staff would prefer that information regarding parallel managed accounts not be included for purposes of reporting information in Sections 1b, 1c, 2b, 3 and 4 (with the exception of Question 11). According to the Responses, in the event that an adviser decides to include parallel managed account information in responses to questions in such Sections, the Staff recommends that, in Question 4, the adviser indicate that it is reporting information regarding its parallel managed accounts when responding to questions related to a reporting fund other than Question 11.

Private Fund's Equity Investments in other Private Funds. The Responses explained that an adviser should indicate in Question 4 whether it is disregarding or including a reporting fund's investment in other private funds for purposes of reporting on Form PF.

Q14 Cost-Based Column. The Responses clarified that assets and liabilities that would be presented in a fund's financial statements using a measurement attribute other than fair market value should be included in the cost-based column in Question 14. The Responses went on to clarify that the sum of the amounts entered in the assets row of Question 14 should approximate the reporting fund's gross assets reported in Question 8 at the time of reporting with the exception of funds with uncalled commitments included in their gross assets. In those cases, according to the Responses, the sum of the values in the assets row of Question 14 should equal the gross assets minus the uncalled commitments amount because such amounts are not reflected as assets on a fund's balance sheet. The sum of the amounts in the liabilities row of Question 14 should approximate the total liabilities reported on the fund's financial

statements. The Responses further noted that if an asset or a liability is reported as representing fair value, though the fair value of the asset or liability is equal to its cost, then that asset or liability should still be categorized in the fair value hierarchy and should not be included in the cost-based column. The Responses also clarified that cash should be included in the cost-based column and cash equivalents, depending on their nature, should be included in the applicable column in the fair value hierarchy or the cost-based column.

Net Asset Value. The Responses explained that, in completing Question 20 for a reporting fund that has gross assets in excess of its net assets, the total of the answers in the "% of NAV" column should generally add up to more than 100%. The Responses noted that Instruction 15, which states that the numerator to be used to determine the percentage of net asset value must be measured on the same basis as gross asset value, also applies to Questions 21, 25, 28, 35 and 57.

- **See a copy of the Responses**

IM Guidance Update Clarifies Advisory Fee Rate Requirement for Multi-Manager Funds

In February 2014, the Division of Investment Management of the SEC issued an IM Guidance Update to assist mutual funds using a multi-manager structure ("**multi-manager funds**") in complying with advisory fee rate requirements.

In a multi-manager fund, a fund's primary investment adviser may delegate certain responsibilities to subadvisers, who effectively serve as day-to-day portfolio managers for the fund. Multi-manager funds operate pursuant to SEC exemptive orders under the Investment Company Act that permit a subadviser to serve under a contract that has not been approved by the fund's shareholders, subject to a set of protective conditions ("**multi-manager orders**"). According to the IM Guidance Update, one such condition (the "**aggregate fee condition**") is that multi-managers must obtain shareholder approval for the aggregate fee rate payable by a fund for both primary and subadvisory advisory services (the "**aggregate advisory rate**").

The IM Guidance Update clarifies how multi-manager funds may comply with the aggregate advisory rate requirement. The SEC requests that all new applications for multi-manager orders include the aggregate fee condition, regardless of whether the multi-manager employs a model in which the fund enters into a contract with only the primary adviser, who then enters into separate contracts with subadvisers (the "**traditional model**") or a model in which the fund enters into a contract with the primary advisor and a contract with each subadviser (the "**direct-pay model**"). According to the IM Guidance Update, the aggregate fee condition should specify that any new subadvisory contract or amendment to any existing primary advisory contract or subadvisory contract that results in an increase in the aggregate advisory rate charged to the fund would be subject to shareholder approval.

Additionally, the IM Guidance Update provides various examples to assist multi-managers using the direct-pay model in complying with the aggregate fee condition requirement. According to the IM Guidance Update, if a fund hires its first subadviser, shareholder approval is required under the aggregate fee condition, unless the rate the fund pays under its primary advisory contract is reduced such that there is no increase in the aggregate advisory fee rate. The SEC also clarified that shareholder approval under the aggregate fee condition is not required if a fund hires an additional subadviser at a rate no higher than the rate of a subadviser being replaced or the rate that could have been allocated to an existing subadviser. Furthermore, the SEC stated that shareholder approval is not required if the rate payable to an existing subadviser increases in an amount corresponding to a decrease in the rate payable to the primary adviser.

- **See a copy of the IM Guidance Update**

IM Guidance Update Advises Investment Companies on Unbundling of Proxy Proposals

In February 2014, the Division of Investment Management of the SEC issued an IM Guidance Update with respect to amendments to investment company charters in light of the requirements of Rule 14a-4 under the Securities Exchange Act of 1934.

According to the IM Guidance Update, the SEC's "unbundling" rule (Rule 14a-4(a)(3) and Rule 14a-4(b)(1) under the Exchange Act) requires that the form of proxy "identify clearly and impartially each separate matter to be acted upon" and provide separate boxes for shareholders to choose between approval, disapproval or abstention "with respect to each separate matter." The IM Guidance Update further stated the Staff's position that a matter should be voted on separately if the Investment Company Act, state law or a fund's organizational documents require a matter under consideration to be submitted to shareholders.

The IM Guidance Update stated that the Staff has commented that proposed amendments to the charters of investment companies should provide shareholders with the ability to separately vote on each proposed material amendment. The IM Guidance Update advised that investment companies consider whether a given matter substantively affects shareholder rights in making the determination as to whether it is material. Examples of proposed amendments that would be material, according to the Staff, are proposals seeking to:

- amend voting rights from one vote per share to one vote per dollar of net asset value;
- authorize a fund to invest in other investment companies;
- change supermajority voting requirements;
- authorize the board to terminate a fund or merge with another fund without a shareholder vote; and
- authorize a fund to involuntarily redeem small account balances.

► **See a copy of the IM Guidance Update**

Industry Update

SEC Announces Initiative Directed at Never-Before Examined Registered Investment Advisers

On February 20, 2014, the Office of Compliance and Examinations of the SEC ("**OCIE**") announced a new initiative (the "**Initiative**") directed at investment advisers that have never been examined, focusing on investment advisers that have been registered with the SEC for three years or more. OCIE had previously announced in its 2014 National Exam Program ("NEP") priorities that examining these advisers is a priority. Please see the ***January 27, 2014 Investment Management Regulatory Update*** for a discussion of the 2014 National Exam Priorities.

As part of the initiative, OCIE will administer examinations through the NEP of investment advisers that have never-before been examined in order to assess whether they are complying with the Advisers Act and the rules thereunder. In connection with the Initiative, OCIE published a letter to registered investment advisers who have never been examined detailing how such registered investment advisers will be evaluated. According to the Letter, examinations will focus on the following areas:

- **Compliance Program**. Registered investment advisers must adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act. According to the Letter, as part of the examination, NEP staff will evaluate the effectiveness of an adviser's compliance program by reviewing the adviser's books and records to determine if an

adviser has adequately identified conflicts of interest and compliance risks, adopted appropriate policies and procedures to address those conflicts and risks, and appointed a Chief Compliance Officer.

- **Filings and Disclosure**. The Letter states that NEP staff will review an adviser's filings and disclosure documents to assess whether the investment adviser has disclosed all material facts regarding conflicts or potential conflicts of interest necessary for clients to make an informed decision whether to enter into or continue an advisory relationship.
- **Marketing**. According to the Letter, NEP staff will analyze marketing materials and assess whether an investment adviser has made any false or misleading statements about its business or performance record, made any untrue statements of material facts, omitted material facts, made any misleading statements or engaged in any manipulative, fraudulent or deceptive activities.
- **Portfolio Management**. According to the Letter, NEP staff will review and evaluate how an investment adviser manages its portfolio, including how it allocates investment opportunities between clients and whether the adviser's practices are consistent with its disclosure.
- **Safety of Client Assets**. Under the Advisers Act, registered advisers that have "custody" of client assets must take certain measures to protect client assets from loss or theft. According to the Letter, NEP staff will evaluate whether an adviser is complying with the relevant provisions of the Advisers Act.

- ► **See a copy of the SEC press release**
- ► **See a copy of the Letter**

Litigation

SEC Sanctions Credit Suisse for Providing Unregistered Services to U.S. Clients

On February 21, 2014, the SEC issued an order instituting settled administrative proceedings (the "**Order**") against Credit Suisse Group AG ("**Credit Suisse**"), an investment adviser (among other things) based in Zurich, for violating certain provisions of and rules under the Exchange Act and the Advisers Act by providing cross-border brokerage and investment advisory services to U.S. clients without registering with the SEC.

According to the Order, starting in 2002, Credit Suisse conducted cross-border advisory and brokerage services for thousands of U.S. clients, eventually collecting fees totaling approximately $82 million without registering as a broker-dealer or investment adviser. According to the SEC, Credit Suisse sent relationship managers to the U.S. to solicit clients, provide investment advice and induce securities transactions, even though it was aware that, in certain instances, if its representatives provided such services, U.S. broker-dealer and investment adviser registration would be required. The Order stated that Credit Suisse only began to exit the business of providing cross-border advisory and brokerage services to U.S. clients in October 2008, after a much-publicized investigation into Swiss bank UBS, and that it took Credit Suisse until 2013 to completely exit the cross-border business.

As a result of these activities, the SEC alleged that Credit Suisse willfully violated Section 15(a) of the Exchange Act and Section 203(a) of the Advisers Act. As part of the settlement, Credit Suisse admitted the facts in the Order and acknowledged that its conduct violated federal securities law. Credit Suisse further agreed to a censure and a cease-and-desist order, and agreed to retain an independent consultant. Credit Suisse also agreed to pay $196,000,000 in disgorgement, prejudgment interest and civil penalties.

- ► **See a copy of the SEC Order**

- See a copy of the Press Release

Notes from Europe: European Regulatory Developments

European Court of Justice Decision on Scope of ESMA's Powers

On January 22, 2014, the European Court of Justice ("**ECJ**") rejected the UK's action to annul powers granted to the European Securities and Markets Authority ("**ESMA**") under the 2012 European Short Selling Regulation (Regulation (EU) No 236/2012) ("**SSR**") to intervene in EU Member States' financial markets in certain circumstances. The UK had brought an action before the ECJ against the European Parliament and the European Council seeking an annulment of Article 28 of the SSR arguing that granting ESMA the power to intervene directly in Member States' financial markets gave ESMA a large measure of discretion of a political nature which is at odds with EU principles relating to the delegation of powers. The UK had further argued that the legal basis for the granting of such powers was incorrect. The ECJ held, however, that Article 28 is compatible with EU law and as such rejected the UK's arguments and dismissed the action in its entirety.

Under Article 28, ESMA can, *inter alia*, in certain specified times of market distress (i.e., where there is a threat to the orderly functioning and integrity of the financial markets or to the stability of the whole or a part of the financial system in the EU) directly prohibit or impose conditions on market participants in specific Member States from entering into short sales or transactions the effect of which is to confer a financial advantage on a person in the event of a decrease in the price or value of another financial instrument. Such measures adopted by ESMA would prevail over any previous measures taken by the Member States' competent authorities and would automatically expire after 3 months unless renewed by ESMA.

This judgment creates a duality of jurisdiction between ESMA and the Member States' competent authorities which clients will need to be mindful of in relation to an increasing range of financial services regulation. Recent and proposed European level financial services legislation has increasingly come in the form of regulations (which are directly applicable in Member State law) rather than directives (which require implementing legislation to be passed at a Member State level). These regulations tend to include powers of intervention for ESMA in cases of market distress that affects the EU's internal market. As such, this judgment represents a further shift in the gravity of financial services regulation from the competent authorities of the Member States to ESMA.

- See a copy of the ECJ's judgment
- See a copy of the Short Selling Regulation

ESMA Publishes Updated Q&A on the Application of the AIFMD

On February 17, 2014, ESMA published its first questions and answers paper on the application of the Alternative Investment Fund Managers Directive ("**AIFMD**"). ESMA will, as with other Q&As that it publishes, be updating the Q&As periodically as and when queries are received. Ultimately, some of the questions may become ESMA guidelines. The purpose of the Q&A is to ensure a common supervisory approaches and practices across the competent authorities in the Member States to AIFMD.

The February 17 Q&A provide clarity in relation to a number of topics, including:

- *Application of the remuneration restrictions*: There are a number of requirements in relation to remuneration set out in the AIFMD, including restrictions on the manner in which the variable component of senior manager or risk takers' remuneration can be paid. For further details of these restrictions, please see the August 8, 2013 Davis Polk Client Memorandum, ***European Regulatory Snapshot: Remuneration in the Financial Services Industry***. The AIFMD

provides that alternative investment fund managers ("**AIFMs**") performing management activities prior to July 22, 2013 will become subject to the AIFMD remuneration rules once they become authorized. The rules on variable remuneration will, however, apply to the calculation of payments relating to new awards of variable remuneration for the performance period following that in which the AIFM becomes authorized (i.e., the AIFMD regime on variable remuneration should only apply to full performance periods and should first apply to the first full performance period after the AIFM becomes authorized). For AIFMs whose accounting period ends on December 31, 2013 however and who submit an application for authorization before July 22, 2014 but obtain authorization after July 22, 2014, the AIFMD rules on variable remuneration should apply to the calculation of payments relating to the 2015 accounting period.

- *Reporting under article 42 of the AIFMD*: Under Article 42 of the AIFMD, non-EU AIFMs are obliged to make regular reports to the competent authorities of the Member States in which they market alternative investment funds ("**AIFs**"). ESMA has clarified that such AIFMs need only make reports in relation to the specific AIFs that are marketed in that Member State.
- *Notification of AIFs*: ESMA has confirmed that AIFMs wishing to market new investment compartments of AIFs in a Member State, even if the AIFM has already notified the local competent authority that it intends to market the AIF, will need to make a new notification in relation to that specific investment compartment.

General questions on the practical application of the AIFMD may be sent to ESMA at **AIFMD-questions@esma.europa.eu.**

- **See a copy of the updated ESMA Q&A**

ESMA Publishes Updated Table of Current AIFMD Memoranda of Understanding

On February 20, 2014, ESMA published an update of its table detailing which EU Member State regulators have signed memoranda of understanding for the exchange of information with which non-EU regulators. Under the AIFMD, one of the three conditions for the marketing of an AIF by a non-EU AIFM is that a cooperation agreement for the purpose of systemic risk oversight be in place between the competent authorities of the EU Member State where the AIFs are to be marketed and the competent authorities of the third country in which both the non-EU AIFM and the non-EU AIF are established in order to allow for the exchange of information between those competent authorities. There are now agreements in place between competent authorities in the majority of EU Member States and the Cayman Islands Monetary Authority, the US Securities and Exchange Commission and the US Commodities and Futures Trading Commission. It is worth noting, however, that as of the date of publication of this update there is no agreement between either the Italian or the Spanish competent authorities and the Cayman Islands Monetary Authority.

- **See a copy of the updated ESMA table**

Political Agreement Has Been Reached on UCITS V

On February 25, 2014, the European Parliament and the Council of the EU reached a political agreement on the proposed text of the fifth directive on undertakings for collective investments in transferable securities ("**UCITS V**"). UCITS V is expected to be formally adopted by the European Parliament at first reading and will come into force 20 days after publication in the Official Journal of the European Union. During the course of 2014, ESMA is expected to adopt the necessary technical standards in relation to UCITS V with the directive expected to apply from 2016.

The key features of the UCITS V directive relate to remuneration, the appointment of a depositary and penalties for funds that fail to comply with Member States' requirements and their reporting obligations. These are set out in greater detail below:

- *Remuneration*: Fund managers would not be required to take investment risks beyond what is accepted by their UCITS investors. In order to encourage managers to take a long term perspective, at least half of the variable element of their pay would have to be in the form of interests in their UCITS (or equivalent non-cash instruments with equally effective incentives) with payment of at least 40% of this variable remuneration having to be deferred for at least 3 years. ESMA has been charged with preparing guidelines setting out which individuals within the manager should be subject to these remuneration requirements.
- *Depositaries*: UCITS or the UCITS manager will be required to appoint a single depositary (either a credit institution or another authorized legal entity with sufficient own funds) to act as custodian and to oversee investor payments to the fund. Depositaries will need to be authorized and will be obliged to segregate investors' money from their own assets. They would also be prohibited from investing in the funds that they act as depositary for and, similarly to depositaries under the AIFMD, they will be deemed liable for any loss of assets, even if they delegate custody of them to a third party.
- *Penalties*: Each EU Member State will be obliged to provide for harmonized administrative penalties for funds that fail to comply with national UCITS authorization and reporting rules. Such penalties are to include, inter alia, a suspension of authorization and a temporary or permanent ban from fund management. Companies can also be fined up to 10% of their annual turnover or €5 million and individuals up to €5 million. Sanctions will also include fines of up to twice the amount of profit made.

- **See a copy of the Press Release**
- **See a copy of the final compromise text of March 13, 2013**

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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