Investment Management Regulatory Update

August 20, 2013

SEC Rules and Regulations

SEC Grants No-Action Relief to Allow Registered Investment Companies to Maintain Assets with CME to Meet Margin Requirements for Additional Swaps Cleared by CME

On July 10, 2013, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued a no-action letter to the Chicago Mercantile Exchange ("**CME**") stating that it would not recommend enforcement action to the SEC under Section 17(f) of the Investment Company Act of 1940 (the "**Investment Company Act**") against any registered investment company (a "**RIC**") if the RIC (or its custodian) places or maintains its assets in the custody of (1) the CME or (2) a CME or a Chicago Board of Trade clearing member that is a Commodity Futures Trading Commission ("**CFTC**") registered futures commission merchant (("**FCM**"), and such an FCM, a "**CME Clearing Member**") to satisfy CME's or a CME Clearing Member's margin requirements for certain cash-settled commodity index swap contracts ("**CIS**") and foreign currency swap contracts ("**FXS**") that are cleared by CME.

Section 17(f) of the Investment Company Act generally requires a RIC to place and maintain its securities only with qualified custodians. Rule 17f-6 under the Investment Company Act generally permits a RIC to place and maintain assets with an unaffiliated CFTC registered FCM in order for the RIC to execute transactions in certain exchange-traded futures contracts and commodity options, but not for CIS and FXS transactions. Under Rule 17f-6, the FCM must comply with certain segregation requirements and other conditions intended to provide protections in respect of the custody of a RIC's assets.

According to the no-action letter, CME operates its own CFTC regulated clearing house, which clears, settles and guarantees the performance of all transactions (including CIS and FXS transactions) cleared by CME or its affiliates. According to the no-action letter, RICs that rely on CME's clearing services must have an account with a CME Clearing Member, which clears CIS and FXS transactions for the RICs and posts margin with CME (thus requiring the RICs to post initial margin to secure performance of the transactions).

According to the no-action letter, CME Clearing Members that purchase, sell or hold CIS and FXS positions for RICs and other customers are required to (1) be registered with the CFTC as an FCM, (2) separately maintain the assets of customers that are not affiliates of the clearing member, (3) maintain adequate capital and liquidity and (4) maintain sufficient books and records to ensure that the foregoing requirements are being met. Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), which subjects certain swap transactions (including CIS and FXS swaps) to central clearing, in 2012, the CFTC adopted a model for the segregation of swap collateral referred to as the "legal segregation with operational commingling" ("**LSOC**") model, as discussed in the January 23, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Final Rule on Protection of Cleared Swap Customer Collateral***. According to the SEC, the relief provided by the no-action letter would permit the clearing of CIS and FXS transactions through FCMs prior to the implementation of any future mandatory clearing requirements of such swap contracts.

According to the no-action letter, the Division would not recommend enforcement action against a RIC that maintains assets in the custody of CME or a CME Clearing Member (and that is unaffiliated with the CME Clearing Member) in respect of CIS and FXS transactions if the requirements of Rule 17f-6 are otherwise satisfied and the RIC's assets are maintained pursuant to a written contract between the parties providing that:

- the CME Clearing Member "will comply with the requirements relating to the separate treatment of customer funds and property of CME and LSOC specifying the substantive requirements for the treatment of cleared OTC derivatives in the cleared swap account class prior to any bankruptcy";
- the CME Clearing Member is permitted to place and maintain the RIC's assets in connection with the clearing of CIS and FXS transactions and that the CME Clearing Member will obtain an acknowledgement (if required by CFTC Rule 1.20(a)) that such custodied assets are held on behalf of its customers in accordance with the requirements of the Commodity Exchange Act (the "**CEA**");
- upon request by the SEC, the CME Clearing Member will provide records or information pertaining to the RIC's assets;
- the CME Clearing Member may only maintain any gains on the RIC's transactions until the next business day after receipt (unless such gains are "*de minimis*"); and
- the RIC may withdraw its assets from the CME Clearing Member if the requirements of Rule 17f-6 are not being satisfied.

According to the no-action letter, the relief will expire on December 31, 2014.

- **See a copy of the no-action letter**

SEC Extends Immediate Effectiveness of Post-Effective Amendments to Additional Closed End Funds

On June 26, 2013, the Division of Investment Management of the SEC issued seven no-action letters to more than 30 closed-end funds (the "**Requesting Funds**") that enable the Requesting Funds to update the financial statements in, and to make non-material changes to, their shelf registration statements by filing a post-effective amendment under Rule 486(b) under the Securities Act of 1933 (the "**Securities Act**") that is deemed immediately effective. According to the no-action letters, each of the Requesting Funds filed and had declared effective by the SEC (or intends to file and have declared effective) a shelf registration statement on Form N-2. Rule 486(b) allows a post-effective amendment to the registration statement of a closed-end fund that makes periodic repurchase offers under Rule 23c-3 under the Investment Company Act (such fund, an "**interval fund**") to become immediately effective upon filing, provided that the post-effective amendment is filed for no purpose other than, among other things, to bring the financial statements up to date or to make non-material changes deemed appropriate by such fund, and that the interval fund makes certain representations concerning the purpose for which the amendment is filed. Absent the relief provided by the no-action letters, Rule 486(b) is not available to non-interval funds (such as the Requesting Funds), and as a result, such a fund must file a post-effective amendment to its registration statement to update its financial statements or to make other non-material changes without such post-effective amendment being deemed immediately effective.

According to the no-action letters, however, the Division would not recommend enforcement action against the Requesting Funds if the Requesting Funds filed post-effective amendments in compliance with Rule 486(b) and:

- the Requesting Fund files a post-effective amendment containing a prospectus pursuant to Section 8(c) of the Securities Act prior to any offering of its securities at a price below net asset value; and
- the Requesting Fund sells newly issued shares at a price no lower than the sum of the Requesting Fund's net asset value (taking into account any per share commission or underwriting discount).

In July 2013, the Division issued an Information Update discussing the extension of the benefits of Rule 486(b) to the Requesting Funds. The Information Update also contains a link to the no-action letters. According to the Information Update, the no-action letters will enable the Requesting Funds to file immediately effective post-effective amendments “without the delay and expense of the review process.” The SEC staff indicated that, due to the fact intensive nature of the issues involved, only the Requesting Funds could rely on these no-action letters.

- ▸ **See a copy of the Information Update**

Industry Update

CFTC Adopts Final Guidance on Cross-Border Swaps and Compliance Schedule

On July 12, 2013, the Commodity Futures Trading Commission (“**CFTC**”) adopted final cross-border guidance (the “**Final Guidance**”) that provides guidelines for the application of the CFTC’s swap regulatory regime to cross-border swap activities. At the same time, the CFTC adopted a phase-in compliance schedule (the “**Exemptive Order**”) that extends, with material changes, the cross-border exemptive order issued by the CFTC in January 2013. The Final Guidance and the Exemptive Order address several topics, including: (1) the final definition of U.S. person for purposes of the CFTC’s swap regulatory regime; (2) guidance on which swaps a non-U.S. person must include in, and can exclude from, its swap dealer *de minimis* and major swap participant (“**MSP**”) threshold calculations; (3) guidance on the types of offices the CFTC would consider to be a “foreign branch” of a U.S. swap dealer or MSP and the circumstances in which a swap transaction would be considered to be “with” such a foreign branch; (4) guidance on how swap-related requirements will be applied to cross-border swap transactions and when substituted compliance would be available if the CFTC determines that a foreign jurisdiction’s rules are comparable to its own; and (5) phased-in compliance periods for many of the swap regulatory regime’s requirements. For more information, see the July 3, 2012 Davis Polk Client Memorandum, ***CFTC Finalizes Cross-Border Swaps Guidance and Establishes Compliance Schedule***.

Comments on the Exemptive Order are due on August 21, 2013.

- ▸ **See a copy of the Final Guidance**
- ▸ **See a copy of the Exemptive Order**

SEC's Division of Investment Management Answers Questions Concerning Form 13F

On July 12, 2013, the staff of the SEC's Division of Investment Management issued responses updating the frequently asked questions ("**FAQs**") regarding the transition from the text-based Form 13F to the new online form and to provide additional clarification about the availability of confidential treatment. As discussed in the ***July 18, 2013 Investment Management Regulatory Update***, Form 13F filers will be required to use the new online version of Form 13F (which is available on the EDGAR Filing Website) starting with the quarter ended June 30, 2013 (which would render such filings due by August 14, 2013 using the online form) and must complete their Form 13F Information Table in accordance with the EDGAR XML Technical Specification. The updated FAQs answer a number of questions regarding Form 13F filings, including the following of particular note:

- *EDGAR Online Filing Procedures*. The FAQs indicate that filers may obtain a copy of the EDGAR Filer Manual on the SEC's website and refer filers to chapter 9 of the manual for specific instructions on how to file Form 13F. In addition, the FAQs provide filers with resources for constructing Form 13F submissions (including the Information Table) using EDGAR XML Technical Specification.
- *Voting Authority*. The FAQs acknowledge that column 8 of Form 13F, relating to voting authority, only allows a filer to enter 8 digits with respect to the number of securities a filer owns for a single issuer. According to the FAQs, if a filer would otherwise be required to enter more than 8 digits, then the filer should enter "99,999,999" and provide the correct number on the cover page as is permitted under Special Instruction 5 of Form 13F.
- *Confidential Treatment*. The FAQs provide that confidential treatment is available for a Form 13F filing pursuant to Section 13(f)(4) of the Exchange Act, under which the SEC may not disclose "personal holdings" information filed on Form 13F, including information that identifies securities held by a natural person, an estate or a personal trust (but not business trusts or investment companies). In addition, Section 13(f)(4) allows the SEC to prevent or delay public dissemination of information filed on Form 13F for "public interest" or investor protection reasons (in accordance with the exceptions under the Freedom of Information Act ("**FOIA**")). The FAQs note that an investment management firm's request for confidential treatment for commercial reasons (such as confidential treatment requests of investment positions, including, most typically, non-risk arbitrage investment positions) may be granted under the FOIA exception 4, which protects "trade secrets and commercial or financial information obtained from a person and privileged or confidential."

The Division also issued an August 2013 IM Information Update in relation to the updated Form 13F FAQs.

- **See a copy of the FAQs**
- **See a copy of the IM Information Update**

Litigation

Department of Justice Indicts Hedge Fund Advisers and SEC Charges Advisers' Founder

On July 25, 2013, the Department of Justice (the "**DOJ**") indicted S.A.C. Capital Advisors, L.P. ("**SAC LP**"), S.A.C. Capital Advisors LLC ("**SAC LLC**"), CR Intrinsic Investors, LLC ("**CR Intrinsic**") and Sigma Capital Management, LLC ("**Sigma Capital**," and together with SAC LP, SAC LLC and CR Intrinsic, the "**SAC Entities**"), a group of affiliated investment advisers founded, owned and controlled by Steven A. Cohen, for being criminally responsible for an insider trading scheme carried out by certain of the SAC Entities' employees and "made possible by institutional practices that encouraged the widespread solicitation and use of illegal inside information." In addition to the DOJ's charges against the SAC Entities, on July 19, 2013, the SEC charged Cohen for failing to "take reasonable steps to investigate and prevent" insider trading by two former employees, Matthew Martoma (the former portfolio manager of CR Intrinsic) and Michael S. Steinberg (the former portfolio manager of Sigma Capital). For a discussion of the SEC's charges against Martoma and Steinberg, please see the ***April 29, 2013 Investment Management Regulatory Update***. The SEC alleged that Cohen, who supervised Martoma and Steinberg, ignored "red flags" that Martoma and Steinberg were using material non-public information ("**MNPI**") in connection with trades executed for hedge funds managed by the SAC Entities. According to the SEC, Cohen praised Steinberg and awarded Martoma a $9 million bonus for their roles in trades made based on MNPI.

In addition, on July 30, 2013, the SEC filed an amended complaint charging Richard Lee, a former SAC LP portfolio manager, and Sandeep Aggarwal, an internet research analyst who the SEC alleged provided MNPI to Lee on which Lee traded, with violating Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Rule 10b-5 thereunder.

In its indictment against the SAC Entities, the DOJ alleged that the SAC Entities' "institutional indifference to. . .unlawful conduct resulted in insider trading that was substantial, pervasive and on a scale without known precedent in the hedge fund industry." The DOJ alleged that from 1999 to 2010, the SAC Entities and certain of their affiliates engaged in an insider trading scheme that (1) sought to hire portfolio managers with "proven access to public company contacts likely to possess [MNPI]," (2) incentivized portfolio managers to recommend to Cohen so-called "high conviction" trading ideas in which the portfolio managers had an "edge" over other investors without any inquiry into whether such an "edge" was based on MNPI, and (3) failed to implement effective compliance procedures or practices to prevent trading based on MNPI. The DOJ alleged that the scheme caused the SAC Entities to have a culture "in which there was no meaningful commitment to ensure that such an 'edge' came from legitimate research and not [MNPI]," which resulted in "predictable and foreseeable" insider trading.

Based on the allegations, the DOJ charged the SAC Entities with violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The DOJ is seeking forfeiture of all proceeds derived from the alleged violations (or, if such proceeds are not available for forfeiture, the DOJ would seek other assets of the SAC Entities up to the value of the forfeitable proceeds).

In addition, the SEC charged Cohen with failing to reasonably supervise Martoma and Steinberg with a view to prevent their violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Further, the U.S. Attorney's Office for the Southern District of New York is pursuing criminal charges against each of Martoma and Steinberg. According to an order granted on August 8, 2013, the SEC's charges against Cohen have been stayed until after the conclusion of the proceedings related to the criminal charges against Martoma and Steinberg.

- **See a copy of the DOJ's indictment against the SAC Entities**
- **See a copy of the SEC's press release announcing the charges against Cohen**
- **See a copy of the SEC's order against Cohen**
- **See a copy of the SEC's amended complaint against Lee and Aggarwal**

CFTC Brings First "Spoofing" Case Against High-Frequency Trading Firm

On July 22, 2013, the CFTC settled charges for "spoofing" against Panther Energy Trading LLC ("**Panther**"), a high-frequency trading firm, and Michael J. Coscia ("**Coscia**"), a floor broker registered with the CFTC and Panther's manager and sole owner. "Spoofing" refers to the practice of placing orders with the intent to cancel such orders before execution to create the impression of market momentum or depth. According to the CFTC's press release on the settlement, the charges against Panther and Coscia are the CFTC's first such "spoofing" case under Section 4c(a)(5)(C) of the CEA, which was added to the

CEA by Section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and which makes it unlawful to engage in any trading, practice or conduct that “is, is of the character of, or is commonly known to the trade as, ‘‘spoofing’’ (bidding or offering with the intent to cancel the bid or offer before execution).”

According to the CFTC’s order charging Panther and Coscia, during an approximately two-month period in 2011, Panther and Coscia employed an algorithmic trading program to place bids and offers on commodity futures contracts, but would quickly cancel such bids and offers before execution. For example, according to the CFTC, Panther and Coscia would place a small sell order, then, “within a fraction of a second,” place large buy orders at progressively higher prices that were higher than the orders being placed by other market participants, which would indicate to the market that there was significant buying interest. According to the CFTC’s order, the practice increased the interest of market participants in Panther and Coscia’s initial sell order. The CFTC alleged that after the sell orders were filled, Panther and Coscia would cancel their buy orders and that the algorithm would then, by design, operate in reverse (i.e., the algorithm would enter a small buy order followed by large sell orders at progressively lower prices with the intent to cancel such orders).

Based on such conduct, the CFTC charged that Panther and Coscia violated Section 4c(a)(5)(C) of the CEA. Without admitting or denying the CFTC’s findings, Panther and Coscia agreed to settle the charges. The CFTC ordered each to cease and desist from future violations of the relevant provisions of the CEA, ordered the payment of disgorgement of $1.4 million plus post-judgment interest and the payment of a civil penalty of $1.4 million plus post-judgment interest, and barred Panther and Coscia from engaging in trading on or subject to the rules of any CFTC registered entity for one year. According to the CFTC’s press release, the CME Group Inc. (the “**CME Group**”), which owns the exchanges on which Panther and Coscia executed the unlawful trades, fined Panther and Coscia $800,000, ordered the payment of disgorgement of $1.3 million and imposed a six-month ban on Panther and Coscia from trading on the CME Group’s exchanges. According to the CFTC’s press release, its order of disgorgement will be offset by any amount paid by Panther and Coscia in connection with the order of disgorgement by the CME Group.

- **See a copy of the CFTC’s press release**
- **See a copy of the CFTC’s order**

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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