Investment Management Regulatory Update

May 20, 2015

SEC Rules and Regulations

SEC Proposes Rules to Modernize and Enhance Information Reported by Investment Companies and Investment Advisers

On May 20, 2015, the Securities and Exchange Commission (the "**SEC**") proposed rules, forms and amendments to strengthen and update reporting and disclosure by registered investment companies ("**RICs**") and investment advisers.

The proposals relating to RICs would enhance reporting of performance and other data for mutual funds, exchange-traded funds ("**ETFs**") and other types of RICs by requiring two new forms: a monthly portfolio reporting form (Form N-PORT) and an annual reporting form (Form N-CEN). These forms would require that RICs report census-type information in a "structured data" format (similar to reporting required for money market funds through Form N-MFP and certain private funds through Form PF). In addition, the proposed amendments would require enhanced disclosures in RICs' financial statements, including specific information relating to derivatives and a RIC's lending activities.

The proposals relating to investment advisers involve a proposed amendment to Form ADV that would require investment advisers to provide additional information regarding use of borrowings and derivatives in separately managed accounts, branch office operations and use of social media (among other things). Further, the SEC stated that the proposals would permit certain "umbrella registration" filing arrangements that are currently outlined in staff guidance. In addition, the SEC proposed amendments to Rule 204-2 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), to require advisers to maintain records of performance calculations and communications related to performance.

The comment period for the proposed rules will be 60 days from the publication in the Federal Register. Davis Polk will be following up with a more detailed summary of these proposed rules.

- See a copy of the Press Release
- See a copy of the Proposed Rules

Industry Update

SEC Division of Investment Management Publishes Cybersecurity Guidance

On April 28, 2015, the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update to assist registered investment companies and registered investment advisers with cybersecurity concerns.

According to the IM Guidance Update, there are a number of measures that funds and advisers should consider when developing cybersecurity policies. These measures fall into three categories: (1) periodic assessments, (2) development of prevention, detection, and response strategies and (3) implementation of such strategies.

Assessments. The IM Guidance Update encourages funds and advisers to implement a program that periodically assesses the following:

- the nature, sensitivity, and location of information that the adviser collects, processes, and stores, and the technology systems utilized;
- internal and external cybersecurity threats and vulnerabilities;
- security controls and processes;
- the potential impact on the adviser if systems are compromised; and
- the effectiveness of the adviser's governance structure for managing cybersecurity risk.

Strategies. The IM Guidance Update also suggests that funds and advisers develop strategies to prevent, detect and respond to cybersecurity threats. A list of such strategies could include:

- controlling access to various systems and data;
- data encryption;
- restrictions on the use of removable storage media and monitoring violations of such restrictions;
- data backup and retrieval; and
- development of an incident response plan.

Implementation. The IM Guidance Update urges advisers to implement such strategies through written policies and procedures, as well as personnel training. According to the IM Guidance Update, the training should educate officers and/or employees on cybersecurity threats, prevention, detection and response measures being taken by the adviser, and compliance monitoring. The IM Guidance Update also states that firms should consider educating investors and clients on how to reduce their exposure to cybersecurity threats that might affect their accounts.

According to the IM Guidance Update, funds and advisers should integrate cybersecurity concerns into existing compliance policies reasonably designed to comply with the federal securities laws. Moreover, they should consider the nature and scope of the business's operations in developing compliance programs. The IM Guidance Update also encourages funds and advisers to consider assessing the adequacy of cybersecurity protections employed by relevant service providers.

- See a copy of the IM Guidance Update

Division of Investment Management Releases FAQs related to Money Market Fund Reforms

The Division of Investment Management of the SEC has released FAQs in response to questions related to the money market fund reforms adopted in July 2014. For a detailed discussion of the amendments to the rules and related requirements governing money market funds, please see the August 5, 2014 Davis Polk Client Memorandum, ***SEC Adopts Money Market Fund Reforms***.

- **See a copy of the FAQs**

OCIE Director Andrew Bowden Leaves SEC; Marc Wyatt Named as Acting Director

On April 7, 2015, the Securities and Exchange Commission ("**SEC**") announced that Andrew Bowden, Director of the Office of Compliance Inspections and Examinations ("**OCIE**"), planned to depart from the SEC after more than three years of service. The SEC announced on April 9, 2015 that Marc Wyatt will serve as Acting Director of OCIE.

During his time with OCIE, Bowden worked on several initiatives related to data and technology. He enhanced OCIE's analysis of its data collections to develop more targeted and effective examinations and promoted the sharing of OCIE's information collections within the SEC and with the public. He also helped transfer the Technology Controls Program to OCIE's oversight and worked to implement OCIE's examination of the industry's cybersecurity preparedness.

Bowden also worked to implement new exam initiatives to address a variety of investor concerns, including the interests of older and retiring investors, the fees paid to distribution entities by investment advisers and mutual funds, business continuity in the wake of Hurricane Sandy, risks posed by fixed income and alternative mutual funds and other developments in the broker-dealer and investment adviser businesses. Bowden also helped to educate newly registered advisers through the "Presence Exam" initiative, which is now expanding into the "Never Before Examined" initiative for new registered investment advisers and registered investment companies.

Bowden joined OCIE in 2011 as the National Associate for the Investment Adviser/Investment Company examination program. He became OCIE's Deputy Director in 2012 and was named Director of OCIE in 2013. According to the press release, Bowden planned to return to the private sector.

Wyatt has acted as OCIE's Deputy Director since 2014, leading the Technology Controls program and serving on OCIE's Operating and Executive Committees. He has also served as the national co-coordinator of the Private Fund Specialized Working Group of OCIE and helped create the Private Fund Examination Unit. Wyatt joined the SEC in 2012, performing examinations as a senior specialized examiner for hedge funds and private equity funds. Before joining the SEC, Wyatt was a senior portfolio manager and principal of a global hedge fund.

- **See a copy of the Andrew Bowden Press Release**
- **See a copy of the Marc Wyatt Press Release**

Litigation

BlackRock Advisors Charged with Failure to Disclose Conflicts of Interest

On April 20, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against BlackRock Advisors, LLC ("**BlackRock**") for breaching its fiduciary duty in violation of Sections 206(2) and 206(4) of the Advisers Act, Rule 206(4)-7 thereunder and Rule 38(a)-1(a) under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). The SEC charged BlackRock in connection with its failure to disclose a conflict of interest created by the

personal business activities of one of its portfolio managers, Daniel J. Rice, III ("**Rice**"). The SEC also charged BlackRock's then-chief compliance officer ("**CCO**") with similar violations.

According to the Order, Rice managed the energy sector assets of several of BlackRock's registered funds, private funds and separately managed accounts while simultaneously serving as the general partner of Rice Energy, an oil and natural gas production business founded by Rice—who had invested approximately $50 million in the company—and run by his family. The SEC alleged that BlackRock learned that Rice had formed an upper-tier vehicle to hold interests in Rice Energy in violation of the firm's private investment policy and subsequently consulted with its compliance personnel, but ultimately permitted Rice to form Rice Energy and did not disclose the matter to the funds' boards or to its advisory clients. The SEC also found that BlackRock failed to monitor Rice's continual investments in the business. According to the Order, BlackRock did not reassess Rice's activities until he later requested that BlackRock permit him to serve on the board of a joint venture between Rice Energy and Alpha Natural Resources ("**ANR**"), one of the largest holdings in BlackRock's Energy & Resources Portfolio, managed by Rice. BlackRock acknowledged the potential conflict of interest and did not permit Rice to accept the board position. BlackRock permitted Rice to continue managing the ANR stock positions subject to certain restriction on information sharing and on Rice's involvement in the management of the joint venture. According to the Order, BlackRock did not disclose these matters to the funds' boards or to its advisory clients.

Under Section 206(2) of the Advisers Act, investment advisers are prohibited from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. The SEC alleged that BlackRock had willfully violated Section 206(2) by failing to disclose Rice's activities to the funds' boards of directors or to its advisory clients, thereby breaching its fiduciary duty. In addition, Rule 206(4)-7 under the Advisers Act requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. According to the Order, BlackRock violated Rule 206(4)-7 by failing to adopt and implement written procedures to evaluate and monitor its employees' external business activities and to make the appropriate disclosures, which failures were caused by BlackRock's then-CCO.

Furthermore, the SEC alleged that BlackRock and its then-CCO caused certain BlackRock funds to violate Rule 38a-1(a) under the Investment Company Act, which generally requires an investment company, through its CCO, to report material compliance matters to the investment company's board at least annually. According to the Order, BlackRock and its then-CCO violated Rule 38a-1(a) by failing to disclose Rice's violations of BlackRock's personal investment policy. According to the SEC's press release, this action represents the first time the SEC has charged an investment adviser for violating Rule 38a-1(a).

BlackRock and the former CCO agreed to settle the charges without admitting or denying the SEC's findings. The SEC censured BlackRock and ordered it to pay a civil money penalty of $12 million and to hire an independent compliance consultant. The former CCO further agreed to pay a civil money penalty of $60,000.

- **See a copy of the Press Release**
- **See a copy of the SEC Order**

SEC Charges Santa Barbara-Based Hedge Fund Firm, Executives and Auditor for Improper Expense Allocations

On April 29, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Santa Barbara-based hedge fund firm Alpha Titans LLC ("**Alpha Titans**"), its CEO, and its General Counsel (collectively, the "**Respondents**") for improper allocation of fund assets to pay adviser-related operating expenses and distribution of materially misleading financial statements to investors, thereby violating Sections 206(2), 206(4), and 207 of the Advisers Act and Rules

206(4)-2, 206(4)-7, and 206(4)-8 promulgated thereunder. The SEC also issued an order (the "**Auditor Order**") in connection with these alleged activities instituting and settling administrative and cease-and-desist proceedings against Alpha Titans' outside auditor for violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder.

According to the Order, the Respondents used assets from two affiliated private funds (the "**Funds**") to pay for operating expenses without clear authorization to do so in the Funds' operating documents. The improper allocations took place from 2009 to 2012 and amounted to $469,522, which was used towards office rent, utilities, technology services, employee salaries and health benefits, and other expenses. According to the Order, Alpha Titans should have disclosed these amounts in its 2009, 2010, 2011 and 2012 Forms ADV as "other" forms of compensation under Item 5.E, but failed to do so. The SEC also alleged that from 2009 to 2012, the Respondents reviewed and distributed audited financial statements to the Funds' investors that failed to disclose almost $3 million in material related party transactions tied to the payment of Alpha Titans' operating expenses by the Funds. Therefore, the SEC found that these financial statements did not comply with GAAP, which provides disclosure requirements for related party transactions, and were thus in violation of Advisers Act Rule 206(4)-2(b)(4). According to the Auditor Order, the outside auditor willfully aided and abetted Alpha Titans' violations by engaging in improper professional conduct while auditing and signing off on the financial statements distributed to the Funds' investors from 2009 to 2012.

According to the Order, the Respondents agreed to settle the SEC's charges without admitting or denying the SEC's findings. Alpha Titans and its CEO agreed to pay disgorgement of $469,522, prejudgment interest of $28,928, and a civil penalty of $200,000. The CEO and the General Counsel agreed to be barred from the securities industry for one year, and the General Counsel further agreed to be suspended from practicing as an attorney before the SEC for one year. According to the Auditor Order, the auditor also agreed to settle the SEC's charges without admitting or denying the SEC's findings, pay a civil penalty of $75,000 and be suspended from practicing as an accountant before the SEC for at least three years.

- **See a copy of the Press Release**
- **See a copy of the Order**
- **See a copy of the Auditor Order**

SEC Orders Maximum Award to Whistleblower in Paradigm Capital Case

On April 28, 2015, the SEC issued an order determining a whistleblower award claim (the "**Award Order**") for thirty percent of the amounts collected in the retaliation case against Paradigm Capital Management ("**Paradigm**"), the maximum amount allowed. In a June 2014 order (the "**Initial Order**"), the SEC charged Paradigm, an Albany, N.Y.-based hedge fund advisory firm, and its owner for engaging in prohibited principal transactions with an affiliated broker-dealer and for retaliating against the employee who reported the misconduct to the SEC, in violation of Section 21F(h) of the Securities and Exchange Act of 1934 as amended (the "**Exchange Act**") and Sections 206(3) and 207 of the Advisers Act. According to the press release, the case marked the first retaliation enforcement action brought under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Section 21F(h)(1) of the Exchange Act generally prohibits employers from taking retaliatory actions against a whistleblower for providing information to the SEC or for cooperating with the SEC in certain actions or investigations. Under Regulation 21F under the Exchange Act, eligible whistleblowers can apply to the Office of the Whistleblower, which administers the program, for an award of up to thirty percent of the monetary sanctions that the SEC and other authorities collect. Awards are paid from the SEC's Investor Protection Fund rather than out of the recovered funds.

According to the Initial Order, Paradigm retaliated against the employee by removing him from his then-current position as the firm's head trader, eliminating his supervisory duties, charging him with investigating the alleged misconduct himself and generally taking steps to marginalize him. Paradigm and its founder settled the proceedings without admitting or denying the SEC's findings. Please see the ***July 24, 2014 Investment Management Regulatory Update*** for more information about the case.

Rule 21F-6 under the Exchange Act sets forth the criteria for determining the amount of an award. Factors that can increase the amount of the award generally include: (1) the significance of the information provided by the whistleblower, (2) the degree, quality and personal cost of the assistance provided by the whistleblower, (3) law enforcement's interest in making the award and (4) the whistleblower's participation in internal compliance systems. According to the Award Order, the SEC granted the employee the maximum award of thirty percent of the recovered amounts, which will total over $600,000, because of the unique hardship suffered by the employee through Paradigm's retaliation and the law enforcement interest in preventing retaliation against whistleblowers.

According to the press release, the SEC has ordered awards of over $50 million to seventeen whistleblowers in the three years since the program began. Please see the ***September 26, 2012 Investment Management Regulatory Update*** for more information about the SEC's first whistleblower award.

- **See a copy of the Press Release**
- **See a copy of the Award Order**
- **See a copy of the Initial 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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