Investment Management Regulatory Update

February 18, 2015

SEC Rules and Regulations

SEC Proposes Hedging Disclosure Rule

On February 9, 2015, the Securities and Exchange Commission (the "**SEC**") proposed a long-awaited rule (the "**Proposed Rule**") on disclosure of company equity hedging policies, as required by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Proposed Rule would require companies to disclose whether they permit any employees, officers or directors, or any of their "designees," to purchase financial instruments or otherwise engage in transactions that are designed to have the effect of hedging or offsetting any decrease in the market value of company equity securities:

- granted as part of compensation; or
- held by them, "directly or indirectly."

The disclosure would be required in any proxy statement or information statement relating to an election of directors. Although the Proposed Rule does not specify when it will go into effect, given the comment period, it cannot go into effect until late April 2015, at the earliest. This means that, for most calendar-year companies, this disclosure should *not* be required during this current proxy season.

The Proposed Rule is a disclosure rule only, which does not require companies to prohibit hedging or adopt hedging policies. The major proxy advisory services, however, are vocal in their belief that allowing executive officer and director hedging is a problematic practice, and companies will undoubtedly continue to feel pressure from shareholders to adopt anti-hedging policies for those individuals.

The SEC has requested comment on the proposal within 60 days after its publication in the Federal Register (which has yet to occur). Thus, the comment period should last through mid-April 2015.

Although open-end registered investment companies (commonly known as mutual funds) would not be subject to the Proposed Rule, closed-end investment companies that have shares that are listed and registered on a national securities exchange ("listed closed-end funds"), along with business development companies, would be required to provide the proposed disclosure. In the release accompanying the Proposed Rule, the SEC explained why it believes the proposed disclosure is not as useful for investors in funds that are not listed closed-end funds. First, according to the SEC, such funds generally have a differing management structure: personnel who operate the fund are generally employed and compensated by a fund's investment adviser and the granting of shares as incentive-based compensation to a fund's directors is uncommon (and in some cases is prohibited). In addition, according to the SEC, such funds are subject to a differing regulatory regime in that, among other things, (i) they are generally not required to hold annual meetings of shareholders and (ii) their shares are purchased and sold differently than those of operating companies.

The SEC stated that listed closed-end funds, while similar in certain respects to funds in general, have features that make requiring the Item 407(i) disclosure appropriate. The SEC highlighted the fact that shares of listed closed-end funds trade at negotiated market prices—and often at a discount to NAV—on a national securities exchange and are not redeemable from the funds. Therefore, according to the SEC, subjecting listed closed-end funds to the proposed disclosure requirements would inform shareholders of whether a listed closed-end fund permits its directors and employees to hedge the value of the fund's securities held by these persons and thus whether they could protect themselves from increases in the fund shares' discount to NAV. This information may be valuable to an investor when evaluating the alignment of interests between the fund director or employee and the fund's other shareholders, according to the SEC, in particular in considering whether the director or employee may be incentivized to seek to decrease the discount to NAV as a result of holding shares in the fund.

The SEC also highlighted the requirement of listed closed-end funds to hold annual meetings of shareholders and that their officers and directors are, like those of emerging growth companies and smaller reporting companies subject to the Proposed Rule, subject to the requirement in Section 16(a) of the Securities Exchange Act of 1934 (the "**Exchange Act**") to report certain hedging transactions.

Please see the February 11, 2015 Davis Polk Client Memorandum, **SEC Proposes Hedging Disclosure Rule**, for a discussion of further highlights of the proposal, including details on the disclosure requirements set forth in the Proposed Rule.

- **See a copy of the Proposed Rule**

Industry Update

Electronic Blue Sky Notice Filings for Regulation D Offerings

On December 15, 2014, the North American Securities Administrators Association ("**NASAA**") announced the launch of an online Electronic Filing Depository ("**EFD**") to accept electronic notice filings in connection with offerings under Rule 506 of Regulation D under the Securities Act of 1933 (the "**Securities Act**") EFD is an Internet-accessible database that allows issuers to electronically submit blue sky notice filings and pay related fees to state securities regulators in connection with Regulation D offerings. Although EFD currently accepts only Form D filings, NASAA expects that it will be expanded in the future to include additional state securities registration and notice filing materials. Filing blue sky notices electronically will reduce the cost of blue sky compliance and reduce the risk of late filings. According to NASAA, filings made on EFD are publicly available at **www.efdnasaa.org**.

Currently, most blue sky authorities accept notice filings made through EFD. It is expected that in a few months, most states will require these filings to be made though EFD.

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

Office of Compliance Inspections and Examinations Releases Cybersecurity Examination Sweep Summary

On February 3, 2015, the Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert summarizing the results of its recent cybersecurity examination sweep (the "**Summary**"). According to OCIE, the staff examined 57 registered broker-dealers and 49 registered investment advisers to understand how broker-dealers and advisers address the legal, regulatory and compliance issues associated with cybersecurity. According to the Summary, the information collected from the firms was related to their practices for identifying risks; establishing cybersecurity governance and oversight processes; protecting firm networks and information; identifying and addressing risks associated with remote access to client information and fund transfer requests; identifying and addressing risks associated with vendors and other third parties; and detecting unauthorized activity. In the Summary, OCIE noted that there was limited review of the accuracy of the responses to staff questions and the extent to which firms' policies and procedures were implemented, and no review of the technical sufficiency of the firms' programs.

The Summary included, among other things, the following key observations from the examinations conducted:

- The majority of examined firms (93% of broker-dealers and 83% of advisers) have adopted written information security policies. Additionally, a majority of the examined firms (89% of the broker-dealers and 57% of the advisers) conduct periodic audits to determine compliance with their information security policies and procedures. Only a small proportion (30% of broker-dealers and 13% of advisers) have written policies and procedures that address how firms determine whether they are responsible for client losses associated with cyber incidents. An even smaller proportion (15% of broker-dealers and 9% of advisers) offered security guarantees to protect their clients from cyber-related losses.
- The vast majority (93% of broker-dealers and 79% of advisers) of examined firms conduct periodic risk assessments to identify cybersecurity threats, vulnerabilities and potential business consequences. Fewer firms (84% of broker-dealers and 32% of advisers), however, require cybersecurity risk assessments of vendors with access to their firms' networks. While most of the examined broker-dealers (72%) incorporate requirements relating to cybersecurity risks into their contracts with vendors and business partners, a smaller proportion (24%) of the examined advisers incorporated such requirements. About half of the broker-dealers (51%) maintain policies and procedures related to information security training for vendors and business partners authorized to access the firm's networks while a much smaller proportion (13%) of advisers have such policies.
- Most examined firms (88% of broker-dealers and 74% of advisers) reported that they have had a cyber-related incident. Approximately half (54% of broker-dealers and 43% of advisers) reported receiving fraudulent emails seeking to transfer client funds. Although the examined firms generally identified misconduct by the employees and other authorized users of the firms' networks as a concern, only a small proportion (11% of broker dealers and 4% of advisers) reported incidents in which an employee or other authorized user engaged in misconduct resulting in the misappropriation of funds, securities, sensitive client or firm information or in damage to the firms' networks.

- Over half of the broker-dealers (58%) maintain insurance for cybersecurity incidents. Only a small number of the advisers (21%) maintain insurance that covers losses and expenses attributable to cybersecurity incidents.

According to the Summary, the staff is still reviewing the information to discern whether there are correlations between the examined firms' preparedness and their other characteristics (such as size or complexity). Additionally, according to the Summary, OCIE will continue to focus on cybersecurity using risk-based examinations.

- **See a copy of the Summary**

Investment Management Director Norm Champ Leaves SEC; David Grim Named as Acting Director

On January 21, 2015, the SEC announced that Norm Champ, Director of the Division of Investment Management (the "**Division**"), planned to depart from the SEC after five years of service. The SEC appointed David Grim as Acting Director of the Division on February 3, 2015.

As Director of the Division, Champ led several structural and policy changes, including creating the Risk and Examination Office of the Division, which uses data collected from the asset management industry to monitor risks at the industry, firm and product level and inform SEC policy, and establishing the Senior Level Engagement Program, which brings together senior leadership from the Division and strategically important asset management firms to discuss market developments and improve the SEC's awareness of emerging issues. In addition, Champ introduced regular "IM Guidance Updates" to provide investors, regulators and the asset management industry with the Division's views on investment management issues.

Champ also played a key role in several SEC policy matters, including the SEC's implementation of the Volcker Rule, focusing on the "covered fund" provisions, and the SEC's reforms to money market mutual funds requiring them to "float" their net asset values for funds sold to institutional investors and applying a "liquidity fee-and-gate" regime for non-government money market mutual funds. Further, Champ worked closely with the SEC to (i) adopt rules requiring asset managers to establish policies and procedures regarding identity theft "red flags," (ii) approve the first actively managed hybrid mutual fund-ETF, (iii) lift the moratorium on considering exemptive applications for certain ETFs and (iv) coordinate the Financial Stability Oversight Council's review of risk in the asset management industry.

Before joining the Division as Director in 2012, Champ served as Deputy Director of the SEC's Office of Compliance Inspections and Examinations. Champ joined the SEC as an Associate Director in the New York Regional Office in 2010. After leaving the SEC, Champ will be a Visiting Scholar at Harvard Law School for the 2015 spring term, where he is also a lecturer of law teaching a course on investment management law biennially.

David Grim has acted as the Division's Deputy Director since 2013, overseeing all aspects of the Division's rulemaking, guidance, risk-monitoring functions and disclosure review. Grim joined the SEC in 1995 as a Staff Attorney in the Division's Office of Investment Company Regulation and later joined the Office of the Chief Counsel, where he was named Assistant Chief Counsel in 2007.

- **See a copy of the Norm Champ Press Release**
- **See a copy of the David Grim Press Release**

Litigation

SEC Grants Second Exemption from Rule 506(d) Disqualification

On January 27, 2015, the SEC issued an order (the "**Order**") to Oppenheimer & Co, Inc. (the "**Respondent**") pursuant to Rule 506(d) of Regulation D under the Securities Act waiving their disqualification from participating in Rule 506 private placements. For a discussion of the first such waiver (the "**November Waiver**") pursuant to Rule 506(d) of Regulation D of the Securities Act, please see the **December 16, 2014 Investment Management Regulatory Update**. According to the SEC's cease-and-desist order giving rise to the disqualification (the "**Cease-and-Desist Order**"), the Respondent aided and abetted illegal activity by a customer and ignored signs that the customer was conducting business without an applicable exemption from the broker-dealer registration requirements under federal securities laws. The SEC also found that the Respondent engaged in unregistered sales of securities for a different client. According to the Order, these actions on the part of the Respondent resulted in violations of Sections 5(a) and (c) of the Securities Act and a failure to reasonably supervise with a view to prevent violations of Section 5 of the Securities Act; violations of Section 17(a) of the Exchange Act and Rules 17a-3(a)(2), 17a-3(a)(9), and 17a-8 thereunder, and willfully aiding and abetting and causing violations of Section 15(a) of the Exchange Act.

Rule 506 of Regulation D under the Securities Act ("**Rule 506**") is a non-exclusive safe harbor that permits the unregistered sale of securities in private placements to "accredited investors" (including individuals with more than $1 million in net worth, excluding primary residence, or with annual income of more than $200,000 in the prior two years and a reasonable expectation of meeting the threshold in the current year, and companies with more than $5 million in assets), subject to certain conditions. 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. Rule 506(d)(2)(ii), however, gives the SEC discretion to grant an exemption from such disqualification upon a "showing of good cause." Please see the December 11, 2013 Davis Polk Client Memorandum, **SEC Issues Guidance on Rule 506 "Bad Actor" Provisions**, for a discussion of the guidance and interpretations regarding certain key aspects of the bad actor rules that affect investment advisers and their funds.

According to the Order, the Respondents have shown good cause by agreeing to comply with the conditions stated in its December 10, 2014 waiver request letter (the "**Letter**"), including:

- Retaining a nationally recognized law firm with significant expertise in Rule 506 offerings (the "**Law Firm**") to review the Respondent's policies and procedures relating to Rule 506 offerings;
- Within 6 months after the issuance of the Rule 506(d) waiver, requiring the Law Firm to submit a written and dated report of its findings to the Respondent which will not be privileged, will be provided to the Division of Corporate Finance and may be reviewed by OCIE in its next examination of the Respondent;
- Within 12 months after the date of the Report, adopting and implementing all recommendations of the Law Firm for changes in or improvements to the Respondent's policies and procedures (subject to a procedure for the Respondents to object to any recommendation they consider "unduly burdensome or impractical");
- After the 12-month period, engaging the Law Firm to review the Respondent's compliance with the Law Firm's recommendations to ensure that all changes in or improvements to the Respondent's policies and procedures have been fully implemented;
- Within 6 months of being engaged to review the Respondent's compliance with its recommendations, requiring the Law Firm will submit a written and dated report of its findings

to the Respondent which will not be privileged, will be provided to the Division of Corporate Finance and may be reviewed by the OCIE in its subsequent examination of the Respondent; and

- Within 60 days after the issuance of the Rule 506(d) waiver, conducting and completing firmwide training for all registered persons on compliance with Rule 506.

While not explicitly referenced in the Order, Respondent is also subject to the undertakings set forth in the Cease-and-Desist Order, which were similar in many aspects—including in the requirement to retain an independent compliance consultant—to the conditions set forth in the November Waiver with respect to the recipients of that waiver. In addition, the November Waiver was valid for only 30 months, after which the respondents could apply for a waiver covering the remaining 30 months of the disqualification period after adopting all of the consultant's recommendations in that case. In the Order, by contrast, the waiver is not time limited. Following the issuance of the Order, SEC Commissioners Luis A. Aguilar and Kara L. Stein issued a dissenting statement with respect to the Order. For a discussion of their dissenting statement, please see the article below, **Two SEC Commissioners Issue Dissenting Statement Regarding Exemption from 506(d) Disqualification**.

- **See a copy of the Order**
- **See a copy of the Cease-and-Desist Order**
- **See a copy of the Letter**

Two SEC Commissioners Issue Dissenting Statement Regarding Exemption from Rule 506(d) Disqualification

On February 4, 2015, SEC Commissioners Luis A. Aguilar and Kara M. Stein (together, the "**Commissioners**") issued a dissenting statement (the "**Statement**") in the matter of the bad actor waiver granted to Oppenheimer & Co, Inc. ("**Oppenheimer**") under Rule 506(d) (the "**Waiver**"). Please see the article above, **SEC Grants Second Exemption from Rule 506(d) Disqualification**, for further discussion of the triggering violations and subsequent Waiver. In the Statement, the Commissioners examined the nature of the violations that triggered the disqualification, explored what they deemed Oppenheimer's history of recidivism and culture of non-compliance and expressed three areas of concern with regards to the conditions on which the Waiver was granted.

According to the Commissioners, the violations that led to Oppenheimer's bad actor disqualification under Rule 506, including knowingly executing unregistered and unlawful transactions on behalf of a client, violating anti-money laundering laws and permitting a customer to act as an unregistered broker were just the most recent of a long line of regulatory failures; since 2005, there have been at least 30 separate regulatory actions against Oppenheimer for violations of security laws and rules thereunder. The Commissioners characterized Oppenheimer as having a "failed compliance culture, from top to bottom" and "an entrenched culture of non-compliance" and went as far to state that "it is questionable whether a waiver is appropriate at all in these particular circumstances."

The Statement identifies three areas in which the Commissioners felt the conditions on which the Waiver was based were insufficient. First, the Commissioners noted that there is no requirement that the law firm hired to review Oppenheimer's policies and procedures be qualified or independent. According to the Commissioners, this move is a shift away from the SEC's traditional approach of requiring independent consultants, including in the first waiver granted to a bad actor under Rule 506(d) in November 2014. Furthermore, the Commissioners stated that the Waiver would allow Oppenheimer to select a law firm that would be incentivized to accommodate Oppenheimer by ignoring or dismissing inadequacies in firm practices. Second, the Commissioners criticized the lack of involvement in the required compliance review process by Oppenheimer's senior management. The Commissioners emphasized the importance of senior management setting the correct tone and providing accountability when attempting to dislodge

entrenched practices and a corporate culture of non-compliance. Third, the Commissioners pointed out that there is no requirement for Oppenheimer to return to the SEC to demonstrate its compliance with the federal securities laws. According to the Commissioners, Oppenheimer's recidivism means that the SEC should not rely on "what is essentially just another unconvincing promise to do better."

In sum, the Commissioners argued that a time-limited waiver would have been appropriate given the nature of Oppenheimer's violations and its history of violating securities laws. The SEC's mandate to protect investors means, according to the Commissioners, that the SEC should demand more accountability from Oppenheimer by requiring a qualified, independent consultant, involvement by senior management in the compliance review process and/or a time-limited waiver.

- **See a copy of the Statement**

UBS Subsidiary Charged with Disclosure and Other Regulatory Violations in Operating Dark Pool

On January 15, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against UBS Securities LLC ("**UBS**") for violations of Sections 17(a) and 17(a)(2) of the Securities Act and Rule 17a-4(b)(1) thereunder, Rule 612 of Regulation NMS promulgated under the Exchange Act and Rules 301(b)(2), 301(b)(5), 301(b)(8), 301(b)(10) and 303 of Regulation ATS promulgated thereunder in connection with its operation and marketing of UBS ATS, an alternative trading system ("**ATS**"), also referred to as a "dark pool," offering execution services received from UBS clients and UBS ATS subscribers.

According to the Order, an SEC examination and investigation revealed that, between May 2008 and March 2011, UBS accepted and ranked hundreds of millions of orders through its ATS that were priced in increments less than one cent ("sub-penny orders"), in violation of Rule 612 of Regulation NMS. According to the SEC, UBS created two order types—PrimaryPegPlus ("**PPP**") and Whole Penny Offset—that enabled UBS ATS subscribers to submit sub-penny orders and receive execution priority ahead of orders entered at whole-penny prices. PPP and Whole Penny Offset also, according to the Order, provided the UBS ATS with an unfair competitive advantage over trading venues that complied with Regulation NMS and therefore rejected sub-penny orders or did not allow subscribers to enter sub-penny orders. Further, according to the SEC, during the period from June 2010 to March 2011, UBS violated Section 17(a)(2) of the Securities Act by marketing the PPP order type almost exclusively to market makers and high-frequency trading firms and failing to disclose the order type to all its ATS subscribers until approximately 30 months after launch.

UBS also violated Section 17(a)(2) of the Securities Act, according to the Order, by failing to disclose to all its ATS subscribers the system's "natural-only crossing restriction" feature (the "**Natural-Only Feature**"), which prevented certain orders from executing against those generally placed by market makers and high-frequency trading firms. According to the SEC, this feature could only be used to benefit orders placed by clients using UBS's trading algorithms (i.e., those that paid to have their trades executed through a UBS trading tool). In addition, according to the Order, UBS violated various rules under Regulation ATS by (i) filing and failing to amend its Form ATS containing incomplete and inconsistent statements concerning the PPP order type and Natural-Only Feature, (ii) failing to establish written standards for restricting access to the Natural-Only Feature, (iii) unreasonably restricting access to the Natural-Only Feature to certain subscribers and (iv) failing to limit access to the confidential trading information of its ATS subscribers. Finally, according to the Order, UBS violated the Securities Act and various rules under Regulation ATS by failing to preserve certain order data from its ATS.

According to the Order, UBS consented to the Order without admitting or denying the findings and must pay a penalty of $12,000,000—tshe largest the SEC has imposed against an ATS—disgorgement of $2,240,702.50 and prejudgment interest of $235,686.14.

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

SEC Charges Mutual Fund Adviser in Connection with Improper Handling of Assets

On February 12, 2015, the SEC issued an order (the "**Order**") instituting and settling cease-and-desist proceedings against an investment adviser to several alternative mutual funds, Water Island Capital LLC ("**Water Island**"), for violating the custody requirements of the Investment Company Act by maintaining millions of dollars of the funds' cash collateral at broker-dealer counterparties instead of the funds' custodial bank.

According to the Order, Water Island serves as the investment adviser to several mutual funds that generally engage in specialized trading strategies. The Investment Company Act generally requires that all registered managed investment companies comply with stringent rules governing the custody of fund assets. If an investment company maintains its investments at a qualified bank, Section 17(f)(5) of the Investment Company Act generally requires that the cash proceeds from the sales of such investments (along with other cash assets) also be kept in the custody of such qualified bank. Although, according to the Order, Water Island's written compliance procedures complied with these requirements, from at least January to September 2012, Water Island did not ensure that such assets were maintained with a qualified custodian. Instead, the SEC alleged that the funds' broker-dealer counterparties held approximately $247 million in cash collateral. Furthermore, according to the Order, Water Island caused the funds to post cash collateral relating to certain swaps in the funds' portfolios, but did not ensure the transfer of these assets to the funds' qualified bank as required by both Section 17(f)(5) of the Investment Company Act and the funds' own policies and procedures.

Section 12(b) of the Investment Company Act generally prohibits funds from distributing their own shares (other than through a principal underwriter) in violation of SEC Rules. Rule 12b-1 under the Investment Company Act generally prohibits funds from compensating a broker-dealer for promoting or selling fund shares or directing brokerage transactions to that broker, except when the relevant fund or its adviser has implemented policies and procedures reasonably designed to, among other things, ensure that the selection of brokers for certain transactions is not influenced by considerations about the sale of shares of that fund or any other fund. According to the Order, Water Island failed to create and maintain an approved list of executing brokers and failed to maintain documentation reflecting the oversight of the funds' compliance with Rule 12b-1(h) policies and procedures, in each case in violation of its own policies and procedures concerning Rule 12b-1(h).

Based on this conduct, the SEC alleged that the Respondents violated Sections 12(b) and 17(f) of the Investment Company Act and Rules 12b-1 and 38a-1 promulgated thereunder. Water Island agreed to cease and desist from committing or causing future violations of the aforementioned provisions and to pay a civil penalty of $50,000.

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

SEC Charges Shelton Financial Group for Hiding Payments to Broker-Dealer

On January 13, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against the investment management firm Shelton Financial Group, Inc. ("**SFG**") and Jeffrey Shelton ("**Shelton**" and together with SFG, the "**Respondents**") for failure to disclose to their clients a compensation arrangement with a broker-dealer and the resulting conflicts of interest.

According to the Order, Shelton is the owner and founder of SFG and served as its Chief Compliance Officer from 2004 to 2010. The SEC alleged that SFG entered into a revenue sharing agreement in 2008 with a registered broker-dealer (the "**Broker**") whereby the Broker agreed to pay SFG a percentage of

every dollar that SFG's clients invested in certain mutual funds offered on the Broker's platform. According to the Order, SFG failed to disclose the revenue sharing arrangement to its clients and also failed to disclose that it had an incentive to recommend the Broker's mutual funds over other investments since such recommendations would generate additional revenue for SFG under the revenue sharing agreement. According to the Order, SFG did not disclose the compensation arrangement on its Form ADV until 2010 and failed to disclose the conflict of interest until October 2013.

Based on this conduct, the SEC alleged that the Respondents violated Sections 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-7 thereunder. According to the Order, the Respondents neither admitted nor denied the allegations. The Respondents agreed to cease and desist from committing or causing future violations of the aforementioned provisions. In addition, SFG agreed to hire a dedicated Chief Compliance Officer and engage an independent consultant to conduct a comprehensive compliance review. The Respondents were ordered to pay disgorgement of $99,114.19, prejudgment interest of $20,952.91 and a civil penalty of $70,000.

- **See a copy of the 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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