Investment Management Regulatory Update

September 24, 2015

SEC Rules and Regulations

BEA Releases New Benchmark Survey for Financial Services Providers, Including Managers of Hedge, Private Equity and Other Private Funds and Separate Accounts

The Department of Commerce's Bureau of Economic Analysis (the "**BEA**") released the final version of the BE-180 Report ("**BE-180**"), a five-year benchmark survey of transactions between U.S. persons that are financial service providers, as defined in the instructions to BE-180, and non-U.S. persons during fiscal year 2014.

BE-180 is required for each U.S. person that is a financial services provider or intermediary, or whose consolidated U.S. enterprise includes a separately organized subsidiary or part that is a financial services provider or intermediary, that made sales or purchases with a non-U.S. person in fiscal year 2014, regardless of whether such person was notified by the BEA. According to the instructions to BE-180, the definition of financial services provider includes, among others, investment advisers, managers and funds, and other financial vehicles (including, but not limited to, mutual funds, pension funds, real estate investment trusts, investors and stock quotation services). If such a financial services provider had combined sales to or purchases from a foreign person of financial services exceeding $3 million for fiscal year 2014, it must provide data on such sales and purchases by type of service, type of affiliation with the counterparty and country. If such a financial services provider's combined sales to or purchases from a foreign person of financial services did not exceed $3 million in fiscal year 2014, such provider must

complete BE-180, but is only required to provide aggregate data on such sales and purchase (and may voluntarily provide more detailed information).

The due date for BE-180 is October 1, 2015. Automatic extensions have been granted by the BEA (i) until November 1, 2015 for entities that have been notified by the BEA and have a BE-180 identification number below 140012490, (ii) until November 1, 2015 for entities that were not notified by the BEA and do not have a BE-180 identification number and (iii) until December 1, 2015 for entities that were notified by the BEA and have a BE-180 identification number above 140012490. The BEA will consider additional extension requests if submitted by November 1, 2015 up to an additional 30 days for automatic extensions under (i) and (ii) and up to an additional 60 days for automatic extensions under (iii) above.

For additional information on the BEA in connection with another five-year benchmark survey (BE-10), please see the May 6, 2015 Davis Polk Client Memorandum, **BE-10 Filing Deadline Nears for U.S. Companies With Foreign Subsidiaries and Other Affiliates**.

- **See a copy of the BE-180 Report**

SEC Issues No-Action Relief Clarifying When a Substantive, Pre-existing Relationship Exists

On August 6, 2015, the Division of Corporation Finance (the "**Division**") of the Securities and Exchange Commission (the "**SEC**") issued a no-action letter (the "**Letter**") to Citizen VC, Inc. ("**CitizenVC**"), clarifying its interpretation of the meaning of general solicitation or general advertising under Rule 502(c) of Regulation D under the Securities Act of 1933 (the "**Securities Act**") in the context of the facts set forth by CitizenVC, an online venture capital firm that facilitates indirect investment by its members in private companies through vehicles it organizes and manages. The Division stated that it concurred in the conclusion that CitizenVC had established policies and procedures sufficient to create substantive, pre-existing relationships between CitizenVC and prospective investors such that CitizenVC would not be deemed to be engaged in general solicitation or general advertising under Rule 502(c).

Section 4(a)(2) of the Securities Act exempts offers of securities that do not involve a "public offering" from the general registration requirement imposed by the Securities Act. Regulation D under the Securities Act ("**Reg D**") establishes a safe harbor for private placements, and with respect to offerings pursuant to Rule 506(b) thereunder, the issuer cannot use general solicitation or advertising in marketing the securities. According to the incoming letter addressed to the SEC (the "**Incoming Letter**"), the SEC staff has clarified in a series of no-action letters that general solicitation is not present where there is a pre-existing, substantive relationship between the issuer (or its agent) and the offerees. The SEC staff's letters further established the position, according to the Incoming Letter, that issuers (or their agents) may establish such pre-existing, substantive relationships through the use of an investor questionnaire detailing the investor's sophistication and accreditation.

In the Incoming Letter, CitizenVC asked the Division to concur in its interpretation that CitizenVC's policies and procedures would be sufficient to create the required relationship such that CitizenVC could offer and sell limited liability company interests on the Internet in compliance with Rule 506(b) of Reg D. CitizenVC represented that it offers interests in special purpose vehicles ("**SPVs**") via its website to pre-qualified investors. According to CitizenVC, each SPV is created to invest in a particular private company through making a direct equity investment or purchasing interests from selling shareholders in such company. Before viewing any offering materials or information about any particular investment or SPV on CitizenVC's website, prospective investors must first complete an online "accredited investor" (within the meaning of Rule 501(a) of Reg D) questionnaire and be accepted for membership. In addition, according to the Incoming Letter, the subscription materials for each investment also contain accredited investor certifications the prospective investor must make and additional risk disclosures.

CitizenVC further represented in the Incoming Letter that, following the receipt of a completed accredited investor questionnaire from a prospective investor, it initiates a "relationship establishment period" during

which it takes various actions to collect information that it believes is sufficient to establish the sophistication of such prospective investor and to establish a substantive relationship, including:

- Contacting the investor via telephone to introduce CitizenVC's representatives and address various matters designed to help CitizenVC to understand the prospective investor's sophistication, including the investor's previous investing experience, financial goals and suitability, risk awareness;
- Sending an initial email to the prospective investor and otherwise contacting such investor online to answer questions about CitizenVC, its website and potential investments;
- Prompting the prospective investor to explore the CitizenVC website and ask questions about the firm, its investment strategy and objectives;
- Confirming the investor's identity and credit history through a third-party credit reporting service;
- Advising the prospective investor of the $50,000 minimum commitment per investment; and
- Promoting, as a general matter, online and offline interactions between CitizenVC and the prospective investor.

According to the Incoming Letter, CitizenVC's policies and procedures do not dictate the necessary duration of the relationship establishment period so as to establish that the offering of interests is suitable for any particular prospective investor. Although CitizenVC noted in the Incoming Letter that the Division's May 29, 1997 no-action letter issued to Lamp Technologies, Inc. (the "**Lamp Letter**") implicitly endorsed a 30-day waiting period, it stated that its relationship establishment period is not governed by a specific time period between satisfactory completion of an accredited investor questionnaire by an investor and the ability of the issuer (or its agent) to offer securities to such investor.

In the Letter, the Division stated that, based on the facts and representations that CitizenVC had set forth in the Incoming Letter, it concurred in the interpretation that CitizenVC's policies and procedures establish a substantive, pre-existing relationship for the purposes of determining whether it engaged in general solicitation under Rule 502(c) of Reg D. The Division emphasized that the quality of the relationship between an issuer and an investor is the most important factor in determining whether the necessary substantive relationship exists. As stated above, the Division had earlier in the Lamp Letter noted the existence of a 30-day waiting period as a factor in reaching its conclusion that a similar process as that proposed by CitizenVC here would not involve general solicitation or advertising within the meaning of Regulation D. Here, however, the Division agreed with CitizenVC that "there is no specific duration of time" that can be relied upon solely to create the required substantive, pre-existing relationship. The Division further highlighted CitizenVC's representation that the relationship with an investor would be established before any offering to such investor, which the Division noted is consistent with its previous guidance.

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

FinCEN's Proposed Rule to Require Investment Advisers to Establish AML Programs

The U.S. Department of the Treasury's Financial Crimes Enforcement Network ("**FinCEN**") recently published a Notice of Proposed Rulemaking (the "**Proposed Rule**") that would extend to certain investment advisers the requirement to establish anti-money laundering ("**AML**") programs and report suspicious activity to FinCEN under the Bank Secrecy Act (the "**BSA**"). The Proposed Rule would also include investment advisers in the BSA's definition of "financial institutions," which would require them to comply with the general BSA reporting and recordkeeping requirements applicable to financial institutions. The Proposed Rule has been many years in the making: FinCEN first proposed AML rules

for unregistered investment companies in September 2002 and for certain investment advisers in May 2003. However, FinCEN withdrew those proposals in November 2008, citing the passage of time as the principal reason for withdrawal. For further discussion of the Proposed Rule, please see the September 16, 2015 Davis Polk Client Memorandum, **FinCEN's Proposed Rule to Require Investment Advisers to Establish AML Programs**.

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

Second Circuit Holds That Whistleblowers Who Report Alleged Wrongdoing Internally Are Entitled to Dodd-Frank's Anti-Retaliation Protections

On September 10, 2015, the U.S. Court of Appeals for the Second Circuit issued a significant opinion, reversing a lower court decision and extending the whistleblower anti-retaliation provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act to whistleblowers who suffer retaliation as a result of reporting wrongdoing internally, without also reporting to the SEC. For a discussion of this decision, please see the September 15, 2015 Davis Polk Client Memorandum, **Second Circuit Holds That Whistleblowers Who Report Alleged Wrongdoing Internally Are Entitled to Dodd-Frank's Anti-Retaliation Protections**.

- **See a copy of the Opinion**

Industry Update

Proposed Treasury Regulations Address Management Fee "Waiver" Arrangements

On July 22, 2015, the Treasury Department issued proposed regulations (the "**Proposed Regulations**") that in many respects are aimed at management fee "waiver" and similar arrangements used by some private equity funds. The Proposed Regulations address the circumstances in which purported partnership allocations, and corresponding distributions, may be treated as a "disguised" compensation arrangement between the partnership and a person that is not a partner. The Proposed Regulations would apply to arrangements entered into or modified after the publication of the corresponding final regulations. However, the preamble to the Proposed Regulations states that, pending the publication of the final regulations, the Treasury Department and the Internal Revenue Service (the "**IRS**") will take the position that the Proposed Regulations generally represent the correct interpretation of current law.

In addition, the preamble to the Proposed Regulations contains some announcements about the application of the IRS revenue procedures with respect to the issuance of profits interests in partnerships that could cause the issuance of a profits interest to be a taxable event, even if that the profits interest is not recharacterized under the Proposed Regulations. These announcements (one of which involves an interpretation of the existing revenue procedures) potentially affect many management fee "waiver" arrangements.

Proposed Rules Relating to Disguised Payment for Services

Under the Proposed Regulations, a "facts-and-circumstances" analysis, with certain specified presumptions, would apply to determine whether any specific purported partnership allocation, and corresponding distribution, to a service-providing partner would more properly be treated as a transaction between the partner and a person other than a partner (a "**Non-Partner Arrangement**"). This determination would be made as of the date on which the arrangement is entered into or modified, without regard to the timing of the relevant allocation and distribution. If any arrangement is recharacterized as a Non-Partner Arrangement, the partnership would be treated as paying compensation to the service provider. This compensation would constitute ordinary income, and all of the provisions of the Code applicable to the taxation of payments for services would apply to it, including the

timing of the income inclusion and the possible application of Sections 409A and 457A of the Code, which address deferred compensation arrangements and could give rise to taxation at penalty rates. The Proposed Regulations do not address the manner in which these provisions would apply.

The Proposed Regulations contain a list of six non-exclusive factors that may indicate that an arrangement is a Non-Partner Arrangement. The most important of these factors is whether the arrangement lacks significant entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. An arrangement that lacks significant entrepreneurial risk will be treated as a Non-Partner Arrangement. By contrast, an arrangement that has significant entrepreneurial risk will generally not constitute a Non-Partner Arrangement unless other factors establish otherwise. Under the Proposed Regulations, the following facts and circumstances would create a presumption that an arrangement lacks significant entrepreneurial risk:

- capped allocations of partnership income if the cap is reasonably expected to apply in most years;
- an allocation under which the service provider's share of income is reasonably certain;
- an allocation of gross income;
- an allocation (under a formula or otherwise) that is predominantly fixed in amount, reasonably determinable or designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider, such as an allocation of net profits from specific transactions or accounting periods that does not depend on the long-term future success of the enterprise; and
- an arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

The presumption created by the existence of any of these facts and circumstances can be rebutted only if the presence of significant entrepreneurial risk can be established by clear and convincing evidence.

Under the Proposed Regulations, presence of any of the remaining five non-exclusive factors may indicate that an arrangement would properly be treated as a Non-Partner Arrangement, even if it entails significant entrepreneurial risk. One of these factors is whether the arrangement provides for different allocations or distributions with respect to different services if the services are provided either by one person or by one or more related persons (*e.g.*, a fund general partner and a fund manager) and the terms of the differing allocations or distributions (*e.g.*, a typical carried interest and a special profits interest received in connection with a management fee waiver) are subject to levels of entrepreneurial risk that vary significantly. Another is whether the service provider became a partner primarily to obtain tax benefits that would not otherwise have been available.

The Proposed Regulations illustrate the fact-and-circumstances analysis through several examples, some of which contain fact patterns that resemble certain management fee "waiver" arrangements. In one example, the general partner of an investment partnership, which invests in assets that are not readily tradable, is entitled to a carried interest subject to an after-tax clawback obligation, while an entity controlled by the general partner is entitled to receive a priority allocation and distribution of net gain realized by the partnership during any twelve-month accounting period in which the partnership has overall net gain, in an amount intended to approximate the fee that would normally be charged for the services performed by this entity. The example concludes that the carried interest has significant entrepreneurial risk because it is determined by reference to the net profits earned over the life of the partnership and is subject to a clawback obligation that the general partner can reasonably be expected to fund. By contrast, the example concludes that the priority allocation to the general partner's affiliate lacks significant entrepreneurial risk, and is therefore treated as a Non-Partner Arrangement, because (i) it is made out of net profits for any accounting period in which the partnership has net gain (and thus does

not depend on the overall success of the partnership) and (ii) the timing of asset sales, and thus the timing of recognition of gains and losses, is controlled by the general partner.

Other examples conclude that similar arrangements, each involving a profits interest issued by an investment partnership in lieu of a management fee that would otherwise have been payable, have significant entrepreneurial risk when one of the two elements in the example described above is absent. In two of these examples, the relevant profits allocations are made only out of net profits, the entity receiving the allocations undertakes an after-tax clawback obligation, measured by reference to the overall net profits over the life of the partnership, and it is reasonable to anticipate that this entity will be able to comply fully with any repayment responsibilities that may arise under the clawback obligation. In another example, an entity is entitled to receive a special allocation and distribution of partnership net gain attributable to a specified future twelve-month accounting period. There is no clawback obligation, but the partnership is a trader in exchange-traded securities and has made an election under Section 475(f)(1) of the Code to mark its securities to market at the end of each taxable year. The example concludes that this arrangement has significant entrepreneurial risk because the partnership's assets have a readily ascertainable market value that is determined at the close of each taxable year and it cannot reasonably be predicted whether the partnership will have net profits with respect to its entire portfolio for the year in which the special allocation will be made.

The Proposed Regulations would apparently not change the treatment of typical carried interest arrangements in private equity funds and incentive allocations in hedge funds. In this regard, the preamble states that, even though they are priority allocations, typical "catch-up" allocations intended to equalize a general partner's return with a preferred return made to the limited partners generally will not be treated as a Non-Partner Arrangement. On the other hand, the Proposed Regulations create a great deal of uncertainty as to whether various management fee "waiver" arrangements would be treated as Non-Partner Arrangements. Moreover, if a purported profits interest were recharacterized under the Proposed Regulations, it is far from clear how the rules of the Code with respect to the taxation of compensation would apply to the resulting Non-Partner Arrangement. In particular, the compensation income taken into account under the Non-Partner Arrangement could be subject to penalty taxes under Sections 409A and 457A of the Code.

Changes to the Profits Interest Safe Harbor

In general, if property is transferred in connection with the performance of services, the fair market value of the property is treated as compensation income in the year in which the service provider's right to the property vests (or is deemed to vest as a consequence of an election made by the service provider under Section 83(b) of the Code). Existing IRS revenue procedures provide a "safe harbor" under which a partnership's issuance of a profits interest to a person who renders services to or for the benefit of the partnership in a partner capacity, or in anticipation of becoming a partner, is not treated as a taxable event, either on the date of issuance or, if the profits interest does not vest until a later date, on the vesting date. This "safe harbor" does not apply if the relevant partner disposes of the profits interest within two years of receiving it.

The preamble to the Proposed Regulations states that the Treasury Department and the IRS have determined that the "safe harbor" does not apply to an arrangement in which a management company that provides services to a fund waives its management fee and the fund's general partner receives a profits interest in the fund. It is not uncommon for a management fee waiver arrangement to have this feature. According to the preamble, the Treasury Department and the IRS believe that this arrangement fails to satisfy the requirements of the applicable revenue procedures for two reasons: (i) the profits interest would not be issued for services provided in a partner capacity, or in anticipation of being a partner, given that the management company, rather than the general partner, provides the relevant services, and (ii) the management company would have disposed of the profits interest, through a constructive transfer to the general partner, within a two-year period. In addition, the preamble announces that Treasury and the IRS intend to issue a new revenue procedure that will provide an

additional exception, under which the "safe harbor" would not apply to a profits interest issued in conjunction with a partner's forgoing payment of a substantially fixed amount for the performance of services, including a fee based on a percentage of partner capital commitments. If the "safe harbor" did not apply to the issuance of a profits interest, the service provider would generally be required to determine the fair market value of the interest and take that amount into income as compensation income.

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

Public Statement by Commissioner Luis A. Aguilar on Enhancing the Commission's Waiver Process

On August 27, 2015, SEC Commissioner Luis A. Aguilar released a public statement regarding how he believes the SEC could enhance its waiver process by providing greater transparency on the process and adopting a more flexible approach to the granting and denial of waivers.

According to Aguilar, the vast majority of waiver requests are handled by the SEC staff pursuant to delegated authority, and generally the Commissioners are not notified when a new waiver request is received or when a waiver is ultimately denied. Further, according to Aguilar, the SEC does not maintain a database of pending waiver requests, and the records documenting the disposition of waiver requests received from well-known seasoned issuers or pursuant to Regulation D of Rule 506 are incomplete and only in summary form, thereby lacking useful information, such as the staff's justification for denying certain waivers. According to his statement, Aguilar believes that the SEC can improve the waiver process by adopting a procedure that provides the SEC with a more comprehensive view of the waiver process, such as through periodic reports detailing the outstanding requests and circumstances triggering them, the final disposition of a request and the ultimate justification for granting or denying a request. Also, according to Aguilar, the SEC could improve its waiver process by creating a public website to track waiver requests and inquiries, on a redacted basis, along with the circumstances that led the SEC or its staff to grant or deny a request.

In addition to enhancing the transparency of the SEC's waiver process, Aguilar discussed the benefits of permitting conditional waivers in certain situations. According to Aguilar, there is inherent uncertainty in the waiver process, given the numerous factors that must be applied to the specific facts and circumstances of each request, and the typical method of granting or denying a waiver without qualification doesn't address that uncertainty. According to Aguilar, the SEC receives many complex waiver requests that are not clear-cut, and for those requests, conditional waivers would offer a more fair and reasonable approach than the current process.

- **See a copy of Aguilar's statement**

NFA Proposes Interpretive Notice on Information Systems Security Programs

On August 28, 2015, the National Futures Association (the "**NFA**") proposed the adoption of an interpretive notice (the "**Notice**") on information systems security programs. The Notice, which is designed to be consistent with guidance by other financial regulators, establishes general requirements for every NFA member, including commodity trading advisors and commodity pool operators, to establish and enforce an information systems security program, but leaves the exact form of such a program up to each NFA member.

The Notice proposes the following general requirements:

- **Written Program**. Each NFA member should establish and implement a written information systems security program ("**ISSP**") that is reasonably designed to protect against information security threats. The ISSP should be approved in writing by the executives of the NFA member.

- **Risk Analysis**. Each NFA member should assess and prioritize its information security risks, including historical and vulnerability analyses, and should also maintain an inventory of critical information technology hardware and software.
- **Protective Measures**. The ISSP of each NFA member should document and describe the safeguards it has implemented in response to the threats and vulnerabilities that it has identified.
- **Response and Recovery**. Each NFA member should create a response plan for managing and mitigating security incidents, including, if appropriate, forming an incident response team.
- **Employee Training**. Each NFA member should educate and train its personnel on information security, including an initial training upon hire and ongoing training during employment.
- **Periodic Review**. Each NFA member should, on at least an annual basis, monitor and review the effectiveness of its ISSP and make adjustments as appropriate.
- **Third-Party Providers**. Each NFA member should consider and address the risks posed by third-party service providers with access to the member's systems, including potentially conducting diligence on the third-party provider's security practices and adopting access controls.
- **Recordkeeping**. Each NFA member should maintain all records relating to its adoption and implementation of an ISSP and its compliance with the Notice.

The Notice is subject to review and approval by the U.S. Commodity Futures Trading Commission.

- **See a copy of the Notice**

Litigation

SEC Charges Citigroup Global Markets for Compliance and Surveillance Failures

On August 19, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Citigroup Global Markets, Inc. ("**CGMI**"), a New York-based registered investment adviser and broker-dealer, and wholly owned subsidiary of Citigroup, Inc., for failing to (i) enforce policies and procedures to prevent and detect securities transactions that could involve the misuse of material, nonpublic information and (ii) adopt and implement policies and procedures to prevent and detect principal transactions entered into by an affiliate. According to the Order, these actions and omissions constituted a willful violation of Section 15(g) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") and Section 206(4) of the U.S. Investment Advisers Act of 1940, as amended (the "**Advisers Act**") and Rule 206(4)-7 thereunder.

Section 15(g) of the Exchange Act generally requires brokers and dealers to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information. According to the Order, CGMI did not adequately monitor the trades executed by several of its trading desks from 2002 to 2012. This failure, according to the SEC, arose from the omission of thousands of trades from the reports used by CGMI to review its trading. The Order stated that the reports were created electronically and several trading platforms that contained information about relevant trades were omitted from the reports.

Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder generally require registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, including violations of Section 206(3) thereof (which generally prohibits an investment adviser from "acting as principal for his own account, knowingly to sell any security to or

purchase any security from a client . . . without disclosing to such client in writing before the completion of the transaction the capacity in which he is acting and obtaining the consent of the client to such transaction"). According to the SEC, from 2007 to 2011, CGMI unwittingly routed over 400,000 transactions on behalf of advisory clients to an affiliated market maker, which executed transactions as principal at or near the market prices for the relevant securities. Although CGMI had policies and procedures in place to prevent such a diversion of certain advisory orders to an affiliate, the SEC alleged that such policies and procedures were not reasonably designed or implemented. This failure was compounded, according to the SEC, by the failure of CGMI's trade surveillance team to detect these principal transactions because it relied on an exception report that was not reasonably designed to cover principal transactions executed through its affiliated market maker.

CGMI had submitted an offer of settlement (the "**Offer**") in anticipation of the proceedings, which the SEC accepted. As set forth in the Offer, CGMI agreed to retain a consultant to (i) review its implementation of its trade surveillance policies and procedures (among other things) and its policies and procedures concerning the handling and routing of advisory orders, and its implementation of such policies and procedures and (ii) prepare a written report evaluating such matters and submit such report to both CGMI and the SEC. In addition, the SEC censured CGMI and ordered CGMI to cease and desist from committing or causing any violations or future violations of Section 15(g) of the Exchange Act and Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Finally, the SEC ordered CGMI to pay a civil money penalty of $15 million.

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

SEC Charges Guggenheim with Failure to Disclose Conflicts of Interest

On August 10, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Guggenheim Partners Investment Management, LLC ("**Guggenheim**") for violations of Sections 204(a), 204A, 206(2) and 206(4) of the Advisers Act, and Rules 204A-1 and 206(4)-7 thereunder. The SEC charged Guggenheim in connection with its failure to disclose a loan made to one of its executives from an advisory client of Guggenheim and its miscategorization of certain client assets that led to Guggenheim's receipt of asset management fees it did not earn, among other violations.

According to the Order, a Guggenheim client, which held accounts managed by Guggenheim, made a $50 million loan to a Guggenheim executive. The loan allegedly financed the Guggenheim executive's personal participation in an acquisition led by Guggenheim's corporate parent. Guggenheim's code of ethics required the disclosure of potential conflicts of interest, and the guidance it provided thereunder prohibited employees from accepting loans from clients. Even though multiple senior individuals at Guggenheim knew about the loan, according to the SEC, no one communicated it to Guggenheim's compliance staff. As a result, according to the Order, Guggenheim's other clients were not notified even as they participated in transactions alongside, and on different terms than, the Guggenheim client that made the loan to the Guggenheim executive.

Under Section 206(2) of the Advisers Act, investment advisers are generally prohibited from engaging in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client. The SEC found that Guggenheim willfully violated Section 206(2) by negligently failing to disclose the loan to its clients. In addition, Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder generally require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. According to the Order, Guggenheim violated Section 206(4) and Rule 206(4)-7 by failing to adopt policies and procedures to detect potential conflicts between the executive's non-advisory business and Guggenheim's obligations as a registered investment adviser. Similarly, the SEC found that Guggenheim violated Section 204A of the Advisers Act

and Rule 204A-1 thereunder, which generally require investment advisers to establish and enforce a written code of ethics that set forth procedures to maintain the adviser's fiduciary duty to clients.

According to the Order, Guggenheim also mistakenly charged one institutional client approximately $6.5 million in asset management fees for investments it did not manage. The investments for which fees were assessed involved trades initiated by the client and not by Guggenheim in its discretionary management role. Guggenheim merely provided non-advisory services, according to the Order, such as processing, trade reconciliation, recordkeeping and accounting services. The SEC found that, because of a coding error in its books and records, Guggenheim charged its asset management fee rather than its lower operational services fee for those services. According to the SEC, the error began in 2009, and Guggenheim did not identify it until January 2013. Guggenheim addressed the issue with the client in January 2014 and issued a credit to the client in November 2014.

Section 204(a) of the Advisers Act and Rule 204-2 thereunder generally require registered investment advisers to make and keep certain true, accurate and current books and records, including records of orders, bills and statements relating to the advisory business. The SEC found that Guggenheim violated these provisions by maintaining inaccurate books and records, resulting in erroneous invoicing of clients.

Guggenheim agreed to settle the charges without admitting or denying the SEC's findings. The SEC censured Guggenheim and ordered it to pay a civil money penalty of $20 million and engage an independent compliance consultant.

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

SEC Charges Investment Advisory Firm with Fraudulent Fee Retention

On September 2, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Taberna Capital Management, LLC ("**Taberna**"), its former managing director and its former chief operating officer for fraudulently retaining fees belonging to Taberna's collateralized debt obligation clients (the "**CDO Clients**"), in violation of the Exchange Act, Sections 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-8 thereunder.

The SEC alleged that, from 2009 to 2012, Taberna charged and retained certain payments known as "exchange fees" (the "**Exchange Fees**") in connection with restructuring transactions between the CDO Clients and the issuers of the underlying obligations in the CDO Clients' portfolios (the "**Issuers**"). A CDO is a special-purpose vehicle that issues debt to investors and uses the proceeds to invest in fixed-income securities or loans. The CDO Clients were each governed by an indenture, according to the SEC, that provided for the engagement of Taberna as the collateral manager for each CDO Client. According to the Order, Taberna received a "collateral management fee" as compensation for acting as collateral manager to the CDO Clients, which was specified in the indentures of the CDO Clients and, according to the SEC, intended to be Taberna's exclusive compensation for its services. Beginning in 2008, Taberna negotiated restructuring transactions with the Issuers, including exchange transactions where the CDO Client returned an Issuer's securities in return for new securities and/or other consideration. The SEC alleged that, beginning in February 2009, Taberna "insisted" that the Issuers pay an Exchange Fee, typically 1% of the value of the exchanged securities, directly to Taberna as consideration for Taberna's considering entering into exchange transactions on behalf of the CDO Clients. During the relevant three-year period, Taberna received Exchange Fees amounting to more than $17 million and retained over $15 million of those fees after paying third-party costs. According to the SEC, the 1% Exchange Fee "greatly exceeded" Taberna's actual costs incurred in connection with the exchange transactions.

The SEC alleged that while Taberna was undertaking the exchange transactions described above, it executed transaction documents, including exchange agreements and term sheets, that misrepresented the Exchange Fees as compensation for third-party costs. During this time, Taberna knew that its

practice was inconsistent with other CDO managers' practices with respect to Exchange Fees. The SEC also alleged that the Exchange Fees created actual and potential conflicts of interest between Taberna and the CDO Clients, since Taberna was incentivized to undertake exchange transactions instead of other possible restructurings, and even "threatened" some Issuers that it would not agree to certain exchanges if the Issuers did not pay an Exchange Fee, without regard to whether the exchange would benefit the CDO Clients. Taberna did not disclose such conflicts of interest to the CDO Clients or their investors, nor did Taberna inform them that it was retaining Exchange Fees in the quarterly reports to investors that provided detailed descriptions of the exchange transactions. Taberna also did not disclose that it received the Exchange Fees as a form of compensation in its Form ADV between 2009 and 2012.

The SEC alleged that, in engaging in the conduct described above, Taberna willfully violated Sections 206(1) and 206(2) of the Advisers Act, which generally prohibit fraud against any client or prospective client. The SEC further alleged that Taberna violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which generally prohibit any investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements not misleading to any investor or potential investor. The SEC also stated that, by not including the Exchange Fees in its compensation on its Form ADV, Taberna violated Section 207 of the Advisers Act, which generally prohibits any person from willfully making any untrue statement of a material fact or omitting any material fact in any report filed with the SEC. The SEC also found that Taberna, which was not registered as a broker or dealer with the SEC at any point in time, violated Section 15(a) of the Exchange Act, which generally prohibits a person from inducing or attempting to induce the purchase or sale of securities unless registered as a broker or dealer. The SEC also found that Taberna's former managing director and its former chief operating officer aided and abetted Taberna's violations.

According to the Order, Taberna agreed to settle the charges without admitting or denying the SEC's findings. The SEC ordered Taberna to pay $13 million in disgorgement, $2 million in prejudgment interest, and $6.5 million in civil money penalties, and to cease and desist from any violations or future violations of Section 15(a) of the Exchange Act, Sections 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-8 thereunder. Taberna's former managing director and its former chief operating officer also agreed to pay penalties amounting to $175,000 in the aggregate.

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