Investment Management Regulatory Update

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Industry Update

IM Director Discusses Changing Regulatory Landscape for Hedge Fund Managers

Norm Champ, the Director of the SEC's Division of Investment Management (the "**Division**"), discussed recent developments and initiatives, along with compliance, examination and enforcement topics for hedge fund advisers, at the Practising Law Institute's 2014 Hedge Fund Management Seminar. Champ highlighted certain changes in the regulatory landscape for hedge fund managers, noting that due to the Dodd-Frank Wall Street Reform and Consumer Protection Act and the SEC's new registration rules, many more private fund managers have had to register as investment advisers, and consequently, as of September 2014, there were approximately 11,438 registered advisers managing approximately $5.4 trillion in regulatory assets, and 875 hedge fund advisers who were exempt from registering with the SEC managing approximately $846 billion in regulatory assets.

Champ discussed the new information available to the SEC through an upgraded Form ADV and the new Form PF. According to Champ, information gathered from Form PF is used by the Office of Compliance Inspections and Examinations ("**OCIE**") and by the Division of Enforcement's Asset Management Unit as part of their routine reviews and investigations. The information gathered on Form ADV and Form PF is also used by the Risk and Examinations Office (the "**REO**"), which maintains an industry monitoring program and an examination program in which the REO often works alongside OCIE. Champ also noted the continuing importance of the SEC initiative to publish guidance on key issues for registered investment advisers in the form of IM Guidance Updates and mentioned that the SEC staff continues to review the comments it has received thus far on its July 2013 proposed amendments to Regulation D. For further discussion of the SEC's proposed amendments, please see the July 29, 2013 Davis Polk Client Memorandum, ***Private Offering Reform: Analysis and Implications***.

Champ also addressed compliance, examinations and enforcement topics for hedge fund advisers. First, Champ highlighted OCIE's initiative to examine newly registered investment advisers through its presence exam initiative. He further emphasized the importance of strong compliance programs, and stated that advisers must be diligent in not only tailoring policies and procedures to their businesses, but also updating them in light of market, regulatory, and guidance change. Champ reiterated OCIE's National Examination Program examination priority of focusing on conflicts of interest, reminding advisers to continue to endeavor to identify, disclose and manage conflicts. He specifically mentioned that even if an adviser obtains the approval or clearance of a conflict by a conflicts committee or the fund's independent board members, disclosure of such conflict to investors may still be required and, furthermore, if such committee itself is conflicted, its approval or clearance may not alleviate the adviser's duty to its investors.

Champ also discussed alternative mutual funds, stating that it was important to discuss these funds because of the growing market for such funds, the increasing amount of hedge fund advisers advising such funds and the fact that, in Champ's opinion, alternative mutual funds present heightened risks in compliance, conflicts of interest, valuation, portfolio management and marketing. Champ encouraged hedge fund advisers to carefully consider the differences in managing a private fund and managing a registered fund, including restrictions on registered funds' ability to charge performance-based fees and the many additional and substantive restrictions, such as the prohibition of certain affiliate transactions and the more onerous compliance framework imposed on advisers by the Investment Company Act.

- **See a copy of Champ's speech**

CFTC Grants No-Action Relief for Certain CPOs of Pools with Wholly-Owned Trading Subsidiaries

On September 8, 2014, the Division of Swap Dealer and Intermediary Oversight (the "**Division**") of the U.S. Commodity Futures Trading Commission (the "**CFTC**") issued CFTC Letter No. 14-112 (the "**Letter**") providing no-action relief from certain reporting obligations of CFTC Regulations 4.7(b), 4.22(c) and/or 4.27(c) to commodity pool operators ("**CPOs**") of parent commodity pools (a "**Parent Pool**") that (i) are not registered as investment companies under the Investment Company Act and (ii) use wholly-owned subsidiaries to trade in commodity interests (a "**Trading Subsidiary**"). The CFTC issued this Letter in response to inquiries and formal requests received by the Division. The no-action relief granted in the Letter permits such CPOs to file with the National Futures Association (the "**NFA**") both an annual report and Form CPO-PQR on behalf of the Parent Pool containing consolidated financial statements and CPO-PQR data, respectively, for the Parent Pool and the Trading Subsidiary in lieu of making a separate filing for the Trading Subsidiary.

The Commodity Exchange Act defines a "commodity pool" as including "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests." Therefore, according to the CFTC, a Trading Subsidiary that is used for the purpose of trading in commodity interests is itself a "commodity pool" or "pool," separate from the Parent Pool. The CFTC further explained that the CPO of a Parent Pool that uses a Trading Subsidiary is required to register with the CFTC as the CPO of such Trading Subsidiary and is subject to compliance with various filing requirements with respect to the Trading Subsidiary, independent of such requirements with respect to the Parent Pool. CFTC Regulation 4.22(c) requires CPOs to file an annual report on behalf of the commodity pool with the NFA, and CFTC Regulation 4.7(b)(3) requires that CPOs operating an exempt commodity pool file a streamlined annual report. In addition, CFTC Regulation 4.27(c) requires a CPO to file with the NFA a report with respect to the direct assets of each pool under its advisement consistent with Appendix A of Part 4 of the CFTC Regulations (namely, Form CPO-PQR).

The Letter provides that the no-action relief is contingent on each of the following requirements: (i) the CPO of the Parent Pool is the CPO of the Trading Subsidiary, (ii) any exposure to the Trading Subsidiary by participants in the Parent Pool is shared pro rata and (iii) the CPO prepares and files with NFA (a) an annual report for the Parent Pool containing consolidated financial statements for the Parent Pool that includes holdings, gains, losses and other financial statement amounts attributable to the Trading Subsidiary and (b) a consolidated report for the Parent Pool that includes the data for the Trading Subsidiary pursuant to CFTC regulation 4.27(c) (i.e. Form CPO-PQR). CPOs are required to file a notice, as described in further detail in the Letter, with the Division in order to claim this no-action relief and such claim will be effective upon filing if the claim is materially complete and accurate. According to the Letter, this no-action relief will automatically expire upon future rulemaking or other CFTC action relating to the same subject matter.

- **See a copy of the Letter**

CFTC Grants No-Action Relief to Permit Additional Third-Party Recordkeepers in Commission Regulations 4.7(b)(4) and 4.23(c)

On September 8, 2014, the Staff of the Division of Swap Dealer and Intermediary Oversight of the Commodity Futures Trading Commission (the "**CFTC**") issued a no-action letter (the "**Letter**") providing clarification on the circumstances in which a commodity pool operator ("**CPO**") can maintain its books and records, and the books and records of the commodity pool it operates, at a third-party recordkeeper rather than at its main business office, stating that a CPO can use a third-party recordkeeper as long as (i) the CPO maintains timely access to the records; and (2) the CPO timely files the statements required pursuant to CFTC Regulations 4.7(b)(5) or 4.23(c).

On August 13, 2013, the CFTC adopted final regulations to harmonize the obligations of registered CPOs under the CFTC Part 4 Regulations for commodity pools that are registered as investment companies ("**RICs**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") with the obligations applicable to RICs under the Investment Company Act and other securities laws (the "**Harmonization Rule**"). The Harmonization Rule amended CFTC Regulations 4.7(b)(4) and 4.23 to permit CPOs to use third-party service providers to maintain their books and records for all types of commodity pools. Prior to the Harmonization Rule, a CPO was required to maintain all books and records required by CFTC Regulations at the CPO's main business office (the "**Main Business Office Requirement**"). Under amended Regulations 4.7(b)(4) and 4.23, a CPO's books and records may be maintained by "the pool's administrator, distributor or custodian, or a bank or registered broker or dealer acting in a similar capacity with respect to the pool." For further information on the Harmonization Rule, please see the September 9, 2013 Davis Polk Client Memorandum, ***CFTC Adopts Final Harmonization Rule for Commodity Pool Operators***.

According to the Letter, the Division believes that limiting the Harmonization Rule exemption to the Main Business Office Requirement to only those enumerated third-party recordkeepers "may be unnecessarily restrictive," particularly in light of the increasingly common practice among CPOs to employ specialized data centers and services, or unenumerated affiliates that have day-to-day control over the CPO's data to manage records. Furthermore, according to the Letter, the CPO remains liable for the fulfillment of its recordkeeping obligations, and is obligated to produce any requested records upon request of the CFTC, regardless of whether the CPO engages a third-party recordkeeper.

The Letter provides exemptive relief from the Main Business Office Requirement of CFTC Regulations 4.7(b)(4) and 4.23 to allow a CPO to use a third-party recordkeeper subject to the following conditions: (1) the CPO will have and maintain timely access to the records, such that the CPO will be able to satisfy the obligations of the applicable CFTC regulations; and (2) the CPO timely and completely files the statements required pursuant to CFTC Regulations 4.7(b)(5) or 4.23(c), as applicable. Furthermore, according to the Letter, the CPO will remain responsible for ensuring that the books and records are maintained pursuant to all applicable CFTC Regulations, regardless of any failures to so maintain them by the third-party recordkeeper.

- **See a copy of the Letter**

Regulators Re-Propose Uncleared Swap Margin, Capital and Segregation Rules for Swap Entities

On September 3, 2014, U.S. banking regulators re-proposed margin, capital and segregation requirements applicable to swap entities for uncleared swaps. The new proposed rules modify significantly the regulators' original 2011 proposal in light of the Basel Committee on Banking Supervision's and the International Organization of Securities Commissions' issuance of their 2013 final policy framework on margin requirements for uncleared derivatives and the comments received on the original proposal. For more on the original proposal, please see the ***May 17, 2011 Davis Polk Investment Management Regulatory Update***.

The revised proposal:

- provides for a compliance deadline of December 1, 2015 for variation margin and a phased compliance schedule for initial margin, running from December 1, 2015 to December 1, 2019, with compliance timing dependent on the uncleared swaps exposures of a swap entity's affiliated group and each counterparty's affiliated group for the June to August period of each prior year;
- does not require initial or variation margin for a swap entity's transactions with non-financial end users;
- includes a revised, and very complex, definition of "financial end user" which differs significantly from the original proposal and existing definitions used by the CFTC and SEC;
- outlines the specific collateral eligible to be used to satisfy the margin requirements and related "haircuts," expanding the list of collateral for initial margin and limiting variation margin to cash;
- does not provide an exemption from the margin requirements for uncleared swap transactions between affiliates; and
- excludes foreign uncleared swaps of foreign covered swap entities, each as defined, from the scope of the margin requirements and provides a process for the regulators to permit substituted compliance with a non-U.S. regulatory framework to satisfy the margin requirements.

The revised proposal would apply to swap entities that are regulated by one of the "**Prudential Regulators**:" the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Authority. The CFTC and SEC have previously issued proposed rules for margin, capital and segregation requirements that would apply to swap entities not regulated by a Prudential Regulator, which differ in many respects from the Prudential Regulators' proposal. However, the CFTC has scheduled a meeting to consider a re-proposed rule on margin requirements for uncleared swaps.

For a detailed discussion of the Proposed Rule, please see the September 15, 2014 Davis Polk Client Memorandum, **Regulators Re-Propose Uncleared Swaps Margin, Capital and Segregation Rules for Swap Entities**.

- **See a copy of the proposed rule**
- **See a copy of the joint press release**

FinCEN Publishes Proposed Rule to Enhance Customer Due Diligence Requirements for Financial Institutions

On August 4, 2014, the Financial Crimes Enforcement Network ("**FinCEN**") published a Notice of Proposed Rulemaking (the "**Proposed Rule**") that would enhance customer due diligence ("**CDD**") requirements for financial institutions by, inter alia, requiring covered financial institutions to identify, and verify the identity of, beneficial owners of their customers, with certain exceptions. The issuance of the Proposed Rule follows FinCEN's Advance Notice of Proposed Rulemaking (the "**ANPRM**") relating to CDD and beneficial owner requirements, published more than two years ago. For more information on the ANPRM, please see the ***March 21, 2012 Davis Polk Investment Management Regulatory Update***. The Proposed Rule would initially cover only those financial institutions subject to a customer identification program requirement — banks, brokers or dealers in securities, mutual funds, and futures commission merchants and introducing brokers in commodities — but FinCEN notes that it may extend CDD requirements in the future to other types of financial institutions. For a detailed discussion of the Proposed Rule, please see the September 30, 2014 Davis Polk Client Memorandum, ***FinCEN's Proposed Rule to Enhance Customer Due Diligence Requirements for Financial Institutions***.

- **See a copy of the Notice of Proposed Rulemaking**

Litigation

SEC Brings Four Enforcement Actions for Undisclosed Principal Transactions and Other Violations

In September 2014, the SEC issued four orders (the "**Orders**") instituting administrative and cease-and-desist proceedings against investment advisers for, among other things, engaging in principal transactions with advisory clients without providing prior written disclosure to, or obtaining consent from, the advisers' clients, in violation of Section 206(3) of the Advisers Act. The SEC issued orders in relation to the alleged violations of Strategic Capital Group, LLC ("**SCG**") and its CEO N. Gary Price ("**Price**"), Barclays Capital Inc. ("**Barclays**"), Yale I. Asbell ("**Asbell**"), and Highland Capital Management, L.P. ("**Highland**" and, together with SCG, Price, Barclays and Asbell, the "**Advisers**"). As the frequency and volume of these Orders indicate, the SEC has been increasingly focused on ferreting out and pursuing investment advisers engaging in principal trades without the appropriate client disclosure and consent. As the SEC stated in the Order relating to Highland, although cross trades can benefit advisory clients in a number of ways, "cross trades involving a principal account heighten the potential for unfair treatment."

According to the SEC, beginning in May 2011, SCG engaged in hundreds of securities transactions with advisory clients on a principal basis when it purchased fixed-income securities from its affiliated registered broker-dealer, RP Capital, LLC ("**RP Capital**") on behalf of the advisory clients. The SEC alleged that RP Capital purchased fixed-income securities from other broker-dealers and then resold them to SCG clients at a higher price, without SCG disclosing that it was acting as principal through RP Capital or obtaining the necessary transaction-by-transaction consent. The SEC also alleged that Price failed to carry out his responsibility as Chief Compliance Officer to implement the policies and procedures in place at SCG to prevent such principal transactions from taking place.

According to the SEC, between January 2009 and December 2011, Barclays engaged in 448 fixed income and 1097 initial public and secondary equity offering security transactions with its advisory clients without informing them that Barclays was acting as a principal for its own account or obtaining their consent for such transactions. The SEC further alleged that Barclays failed to send any written disclosure to certain clients with respect to these transactions, and sent certain clients consent notices with incomplete information that, according to the SEC, did not enable Barclays' advisory clients to make an informed decision as to whether to consent to such transactions. According to the SEC, these transactions resulted in $2,853,119.62 in revenue for Barclays. For more information on the SEC's charges against Barclays, please see the below article, ***SEC Charges Barclays with Compliance Failures after Acquiring Lehman***.

According to the SEC, between May 2010 and March 2011, Asbell was the sole trustee of a trust (the "**Trust**") established for the benefit of family members of a deceased former advisory client. The SEC alleged that Asbell caused the Trust to purchase shares of four different companies from Asbell and his family members without first providing the Trust a written disclosure of these principal transactions.

According to the SEC, between 2007 and 2009, Highland engaged in a number of transactions with its advisory clients without disclosing in writing that Highland was acting as principal before the trades were settled. The SEC alleged that on September 23, 2008, an account in Highland's name purchased $3,300,423 in securities from one of Highland's advisory clients without obtaining such client's consent and on September 19, 2008, Highland advised two clients to sell approximately $15 million in debt securities to four separate accounts in which Highland had an ownership interest, again without obtaining such clients' consent.

According to the Orders, each of the Advisers was ordered to cease and desist from causing any further violations of the Advisers Act, to comply with their individual undertakings, and to be censured. Furthermore, according to the Orders: (i) SCG was ordered to pay $368,459 in disgorgement, $17,831.50 in prejudgment interest, and $200,000 in civil money penalties; (ii) Price was ordered to pay $50,000 in civil money penalties; (iii) Barclays was ordered to pay $15 million in civil money penalties; (iv) Asbell was barred from association with, and prohibited from serving as, an investment advisor and ordered to pay $60,622.90 in disgorgement, $5,772.65 in prejudgment interest, and $150,000 in civil money penalties; and (v) Highland was ordered to pay $225,000 in civil money penalties.

- **See a copy of the SEC's press release for SCG and Barclays**
- **See a copy of the SEC's order for SCG, Barclays, Asbell and Highland**

SEC Charges Barclays with Compliance Failures after Acquiring Lehman

On September 23, 2014, the SEC issued an order instituting cease-and-desist proceedings (the "**Order**") against Barclays Capital Inc. ("**Barclays**") for failing to maintain an adequate internal compliance program following Barclays' acquisition of the Lehman Brothers' ("**Lehman**") advisory business in September 2008. According to the Order, Barclays violated Sections 204(a), 206(3), 206(4) and 207 of the Advisers Act and Rules 204-2, 206(4)-2 and 206(4)-7 thereunder.

According to the Order, the SEC alleged that Barclays violated Section 206(3) of the Advisers Act by engaging in principal transactions without obtaining the necessary client consent and charged commissions and fees, and earned revenues, that were not adequately or correctly disclosed to its clients. For more information about Barclays' alleged engagement in principal transactions, please see the above article, ***SEC Brings Four Enforcement Actions for Undisclosed Principal Transactions and Other Violations***. In addition, the SEC alleged that Barclays failed to adopt and implement policies and procedures and did not maintain certain required books and records to prevent other violations. Further, according to the SEC, Barclays violated certain of the provisions of Rule 206(4)-2 under the Advisers Act (the custody rule) by, among other things, failing to ensure that certain client funds and securities were subject to verification by an annual surprise examination by an independent public accountant and failing to have a reasonable basis to believe that the qualified custodian for certain client funds sent account statements to the applicable clients on a quarterly basis. The SEC also alleged that Barclays violated Section 207 of the Advisers Act by materially underreporting its assets under management in its March 31, 2011 amendment to its Form ADV.

Without admitting or denying the SEC's findings, Barclays settled the proceedings. Barclays agreed to be censured, pay a civil penalty of $15 million and undertake several remedial measures, including reimbursing its affected clients approximately $3.8 million, retaining an independent compliance consultant to review its policies and address the violations, preserving records of its compliance with such undertakings and notifying its advisory clients of the Order.

- **See a copy of the SEC's press release**
- **See a copy of the Order**

SEC Charges Wells Fargo with Failing to Maintain Adequate Insider Trading Controls and Withholding and Falsifying Documents

On September 22, 2014, the SEC issued an order instituting settled administrative proceedings (the "**Order**") against Wells Fargo Advisors LLC ("**Wells Fargo**"), a dually registered investment adviser and broker-dealer, for violating Sections 15(g), 17(a) and 17(b) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") and Rule 17a-4(j) thereunder and Sections 204A and 204(a) of the Advisers Act by failing to maintain sufficient controls with regard to insider trading and withholding and falsifying documents during the subsequent investigation. According to the press release, the SEC's charges are the first against a broker-dealer for failing to protect a customer's material nonpublic information.

Section 15(g) of the Exchange Act generally requires broker-dealers to establish, maintain and enforce policies and procedures to prevent the misuse of material nonpublic information. According to the Order, a Wells Fargo representative misappropriated confidential inside information relating to the acquisition of Burger King Holdings, Inc. ("**Burger King**") that he had received from a customer in 2010 and traded on the basis of this information, both for himself and through tipping several of his Wells Fargo customers. According to the Order, Wells Fargo reviewed this trading but failed to take any action due to inadequate policies and inconsistent enforcement of existing policies.

In addition, according to the Order, Wells Fargo initially withheld certain documents requested by the SEC relating to Wells Fargo's internal review of the representative's trading activity with respect to Burger King securities without any explanation for the delay in production. Moreover, according to the Order, one of the documents Wells Fargo did produce following the delay was altered prior to its production.

Wells Fargo settled the proceedings, admitting to the SEC's findings and acknowledging that its conduct violated the federal securities laws. Wells Fargo agreed to be censured, pay a civil penalty of $5 million and undertake remedial measures, including retaining an independent compliance consultant to review its policies and address the violations and preserving records of its compliance with such undertakings.

- **See a copy of the SEC's press release**
- **See a copy of the Order**

Notes from Europe: European Regulatory Developments

European Regulatory Developments Regarding Remuneration in the Financial Services Industry

The move toward stricter regulation of remuneration in the financial services industry in the European Union has continued over the course of the past year, rendering the web of overlapping European Directives and local EU Member State law and regulation, each of which seeks to place limits on remuneration, ever more confusing. There are four main European Directives that regulate remuneration: Capital Requirements Directive IV ("**CRD IV**"); Alternative Investment Fund Managers Directive ("**AIFMD**"); fifth Undertakings for Collective Investment in Transferable Securities Directive ("**UCITS V**"); and Markets in Financial Instruments Directive ("**MiFID**").

CRD IV sets out detailed requirements in relation to the remuneration policies and practices of banks and other financial institutions, including a cap on bonuses which has proved particularly contentious.

The European Securities Market Authority ("**ESMA**") has adopted the Guidelines on sound remuneration policies under the AIFMD, which together with the AIFMD set out the framework for the remuneration of identified staff at managers of alternative investment funds. The AIFMD regulates alternative investment fund managers ("**AIFMs**") other than UCITS funds and includes restrictions on variable compensation of certain identified staff of EU-authorised AIFMs. It is worth noting that there is no cap on variable pay under the AIFMD, nor are there any malus or clawback requirements.

On 23 July 2014, the Council of the EU announced that it has adopted the text of the UCITS V Directive that the European Parliament had adopted on 15 April 2014. The publication of the Directive in the Official Journal of the EU is expected to occur in Q4 2014. UCITS V's objectives are to enhance the depositary's duties and liabilities, introduce common standards for sanctions arising from UCITS V and create remuneration policies for investment and management companies.

ESMA has published the ESMA MiFID Guidelines with the aim of ensuring that firms' remuneration policies and practices are aligned with their conflict of interest and conduct of business obligations so that their clients' "interests are not impaired by the remuneration policies and practices adopted by the firm in the short, medium and long term." In addition, the ESMA MiFID Guidelines set out a number of examples of what ESMA considers to be good and bad practice in relation to firms' remuneration policies and practices. A large number of elements of the MiFID II Directive need to be further specified in delegated acts to be adopted by the European Commission and technical standards.

For a detailed discussion of the regulatory developments, please see the September 5, 2014 Davis Polk Client Memorandum, ***European Regulatory Snapshot: Remuneration in the Financial Services Industry 2014***.

- **Read the text of CRD IV**
- **Read the text of AIFMD**
- **Read the text of UCITS V**
- **Read the text of MiFID I**
- **Read ESMA's Guidelines on Remuneration Policies and Practices**
- **Read the text of the MiFiD II directive**
- **Read the text of the MiFiD II regulation**

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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