

Investment Management Regulatory Update

Breaking News on Enforcement Activity

- Hedge Funds Under Scrutiny for Bets Against the Euro

SEC Rules and Regulations

- SEC Adopts Amendments to Money Market Fund Rules

Industry Update

- New Developments Regarding Pay-to-Play Arrangements
- Treasury Proposes “Volcker Rule” Legislative Text
- FINRA Offers Guidance on Members’ Use of Social Media Websites

Litigation

- Investment Advisory Firm Executive Settles Charges of Insider Trading in Shares of a Mutual Fund
- State Street Charged with Misleading Investors About Sub-Prime Mortgage Investments

Breaking News on Enforcement Activity

Hedge Funds Under Scrutiny for Bets Against the Euro

According to recent news reports, the antitrust division of the United States Department of Justice (the “**Justice Department**”) has launched an investigation into recent hedge fund trading activity against the Euro. A primary subject of the Justice Department investigation appears to be a February 8, 2010 dinner party at which a group of hedge fund traders allegedly discussed how hedge funds could benefit from a decline in the Euro’s value. While reports indicate that the discussion of the Euro lasted only about five minutes, there have been allegations that a wave of selling hit the Euro in the following days.

Although the Justice Department has not issued an official statement, press reports indicate that the investigation is focused on whether certain hedge fund representatives present at the dinner party might have colluded to short sell the Euro, thus driving the currency’s price down. In connection with the investigation, it is reported that several hedge funds have been asked by the Justice Department not to destroy trading records relating to their recent currency trading activity. The European Commission has also reportedly announced that it will launch an investigation into sovereign credit-default swaps and their role in driving down the price of the Euro.

Davis Polk is examining the issues underlying the Justice Department’s investigation and will continue to monitor events in this area.

- ▶ [See The Wall Street Journal article *Hedge Funds Try ‘Career Trade’ Against Euro*](#)
- ▶ [See the Bloomberg article *U.S. Said to Tell Hedge Funds to Save Euro Records*](#)
- ▶ [See The New York Times article *Traders Seek Out the Next Greece in an Ailing Europe*](#)

SEC Rules and Regulations

SEC Adopts Amendments to Money Market Fund Rules

Following a full-scale review of the money market fund regulatory regime after the Reserve Primary Fund “broke the buck” in September 2008, the SEC on February 22, 2010 issued a release (the “**Adopting Release**”) adopting rules and rule amendments with respect to money market funds (the “**Amendments**”). Among other things, the Amendments tighten a number of conditions imposed on money market funds to limit their exposure to certain risks, such as credit, currency and interest rate risks. The Amendments require money market funds to increase the credit quality of their portfolios, to reduce the maximum weighted average maturity of their portfolios, and to maintain liquidity buffers to enable the funds to withstand sudden redemption demands. The Amendments also introduce procedural requirements for money market funds. For example, the Amendments require that money market fund managers stress test their portfolios and provide investors with portfolio information. The Amendments also provide a means for a liquidating money market fund to be wound down in an orderly manner where the fund has broken the buck. The Amendments essentially maintain the current stable net asset value regime for money market funds and do not require them to adopt a floating net asset value model.

In addition to introducing the Amendments, the Adopting Release notes that the SEC expects to address additional issues in the future and intends to propose further reform to the regulation of money market funds. In particular, the Adopting Release explains that the SEC has solicited, and is in the process of considering, comments on additional and more fundamental regulatory changes—such as a transition to a floating net asset value—that could potentially “transform the business and regulatory model on which money market funds have been operating for more than 30 years.”

The Amendments become effective on May 5, 2010 with mandatory compliance for various aspects of the Amendments phased in over time.

In order to limit money market funds’ credit risk exposure, the Amendments reduce money market funds’ ability to invest in “Second Tier Securities” (*i.e.*, generally, certain securities that have received only the second-highest short-term credit rating) thereby primarily restricting the funds to investing in “First Tier Securities” (*i.e.*, generally, securities that have received only the highest short-term credit rating). Money market funds are prohibited from acquiring any Second Tier Securities with a maturity in excess of 45 days (rather than the current limit of 397 days). Further, money market funds are only permitted to have 3% of total assets invested in Second Tier Securities (instead of the current 5% limit) and may not have more than one-half of one percent of total assets concentrated in Second Tier Securities of a single issuer (as compared to the current limit of the greater of 1% or \$1 million). The Adopting Release notes that the adopted 3% limit will reduce money market funds’ aggregate risk exposure, while continuing to allow fund investors to benefit from the higher returns that limited exposure to Second Tier Securities can provide. The Adopting Release also explains that the concentration limit with respect to any single issuer of Second Tier Securities will enhance the resilience of money market funds by decreasing the ability of a single issuer’s default to cause a money market fund to break the buck.

While the rules governing money market funds continue to utilize credit ratings issued by nationally recognized statistical rating organizations (“**NRSROs**”) by restricting investments in rated securities to those receiving the highest ratings by certain NRSROs, the Amendments introduce new requirements intended to minimize over-reliance on NRSRO ratings and foster competition among NRSROs. First, the Amendments retain the existing requirement that a fund’s board of directors (or its delegate) conduct an independent credit analysis of every security that a money market fund purchases. The Amendments also introduce a new process pursuant to which each fund’s board of directors must designate four or more NRSROs whose credit ratings the fund will look to for purposes of satisfying the minimum ratings requirements embodied in the definition of Eligible Securities. The board of directors must annually, with the benefit of the recommendation of the fund’s adviser and its credit analysts, determine that these

NRSROs' ratings are reliable for this purpose. The Adopting Release asserts that this approach will place greater responsibility on boards of directors and encourage NRSROs to compete for such designations. The Amendments also reduce potential over-reliance on NRSROs by eliminating a requirement that money market funds invest in asset backed securities only if they are rated by an NRSRO.

In order to lessen the exposure of money market funds to risks such as interest rate risk, spread risk and liquidity risk, the Amendments enhance existing maturity limitations on a money market fund's portfolio. The Adopting Release notes some of the dangers of a portfolio that is weighted towards securities with longer maturities. As the Adopting Release notes, such a portfolio will increase a fund's exposure to interest rate risk, amplify spread risks, and decrease the ability of a fund to pay redeeming shareholders. The Amendments respond to this risk by shortening the maximum dollar-weighted average maturity of a fund's portfolio from 90 to 60 days as a means of enabling funds to withstand, among other things, greater interest rate changes and larger increases in spreads. The Amendments also further restrict the extent to which a fund can invest in longer-term securities that may expose a fund to spread risks by adopting a 120-day limit on the weighted average life of a money market fund's portfolio.

The Amendments, for the first time, mandate that money market funds meet minimum liquidity standards. Under the Amendments, money market funds must maintain a minimum percentage of their assets in highly liquid form. All money market funds are required to ensure substantial weekly liquidity by maintaining at least 30% of their assets in cash, U.S. Treasury securities, certain other government securities with a maximum remaining maturity of 60 days, or securities that convert into cash within one week. Further, taxable money market funds must also ensure a moderate level of daily liquidity by maintaining at least 10% of their total assets in cash, U.S. Treasury securities, or securities that convert into cash within one day. These liquidity requirements seek to ensure that a fund is able to pay redeeming shareholders even in market conditions in which money market funds cannot rely on a secondary or dealer market to provide immediate liquidity. The Amendments apply the same minimum liquidity standards to both institutional and retail money market funds, but the Adopting Release notes that the SEC will revisit its decision to do so and "reevaluate whether there is a workable objective definition that would accurately identify funds with lower liquidity needs." The Amendments also bolster liquidity by restricting money market funds' ability to purchase illiquid securities. The new restriction prohibits money market funds from making any purchase of illiquid securities that would result in more than 5% of the fund's portfolio consisting of illiquid securities, which are defined as securities that cannot be liquidated within seven days at approximately the value ascribed to them by the fund.

In another liquidity-related measure, the Amendments require money market funds to hold sufficiently liquid securities to satisfy foreseeable redemptions. As the Adopting Release notes, this requirement, depending upon the volatility of a fund's cash flows, may require a fund to maintain greater liquidity than is required by the daily and weekly liquidity requirements discussed above. The Adopting Release does not provide specific compliance procedures, noting instead that it is the responsibility of each fund's management and board of directors to "evaluate the fund's liquidity needs." Thus, the Adopting Release notes that, in order to comply, a fund should adopt policies and procedures designed to appropriately identify risk characteristics of the fund's shareholders. Moreover, the Adopting Release cautions directors considering such policies and procedures to bear in mind that a fund manager's interests in attracting additional assets may conflict with its duty to manage the fund in a manner consistent with maintaining a stable net asset value.

Under another liquidity-related provision, the board of directors of each money market fund will be required to adopt procedures providing for periodic stress testing of the money market fund's portfolio. The stress testing will assess the fund's ability to maintain stable net asset value per share in spite of hypothetical economic stresses, such as significant redemptions, changes in short-term interest rates or changes in the portfolio's credit quality. A fund's board of directors need not design the stress tests, but must receive a report of the results of each stress testing at the board's next regularly scheduled meeting

(or sooner if the results are sufficiently negative). Money market funds are required to retain records of the stress testing for six years.

Two changes are introduced by the Amendments with respect to money market funds' investments in repurchase agreements. First, the Amendments restrict funds to investing only in repurchase agreements collateralized by cash items or Government securities in order for the fund to "look through" the repurchase issuer to the underlying collateral for diversification purposes. Second, the Amendments reinstate a provision eliminated in 2001 that makes the "look through" available only where a fund's board of directors (or its delegate) has evaluated the creditworthiness of the repurchase agreement's counterparty.

The Amendments also introduce new requirements to enhance disclosure by money market funds regarding their portfolio securities. The disclosure requirements are intended to provide investors with some insight into the risks to which each fund is exposed. On a monthly basis, money market funds are required to post to their websites a schedule of their investments, including, among other things, the name of the issuer, the category of investment, CUSIP number, principal amount, maturity date, final legal maturity date, coupon or yield, and amortized cost value. Each money market fund must also provide for both the money market fund and each class of the fund certain information regarding the dollar weighted average portfolio maturity. All information, which must be current as of the last business day of the prior month and posted no later than the fifth business day of each month, must be maintained on the website for a minimum period of six months.

Money market funds are also required, under the Amendments, to provide the SEC with a monthly electronic filing of more detailed portfolio information that will be used to create a central database of money market fund portfolio holdings. This information, which will be made public 60 days after the end of the month to which the information pertains, will be provided to the SEC on a new Form N-MFP. The information provided on a money market fund's Form N-MFP includes the information disclosed on that fund's website, as described above, as well as, among other things, additional information about whether the securities are rated and, if so, the ratings of each security assigned by the designated NRSROs, whether the instrument has certain enhancement features, the percentage of the fund's assets invested in the security, and whether the security is an illiquid security. The fund must also report on Form N-MFP certain information about the fund itself, such as the dollar weighted average maturity of the portfolio and its seven-day gross yield.

Most notably, however, each money market fund is required to report on Form N-MFP the market-based values of each portfolio security and the fund's "shadow net asset value" (*i.e.*, the fund's market-based net asset value per share), with separate entries for values that do and do not take into account any relevant capital support agreements. The Adopting Release notes that this information will assist the SEC in "understanding . . . fund portfolio valuation practices as well as the potential risks associated with a fund." Additionally, the Adopting Release asserts that public disclosure will help investors make better informed decisions about money market fund investments and will contribute to a dialogue between investors and a fund's manager about the fund's risk profile and any plans to address discounts between the shadow net asset value and the stable net asset value. According to the Adopting Release, the SEC believes that the 60-day lag on public disclosure appropriately alleviates concerns about the disclosure of market-based values, including the concern that such disclosure might result in heightened redemption requests that exacerbate pricing deviations, since the fund may take steps during those 60 days to resolve issues that might cause investor concern.

The first mandatory filing on Form N-MFP will be due on December 7, 2010, for holdings as of the end of November 2010. In light of this compliance date, the Amendments also extend the expiration date of Rule 30b1-6T, promulgated pursuant to the Investment Company Act of 1940, to December 1, 2010. Once mandatory, Form N-MFP will subsume the information currently provided to the SEC by Rule 30b1-6T, which requires weekly filing of portfolio information by money market funds whose market-based net asset value per share is below \$0.9975.

The Amendments also introduce new measures centered around the possibility of money market funds breaking the buck and aimed at improving operations at money market funds. The Amendments require that every fund (or its transfer agent) have the capacity to process purchases and redemptions at a price based upon the fund's current net asset value per share regardless of whether this corresponds to the stable net asset value or price per share. This enables a fund that breaks the buck to continue processing purchases and redemptions. In addition, the Amendments introduce a new rule that permits money market funds to suspend redemptions and postpone payment of redemption proceeds after the fund's board of directors (including a majority of disinterested directors) has determined that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results and has irrevocably approved liquidation. Prior to implementing the suspension, the fund must notify the SEC of its decision to suspend redemptions and liquidate. As the Adopting Release notes, this provision permits the orderly termination of a fund and reduces the harmful effects to investors of a run on the fund. The provision also allows the SEC, upon notice and hearing, to take steps, such as requiring the fund to resume honoring redemptions, for the protection of investors.

Finally, the Amendments ease the conditions under which a money market fund's affiliates may purchase distressed assets in order to protect the fund from losses. In particular, affiliates are now permitted to purchase a fund's portfolio security that has ceased to be an Eligible Security or has defaulted as long as the affiliate purchases the security in cash and at a price that is equal to the greater of amortized cost or market value, including accrued interest. An affiliate may purchase any other portfolio security, subject to the same requirements as well as a clawback mechanism that requires the affiliate to return to the fund any profit realized from the subsequent sale of the security. Any time a fund's affiliates purchase securities pursuant to this rule, the fund must promptly notify the SEC by electronic mail of the sale and provide a reason for the purchase.

- ▶ [See a copy of the Adopting Release](#)

Industry Update

New Developments Regarding Pay-to-Play Arrangements

As previously reported in several *Investment Management Regulatory Updates*, including the [October 9, 2009](#), [November 11, 2009](#), [January 7, 2010](#) and [February 5, 2010](#) editions, pay-to-play practices have been, and continue to be, a hot topic of investigation and reform. Most recently, California Assemblyman Ed Hernandez (D) has proposed a law that would enhance the regulation of placement agents in relation to California's public pension funds. With respect to the SEC's proposal to impose a blanket ban on the use of placement agents to solicit business from government pension plans, Andrew J. Donohue, Director of the SEC's Division of Investment Management, noted in a recent speech that the SEC staff is actively addressing criticisms and recommendations raised by industry participants. Among the items being considered by the SEC staff is a comment letter from Senator Christopher Dodd (D-Conn.), Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, in which he suggests an alternative approach to curb pay-to-play practices. Additionally, in New York, Attorney General Andrew M. Cuomo announced settlement agreements with two firms implicated in pay-to-play practices involving the New York State Common Retirement Fund ("**NYCRF**"). Finally, on February 18, 2010, New York City Comptroller John C. Liu announced a new set of pay-to-play rules regarding New York City pension plans.

We discuss each of these developments below.

California Assembly Bill No. 1743

In light of discoveries that certain investment managers have paid millions of dollars to influential placement agents in order to secure investments from the California Public Employees' Retirement

System (“**CalPERS**”), Assemblyman Hernandez has proposed a bill (the “**Hernandez Bill**”) that would require placement agents to register as lobbyists in order to be eligible to solicit investments from public retirement plans. Under the Hernandez Bill, placement agents would be defined as lobbyists in accordance with California’s Political Reform Act and would be subject to stringent gift limits, bars on campaign contributions, and bans on receiving compensation linked to investment decisions by California state pension plans. According to the press release issued by the California State Controller’s Office, placement agents would have to report every quarter on their fees and compensation and on any honoraria or gifts that they receive. The Hernandez Bill would apply to placement agents soliciting CalPERS, the California State Teachers’ Retirement System and those retirement plans in California that are subject to lobbyist registration requirements. According to California State Treasurer Bill Lockyer, the proposed law would “help protect the integrity of [public pension fund investment] decisions by increasing transparency and reducing the ability of high-paid middlemen to use money and gifts to win favorable treatment.”

The SEC’s proposed ban on placement agent solicitation of government pension plans

In its proposed pay-to-play rule, *Release No. IA-2910*—Political Contributions by Certain Investment Advisers, the SEC proposed an outright ban on the use of placement agents by investment advisers to obtain government clients as part of its efforts to stem pay-to-play activities by investment advisers.

The SEC’s proposed pay-to-play rule generated well over 200 comment letters, many of which are critical of the SEC’s proposed approach. In a February 25, 2010 speech, Mr. Donohue acknowledged this reaction to the SEC’s proposal and indicated that the SEC staff is in the process of working through comments submitted on the proposed pay-to-play rule, which include Davis Polk’s comment letter dated October 6, 2010 and crafting a recommendation for a final rule. In particular, Mr. Donohue indicated that the SEC staff is determining how to best address comments regarding, among other things, “the proposal’s ban on payment to third party placement agents.” Mr. Donohue noted that, on this point, commenters argued “that placement agents can provide important services to investment advisers seeking to compete for government business, as well as to pension plans.” Finally, Mr. Donohue noted that he has, in a letter to FINRA, indicated that if FINRA were to ban pay-to-play activities by registered broker-dealers, the SEC could exclude registered broker-dealers from its proposed blanket ban on the solicitation of government business by placement agents.

Among those commenting on the SEC’s proposed pay-to-play rule was Senator Dodd. In a comment letter dated February 2, 2010, Senator Dodd opposed such an “across-the-board prohibition” and instead recommended “strong regulation” of placement agents. Acknowledging the need for increased protection of investors and other beneficiaries as well as the beneficial role played by placement agents in channeling investment opportunities, Senator Dodd proposes a regime similar to that reflected in his proposed Restoring American Financial Stability Act, which would require “municipal advisors” (essentially, advisers to and solicitors of municipal entities) to register with the SEC. This would permit the SEC “to monitor the activities of placement agents” and would “increase transparency and disclosure in the marketplace, [as well as] prevent abuses . . . without prohibiting . . . useful and legitimate practices.”

Settlements pursuant to New York State Attorney General investigation

As previously reported in the [January 7, 2010 Investment Management Regulatory Update](#), the New York Attorney General’s office has been engaged in a two-year, ongoing investigation of pay-to-play practices involving the Office of the New York State Comptroller (the “**OSC**”) and the NYCRF. Pursuant to this investigation, on February 8, 2010, Attorney General Cuomo announced settlement agreements with Markstone Capital Group LLC (“**Markstone**”), an Israeli venture capital firm, and Wetherly Capital Group LLC, a California-based placement agent firm, together with its broker-dealer DAV/Wetherly Financial (“**Wetherly**”).

On account of gifts and contributions made to top OSC officials by Markstone founder Elliot Broidy, as detailed in the [January 7, 2010 Investment Management Regulatory Update](#), Markstone allegedly secured a \$250 million investment and received approximately \$18 million in management fees from the NYCRF in connection with such investment. Subsequently, a settlement agreement has been concluded with the Office of the Attorney General, under which Markstone must pay \$18 million in restitution to the NYCRF.

Wetherly received placement fees in excess of \$3.1 million pursuant to agreements with three private equity firms that Wetherly introduced to the NYCRF that entitled Wetherly to receive a portion of any investments NYCRF made with these firms. In each case, Wetherly allegedly paid approximately \$500,000 of the fees it received to Henry “Hank” Morris, political adviser to Alan Hevesi, who was Comptroller at the time, and approximately \$140,000 to Julio Ramirez, Jr., an unlicensed placement agent who introduced Wetherly and Morris. Under a settlement with Attorney General Cuomo’s office, Wetherly has agreed to return \$1 million to the NYCRF.

Additionally, both Markstone and Wetherly have pledged to adopt Attorney General Cuomo’s Public Pension Fund Reform Code of Conduct.

Reforms to New York City pension fund investment solicitations

On February 18, 2010, New York City Comptroller John C. Liu announced a new set of rules regarding the solicitation of New York City pension plan investments. Mr. Liu indicated that “changes have been formulated to ensure the utmost of integrity in investment decision-making, with the prime objective of maximizing returns to protect taxpayers and our pensioners.” To become effective, these new regulations, in so far as they relate to placement agents, must be approved by the pension boards of the New York City Employees’ Retirement System, the Teachers’ Retirement System, the New York City Police Pension Fund, the New York City Fire Department Pension Fund, and the Board of Education Retirement System. Some of the key elements of the proposed rules are highlighted below.

- ***Ban on Campaign Contributions.*** Investment managers and their agents dealing with or soliciting business from the New York City pension plans would be banned under the new rules from making campaign contributions to the Comptroller’s Office. This prohibition would be in addition to the New York City Campaign Finance Act requirements, which regulate campaign contributions and their disclosure.
- ***Rules for Fund Managers.*** Among other things, fund managers would be prohibited from giving any gifts to employees or trustees of the Comptroller’s Office or New York City’s pension plans and would be required to certify their compliance with this prohibition. Additionally, fund managers would be required to disclose all correspondence with the Comptroller’s Office with respect to new investments as well as all interactions with pension system trustees and other persons involved in the administration of investment decisions. Disclosure would also be required by fund managers of fees paid to and terms of agreements with third-party marketers and placement agents, as well as of the fact that any such fees are fully paid by the manager. While not entirely clear from the Comptroller’s announcement, these rules presumably would only apply to fund managers that solicit investments from New York City pension plans.
- ***Rules for Placement Agents and Third-Party Marketers.*** The new changes, on the one hand, would tighten current regulation by imposing a ban on placement agents and third-party marketers to the extent such agents are providing only “finder’ or introduction services.” On the other hand, the proposed rules relax current rules with respect to private equity placement agents, who would, under the new rules, be allowed to “provide legitimate value-added services such as due diligence and similar professional services on behalf of prospective investors.” In addition, the reforms would require agents and marketers to show their ability to generate capital outside New York City, by proving that they raised \$500 million in two of the past three years from institutions other than New York City pension plans. Resumes of key personnel who interact with decision-makers within the pension plans would have to be submitted as well as a full account of

“value-added services” provided. Further, placement agents and third-party marketers soliciting New York City pension plans would be required to be registered with either the SEC or the Financial Industry Regulatory Authority.

- *Penalties.* Contracts for investment or commitment with New York City pension plans would be required to contain provisions that permit the pension plans to terminate or rescind the investment or commitment and to recoup all management and performance fees if fund managers violate the new rules.

We will continue to monitor developments with respect to pay-to-play investigations and regulations.

- ▶ [See a copy of the California Assembly Bill No. 1743](#)
- ▶ [See a copy of the press release from the California State Controller's Office](#)
- ▶ [See a copy of Andrew J. Donohue's speech](#)
- ▶ [See a copy of Senator Dodd's comment letter to the SEC](#)
- ▶ [See a copy of the press release from the Office of the New York Attorney General](#)
- ▶ [See a copy of the press release from the New York City Comptroller's Office](#)

Treasury Proposes “Volcker Rule” Legislative Text

On March 3, 2010, the U.S. Department of the Treasury released proposed legislative text to implement the “Volcker Rule” (the “**Proposal**”), which was proposed by President Barack Obama as reported in the January 25, 2010 Davis Polk Client Memorandum *President Obama Proposes Size and Activities Limits for Financial Institutions*. The legislative text provides greater detail regarding the specific scope of the Volcker Rule as envisioned by the Obama Administration. While this article addresses only those aspects of the Proposal that are of particular importance for our Investment Management clients, a description of the full Proposal (including its restrictions on proprietary trading) is available in the March 4, 2010 Davis Polk Client Memorandum *Treasury Proposes “Volcker Rule” Legislative Text*.

The Proposal, which would introduce new sections to the Bank Holding Company Act of 1956 (“**BHCA**”), would, among other things, require “appropriate Federal banking agencies” to introduce a prohibition against certain institutions sponsoring or investing in private equity or hedge funds, which are defined as entities that are exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or “such similar funds as determined by the appropriate Federal banking agencies.” In particular, this prohibition would apply to insured depository institutions, companies that control an insured depository institution, and companies that are “treated as a bank holding company” for purposes of the BHCA (together, “**Covered Entities**”).

The Proposal’s prohibition on “sponsoring” a private equity or hedge fund would prohibit Covered Entities from, among other things: serving as a general partner, managing member, or trustee of a fund; selecting or controlling a majority of the directors, trustees or management of a fund; or sharing any variation of the same name with a fund for various purposes. The Proposal provides two narrow exceptions to the prohibition on investments in hedge funds and private equity funds for investments in small business investment companies and certain “public welfare” investments. The investments anticipated by these exceptions, however, must be implemented pursuant to a separate statutory authorization and would be subject to any conditions prescribed by the appropriate Federal banking agency. Additionally, under the Proposal, any Federal Reserve-supervised “nonbank financial company” that sponsored or invested in hedge funds or private equity funds (other than pursuant to the narrow exceptions described above) would be subject to additional capital requirements and additional quantitative limits to be adopted by the Board of Governors of the Federal Reserve System. Notably, the Proposal fails to define the term

“nonbank financial company,” raising some question as to what type of entities this concept is meant to capture.

The Proposal would also introduce limitations on certain transactions or relationships with hedge funds and private equity funds. Any Covered Entity that serves as the investment adviser or investment manager of a hedge fund or private equity fund would be prohibited from providing custody, securities lending and other prime brokerage services to such fund. Further, such a Covered Entity would be barred from entering into any covered transaction, as defined in Section 23A of the Federal Reserve Act, with the fund that it advised or managed (such as making a loan to the fund or guaranteeing the fund’s obligations). A Covered Entity (other than an insured depository institution) that acts as an investment adviser or investment manager to a hedge fund or private equity fund would also be subject to Section 23B of the Federal Reserve Act (“**Section 23B**”) as if such Covered Entity were a member bank and such fund were an affiliate (which would essentially require transactions between them to be on arm’s length terms). Insured depository institutions are likely carved-out of this section of the Proposal because these institutions are already subject to Section 23B.

- ▶ [See a copy of the Proposal](#)

FINRA Offers Guidance on Members’ Use of Social Media Websites

On January 25, 2010, the Financial Industry Regulatory Authority (“**FINRA**”) issued a Regulatory Notice (the “**Notice**”) providing guidance to member firms regarding the application of FINRA’s rules governing communications with the public to the use of “social media Web sites, such as blogs and social networking sites,” sponsored by a firm or its registered representatives. In general, the Notice does not break new ground, but specifies how existing FINRA rules and established prior guidance apply to these types of media.

The Notice, which takes the form of a series of questions and answers, addresses various regulatory questions that may arise in the social media context, including the following:

- *Recordkeeping Responsibilities.* According to the Notice, before a firm, or its associated persons, communicate through a social media website, it must ensure that it is able to retain records of any such communications that relate to its “business as such” as required by Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (the “**Exchange Act**”) and NASD Rule 3110. The Notice also reminds firms that it is their responsibility to determine whether available technology systems provide the retention and retrieval functions necessary to ensure compliance with FINRA’s books and records rules.
- *Suitability Responsibilities.* Any recommendation of a security made through a social media website will trigger the suitability requirements of NASD Rule 2310 and require the broker-dealer to determine that the recommendation is suitable to every investor to whom it is made available. The Notice warns that recommendations of specific investment products may also trigger requirements under the federal securities laws. Consequently, the Notice advises firms to adopt policies and procedures reasonably designed to address such communications and, as best practice, to consider prohibiting all such communications unless previously approved by a registered principal.
- *Types of Interactive Electronic Forums.* According to the Notice, FINRA considers static postings to a member firm’s blog or on a social networking site to constitute “advertisements” under FINRA Rule 2210, and therefore must receive appropriate approval from a registered principal prior to posting. Real-time interactive communications, however, would be considered to be made in an “interactive electronic forum” and would be subject to the rules governing public appearances. Thus, these would not require prior approval but would remain subject to other supervisory requirements and content requirements.

- *Supervision.* With respect to interactive communications, while principal approval may not be required, the Notice explains that firms must supervise the communications in a manner “reasonably designed to ensure that they do not violate the content requirements of FINRA’s communications rules.” To this end, the Notice indicates that firms may opt to employ risk-based principles to determine the extent to which proper supervision requires the review of incoming, outgoing and internal electronic communications. Further, the Notice emphasizes that firms must have policies and procedures for the review by a supervisor of employees’ electronic communications that relate to certain subject matters that require review under FINRA rules and federal securities laws. FINRA has previously provided guidance on this topic in its Regulatory Notice 07-59 (*FINRA Guidance Regarding Review and Supervision of Electronic Communications*). Additionally, the Notice directs firms to adopt policies and procedures reasonably designed to ensure that those who establish or participate in social media sites are “appropriately supervised, have the necessary training and background to engage in such activities, and do not present undue risks to investors.”
- *Third-Party Posts.* FINRA will generally not consider third party posts on social media sites established by a firm or its personnel to be a communication of the firm subject to Rule 2210. However, the Notice cautions that such third-party posts may be attributed to the firm under certain circumstances where the firm has either been involved in the preparation of the content or has in some way endorsed or approved the content. As part of its analysis, FINRA will take into consideration a firm’s use of a disclaimer that third-party posts have not been reviewed and do not reflect the firm’s views. The Notice also describes certain best practices, including establishing guidelines for third-party usage, implementing processes for screening third-party content, and disclosing firm policies with respect to responsibility for third-party content.
 - ▶ [See a copy of the Notice](#)
 - ▶ [See a copy of the Notice 07-59, FINRA Guidance Regarding Review and Supervision of Electronic Communications](#)

Litigation

Investment Advisory Firm Executive Settles Charges of Insider Trading in Shares of a Mutual Fund

On January 20, 2010, the SEC announced that it settled charges against Charles J. Marquardt of insider trading in the shares of the mutual fund Evergreen Ultra Short Opportunities Fund (the “**Fund**”). The activity occurred, according to the SEC’s complaint, when Marquardt was the Senior Vice President and Chief Administrative Officer for the Fund’s investment adviser, Evergreen Investment Management Company, LLC (“**Evergreen**”).

According to the SEC’s complaint, on June 12, 2008, while in possession of knowledge that the Fund might reduce the value of some of its securities, thereby decreasing the Fund’s net asset value and possibly causing it to close, Marquardt redeemed all of his Fund shares. On the same day, a family member of Marquardt also redeemed his Fund shares. Subsequently, the Fund reduced the value of the securities and announced that it would liquidate. The SEC alleged that as an officer of Evergreen, the adviser to the Fund, Marquardt had a “fiduciary duty to Evergreen not to trade [in shares of the] Fund while in possession of material, nonpublic information about the Fund.” By acting upon Marquardt’s inside knowledge, according to the SEC, Marquardt and his family member violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and avoided aggregate losses of approximately \$19,000.

Marquardt agreed to disgorgement of the avoided losses, interest of approximately \$1,200, a penalty of approximately \$19,000 and a bar from association with any broker, dealer or investment adviser for two years.

- ▶ [See a copy of the SEC's press release announcing settlement of the charges](#)
- ▶ [See a copy of the SEC's complaint](#)

State Street Charged with Misleading Investors About Sub-Prime Mortgage Investments

On February 4, 2010, the SEC announced that it settled charges against State Street Bank and Trust Company (“**State Street**”) for selectively disclosing to certain investors, and misleading other investors about, the risks associated with their investment in its Limited Duration Bond Fund (the “**Fund**”). Discussed below are the SEC’s findings and the related facts, based on the SEC’s order.

With respect to the misleading of investors, the SEC noted that State Street’s marketing materials omitted material information, contained misleading statements and generally promoted the Fund as an alternative to money market funds even though it was heavily invested in sub-prime mortgage-backed instruments. Indeed, State Street described the Fund as having 100% exposure to ABS and 0% to MBS.

Additionally, between 2005 and 2007, State Street’s standard response to investors’ requests for proposal (“**RFPs**”) regarding the Fund’s use of derivatives was that “approximately 20-30% of the portfolio is comprised of derivative securities [and the Fund does] not maintain a leveraged exposure.” However, during that time, the Fund maintained a leveraged exposure and held sub-prime derivative contracts that exceeded 20-30% of the Fund. According to the SEC, State Street reported the sub-prime derivative exposures based only on market values rather than notional values and by so doing, investors were not informed that the Fund’s true, leveraged exposure to sub-prime investments was in excess of 100% of the Fund’s market value. The SEC stated in particular that “where a portfolio of assets includes derivative instruments, information about a portfolio’s notional value relative to its market value may be necessary to determine a portfolio’s exposure to leverage.”

The charges of selective disclosure were based on the SEC’s finding that State Street’s internal advisory groups (the “**Advisory Groups**”), which managed some of the accounts invested in the Fund, and certain investors had more complete and accurate knowledge of the Fund’s holdings and risks than did investors who relied on State Street’s general disclosure documents. On the basis of this knowledge, certain of the Advisory Groups recommended that their clients (including the pension plan of State Street’s parent company) redeem out of the Fund. At the same time, the SEC alleged, State Street encouraged other investors to remain in the Fund.

The Advisory Groups were able to obtain this information for several reasons: some of the Advisory Groups’ employees were members of State Street’s confidential Investment Committee; the Advisory Groups had access to the advisory personnel who managed the Fund; and the Advisory Groups received information that was only distributed internally which accurately reflected the Fund’s exposure to the sub-prime mortgage market. As a result of attendance at internal meetings, for example, some employees of the Advisory Groups were aware that the Fund planned to sell assets and that the Fund’s portfolio managers were expecting further losses in the Fund. This information was not disclosed to investors. The SEC’s order also drew attention to the lack of information barriers imposed on the Advisory Groups. For example, the Advisory Groups were not barred from making investment decisions about the Fund after attending meetings of the Investment Committee.

Further, according to the SEC, in 2007 State Street developed a list of Frequently Asked Questions (“**FAQs**”) relating to the sub-prime mortgage collapse. The FAQs were distributed to the Advisory Groups and client service personnel as a tool for communicating orally with investors who requested information

about the sub-prime market. As a result of information contained in the FAQs but not otherwise disclosed, investors and their consultants who requested information learned of the Fund's holdings, State Street's plans to lower the prices of some of the Fund's securities and State Street's largest Advisory Group's decision to redeem its clients from the Fund. State Street did not generally disseminate this information to the rest of the Fund's investors.

Shortly after receiving this information, many investors also redeemed their shares of the Fund. State Street satisfied the redemption requests from these better-informed investors by selling the Fund's most liquid holdings, thereby leaving the Fund and its less-informed investors with largely illiquid securities.

State Street has agreed to pay more than \$255 million in restitution to investors in the Fund, disgorgement and interest of more than \$8.3 million and a \$50 million penalty. State Street had previously agreed to the payment of nearly \$350 million in settlement of private investor lawsuits, which brings its total tally to over \$660 million.

- ▶ [See a copy of the SEC's press release announcing settlement of the charges](#)
- ▶ [See a copy of the SEC's order](#)

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

John G. Crowley	212 450 4550	john.crowley@davispolk.com
Nora M. Jordan	212 450 4684	nora.jordan@davispolk.com
Yukako Kawata	212 450 4896	yukako.kawata@davispolk.com
Leor Landa	212 450 6160	leor.landa@davispolk.com
Danforth Townley	212 450 4240	danforth.townley@davispolk.com
Joseph J. Cipolla	212 450 4911	joseph.cipolla@davispolk.com

© 2010 Davis Polk & Wardwell LLP

Notice: This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have any questions about the matters covered in this publication, the names and office locations of all of our partners appear on our website, davispolk.com.