Investment Management Regulatory Update

August 22, 2012

SEC Rules and Regulations

SEC Staff Responds to Questions About Form PF

On July 19, 2012, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued additional responses (the "**Responses**") to frequently asked questions regarding Form PF. Investment advisers registered or required to register with the SEC under the Investment Advisers Act of 1940 (the "**Advisers Act**") that advise one or more private funds (*i.e.*, 3(c)(1) or 3(c)(7) funds) and that have at least $150 million in private fund assets under management ("**private fund advisers**") are required to file Form PF with the SEC for the purpose of reporting systemic risk information to the SEC. Additionally, private fund advisers that are also registered with the Commodity Futures Trading Commission (the "**CFTC**") as commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**") and are required to file Form PF under the Advisers Act must file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are private funds. Such CPOs and CTAs may file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are not private funds. Please see the ***November 18, 2011 Investment Management Regulatory Update*** for a discussion of the final Form PF rules, the ***June 19, 2012 Investment Management Regulatory Update*** for a discussion of the initial Form PF deadlines and the ***July 16, 2012 Investment Management Regulatory Update*** for a discussion of previously posted SEC responses to frequently asked questions regarding Form PF.

The Responses provided guidance on a number of important Form PF topics including:

Compliance with Prior SEC Guidance. The Responses addressed situations in which private fund advisers, in preparing their internal systems to meet the July 16 or August 29 initial filing deadlines, made assumptions regarding how to respond to certain questions that were inconsistent with guidance that has since been provided by the SEC (the "**SEC Guidance**"). The Responses clarified that a private fund adviser subject to the July 16 filing deadline is not required immediately to amend its initial filing to reflect the SEC Guidance, but may instead wait until its next required filing to correct its responses as long as it notes in Question 4 any assumptions made in its initial filing that were inconsistent with the SEC Guidance.

Further, the Responses confirmed that a private fund adviser subject to the August 29 filing deadline must still file Form PF by this date even if it will respond in a way that may be inconsistent with the SEC Guidance. However, the SEC staff would not recommend an enforcement action against such private fund adviser if (i) its assumptions in completing its initial report were reasonable based on the facts and circumstances governing at the time its reporting system was being developed, (ii) it identifies in Question 4 any assumptions or other approaches that it took in reporting information on Form PF that are inconsistent with the SEC Guidance and (iii) future required reports reflect the SEC Guidance.

Value of Parallel Managed Accounts. The Responses clarified that, when calculating the value of a parallel managed account for purposes of (i) determining whether the account is a dependent parallel managed account subject to aggregation with the reporting fund or (ii) reporting its value in Question 11, the market value of the derivatives held in the parallel managed account should be used for this calculation instead of the gross notional value, if that is how the value of the account is reported to the account holder.

Borrowings. The Responses also provided guidance on the term "borrowings" for purposes of Questions 12 and 43 and clarified that "borrowings" include secured borrowings, unsecured borrowings and synthetic borrowings but not leverage embedded through the use of derivatives. Furthermore, the Responses provided a non-exhaustive list of the types of borrowings that would be reported: (i) short sales (and, according to the Responses, the value of a borrowing that includes selling a security short is the value that is reported internally and to current and prospective investors of the fund that is selling the security short), (ii) securities lending transactions, (iii) reverse repurchase agreements, (iv) transactions in which variation margin is owed, but as a result of not reaching a certain set threshold, has not yet been paid by a fund and (v) transactions involving synthetic borrowings (*e.g*., total return swaps that meet the failed sale accounting requirements).

Counterparty Credit Exposure. The Responses addressed several questions relating to the reporting of counterparty credit exposure and collateral in Questions 22, 23, 36 and 37. For example, the Responses clarified that Questions 22 and 23 are designed to report on counterparty credit exposure related to over-the-counter derivatives positions, loans and loan commitments. Private fund advisers, according to the Responses, should not include assets held by a custodian or prime broker (that are not otherwise held as collateral by such custodian or prime broker as derivative counterparties or lenders) or futures positions or excess margin held at a futures commission merchant in responding to Questions 22 or 23. In addition, the Responses stated that investors that are owed redemption proceeds should not be considered credit counterparties for purposes of Question 22.

The Responses also provided guidance on what should be reported for six different types of counterparty transactions that are not centrally cleared:

- Securities lending: A private fund adviser should report in Question 22 the current market value of the securities that the private fund has lent to the counterparty, but should not include in Question 22 any collateral that it has received from the counterparty.
- Short transactions: A private fund adviser should report in Question 23 the current market value of the security that the private fund has sold short, but should not include in Question 23 any cash proceeds that it has received as a result of the transaction.
- Reverse repurchase agreements: A private fund adviser should report in Question 23 the amount of cash that the private fund has received from the counterparty, but should not include in Question 23 the amount of any collateral posted to the counterparty.
- Repurchase agreements: A private fund adviser should report in Question 22 the amount of cash lent by the private fund to the counterparty, but should not include in Question 22 the amount of any collateral posted by the counterparty.

- Non-cleared derivatives transactions with an unrealized gain: A private fund adviser should report in Question 22 the amount of the unrealized gain on the transaction, but should exclude the amount of any collateral posted by the counterparty or the private fund.
- Non-cleared derivatives transactions with an unrealized loss: A private fund adviser should report in Question 23 the amount of the unrealized loss on the transaction, but should exclude the amount of any collateral posted by the counterparty or the private fund.

In addition, for purposes of responding to Questions 22 and 23, a private fund adviser should not net a private fund's positions across different counterparties unless such entities are affiliated with one another and netting is permitted by the instructions to these two questions. The Responses further noted that, when calculating responses to Questions 22 and 23, amounts attributable to either initial margin or variation margin should not be included, but that large hedge fund advisers responding to Questions 36 and 37 regarding collateral should include initial margin and variation margin.

Stress Testing of Market Factors. The Responses clarified that, for purposes of Question 42, a private fund adviser is required to report on market factors that it believes are relevant to a private fund's portfolio and has the capacity to test using its current models or other systems. Therefore, a private fund adviser that maintains systems capable of simulating the effect of a market factor identified in Question 42 as part of its risk management, but that does not currently test for the market factor or does not test for the specific changes identified in Question 42 (*e.g.*, a 5% increase), must still report on changes to the market factor if the private fund adviser believes it is relevant to the private fund's portfolio.

Derivatives Positions. The Responses also provided guidance on questions relating to reporting the aggregate value of derivatives positions. For example, they clarified that in reporting the aggregate value of all derivatives positions in Question 44, a private fund adviser should not include any closed-out positions if those positions were closed out with the same counterparty and result in no credit or market exposure to the private fund.

- **See a copy of the Responses**

Industry Update

Legislation Imposing User Fees to Cover Investment Adviser Examinations Is Introduced in the House

On July 25, 2012, Representative Maxine Waters (D-Calif.) introduced in the House of Representatives a bill—the Investment Adviser Examination Improvement Act of 2012—that would amend the Advisers Act to require that certain investment advisers pay an annual fee to the SEC to help cover the SEC's costs of conducting inspections and examinations of such investment advisers. The bill is co-sponsored by Representatives Barney Frank (D-Mass.), the ranking member of the House Financial Services Committee, and Michael Capuano (D-Mass.).

The bill, which is designed to increase the number and frequency of SEC examinations, would authorize the SEC to collect annual fees from investment advisers subject to inspection or examination by the SEC (no fees would be collected by the SEC from state-regulated investment advisers that are prohibited from registering with the SEC pursuant to Section 203A of the Advisers Act). The SEC would be required to ensure that the aggregate amount of fees collected for a specific year is equal to the estimated cost to the SEC of carrying out "additional inspections and examinations," which would be defined as those inspections and examinations that, in a given fiscal year, exceed the number of inspections and examinations of investment advisers conducted during fiscal year 2011.

The bill would also require the SEC to promulgate rules that establish a formula for determining the amount of fees to be collected from an individual investment adviser based on certain factors, including:

(i) the anticipated costs of conducting inspections and examinations of investment advisers, taking into account the frequency of such inspections and examinations, (ii) such investment adviser's assets under management (excluding any assets attributable to clients that are registered investment companies), (iii) the number and type of clients of such investment adviser and (iv) other objective factors (such as risk characteristics) that the SEC deems appropriate for consideration. The formula, as well as any factors used to determine such formula, would be made publicly available. In addition, the Comptroller General would be required to conduct a biennial audit of the fees collected by the SEC and to report such findings to the House Financial Services Committee and the Senate Banking, Housing and Urban Affairs Committee.

The bill was introduced in response to a January 2011 SEC study mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), which concluded that the SEC lacked the resources to adequately examine registered investment advisers and provided recommendations to strengthen the investment adviser examination regime. The study, which is discussed in further detail in the ***February 14, 2011 Investment Management Regulatory Update***, considered various options for increased investment adviser oversight, including the imposition of user fees on investment advisers. According to a press release by Representative Waters on July 25, 2012, user fees provide "the simplest, most efficient solution to the problem of inadequate adviser oversight" and would be a cost effective solution for the industry because the "user fees contemplated in [the bill] would only be used to fund the regulation of investment advisers, and not to subsidize other functions at the SEC."

The bill is an alternative to the Investment Adviser Oversight Act of 2012 (the "**Oversight Bill**"), which was introduced in the House on April 25, 2012 and would require that investment advisers registered with the SEC or with a state (subject to certain exemptions) become members of a "registered national investment adviser association" that would conduct inspections and examinations of "[i]nvestment advisers that conduct business with retail customers." For further details on the Oversight Bill, please see the ***May 17, 2012 Investment Management Regulatory Update***.

We will continue to monitor developments.

- **See a copy of the bill**

Recent CFTC Developments: Final Rules on Swap Definitions, Compliance Dates for CPO/CTA Registration, Cross-Border Guidance and Mandatory Clearing of Swaps

Final Swap Definitions. On July 6, 2012 and July 10, 2012, the SEC and the Commodity Futures Trading Commission (the "**CFTC**"), respectively, adopted joint final rules further defining the terms "swap," "security-based swap" and "security-based swap agreement," and delineating jurisdiction over "mixed swaps" between the agencies. These definitions are necessary for a determination of whether an instrument falls within the regulatory authority of the CFTC, the SEC or both, and for a determination of whether an asset manager will be subject to regulation and registration as a commodity pool operator ("**CPO**") or commodity trading advisor ("**CTA**") because of its swaps activities. The final rules will become effective on October 12, 2012. For further discussion of these final rules, please see the July 11, 2012 Davis Polk Client Newsflash, ***SEC and CFTC Finalize Swap Product Definitions: The Title VII Swap Countdown Begins*** and the July 19, 2012 Davis Polk Client Newsflash, ***CFTC Addresses Compliance Dates for CPO/CTA Registration; Swap Definitions Finalized; CFTC Provides Cross-Border Guidance***.

CPO/CTA Registration. On July 10, 2012, the CFTC issued a no-action letter that extends until December 31, 2012 relief from registration as a CPO or CTA that was previously available to asset managers. As discussed in the February 23, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Amendments to Registration Exemptions for CPOs and CTAs and Proposes Harmonization Rules for Registered Fund CPOs***, in February 2012, the CFTC adopted amendments that (i) rescinded the

Rule 4.13(a)(4) exemption from registration that was previously available for CPOs of private funds that are offered only to certain highly sophisticated investors and (ii) restricted the scope of the exclusion from CPO registration for registered investment companies ("**RICs**") under Rule 4.5.

As a result of the CFTC's February 2012 amendments, the Rule 4.13(a)(4) exemption ceased to be available for any private fund launched on or after April 24, 2012, and the CPO of such a fund was required either to comply immediately with the requirements of a different exemption or register with the CFTC. The Rule 4.13(a)(4) exemption would, however, remain available until December 31, 2012 for CPOs of existing private funds that claimed the exemption prior to April 24, 2012. The CPO of a RIC relying on Rule 4.5 would need to comply with the amendments for purposes of registration by the later of December 31, 2012 or 60 days after the adoption of final rules under the Dodd-Frank Act defining the term "swap" and establishing margin requirements for such instruments.

In the no-action letter, the CFTC extended the compliance date until December 31, 2012 for CPOs of private funds launched after April 24, 2012 whose investors meet the qualification requirements previously set forth in Rule 4.13(a)(4), as long as the CPO files with the CFTC the notice required to claim such relief. The CFTC also confirmed that CPOs of RICs launched after April 24, 2012 would have a December 31, 2012 registration compliance deadline. In addition, the CFTC granted relief from registration until December 31, 2012 to CTAs of private funds or RICs whose CPOs are also exempt from registration, as long as the CTA files with the CFTC the notice required to claim such relief. The CFTC declined, however, to extend the period for including swaps in the trading thresholds under Rule 4.5 and Rule 4.13(a)(3). For further discussion of the no-action letter, please see the July 19, 2012 Davis Polk Client Newsflash, ***CFTC Addresses Compliance Dates for CPO/CTA Registration; Swap Definitions Finalized; CFTC Provides Cross-Border Guidance***.

Cross-Border Guidance. The CFTC also recently addressed the reach of the new Dodd-Frank Act requirements in the case of swaps transactions involving non-U.S. persons. In proposed guidance and a proposed exemptive order, the CFTC clarified that the requirements apply to the swap activities of any person that is a "U.S. person" and proposed a broad definition of the term "U.S. person" that would capture entities and persons that may not be U.S. persons under the definition in Regulation S of the Securities Act of 1933 (the "**Securities Act**"). An asset manager that engages in swaps, whether on a proprietary basis or on behalf of its clients, should assess whether it or its clients are "U.S. persons", and thus would be subject to these requirements. For further discussion of the cross-border guidance, please see the July 19, 2012 Davis Polk Client Newsflash, ***CFTC Addresses Compliance Dates for CPO/CTA Registration; Swap Definitions Finalized; CFTC Provides Cross-Border Guidance***.

Mandatory Clearing of Swaps. On July 24, 2012, the CFTC finalized a rule establishing a schedule for compliance with the mandatory clearing requirements for swaps under Title VII of the Dodd-Frank Act. On the same day, the CFTC proposed the first determination of classes of swaps that will be subject to mandatory clearing. Together, these actions begin the CFTC's implementation of mandatory clearing of swaps. For further discussion of the CFTC's final clearing phase-in rule and the proposed mandatory clearing determination, please see the July 30, 2012 Davis Polk Client Newsflash, ***CFTC Begins Implementation of Mandatory Clearing of Swaps***.

- **See a copy of the CFTC's no-action letter regarding CPO/CTA registration**

Legislation Seeking to Increase SEC Civil Penalties Is Introduced in the Senate

On July 23, 2012, Senator Jack Reed (D-R.I.) and Senator Charles Grassley (R-Iowa) introduced in the Senate a bipartisan bill—the Stronger Enforcement of Civil Penalties Act of 2012—that would, among other things, authorize the SEC to seek significantly higher monetary penalties from individuals and entities charged with tier three violations in civil and administrative actions than is permitted under current law by amending the Securities Act, the Securities Exchange Act of 1934 (the "**Exchange Act**"), the Investment Company Act of 1940 (the "**Investment Company Act**") and the Advisers Act. The bill was introduced in response to SEC Chairman Mary Schapiro's letter to Senator Reed in November 2011, which proposed statutory increases to the civil monetary penalties that the SEC is authorized to seek. For further discussion of this letter, please see the ***January 23, 2012 Investment Management Regulatory Update***.

Tier three violations—the most serious securities law violations—are those violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement that results in (or creates a substantial risk of) substantial losses or substantial pecuniary gain to the violator. The bill would increase the statutory cap applicable to tier three violations in civil and administrative proceedings from $150,000 to $1 million per violation for individuals and from $725,000 to $10 million per violation for entities and would authorize the SEC to seek, per tier three violation, the greater of (i) $1 million or $10 million (depending on whether the defendant is an individual or entity), (ii) three times the gross pecuniary gain to such defendant and (iii) the amount of losses incurred by victims as a result. The bill would also increase the maximum penalty for individuals and entities charged with tier one violations (*i.e.*, basic securities law violations) and tier two violations (*i.e.*, violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement).

In addition, the bill would authorize the SEC to seek three times the applicable cap against an individual or entity that was "criminally convicted for securities fraud or became subject to a judgment or order imposing monetary, equitable, or administrative relief in any [SEC] action alleging fraud" during the previous five years. The bill would also authorize the SEC to seek civil penalties against an individual or entity that violates a federal court injunction or a bar obtained or imposed by the SEC.

According to Senator Reed in a press release on July 23, 2012, the bill would "give the SEC more tools to demand accountability from Wall Street." While SEC officials currently have the authority to seek civil penalties above the statutory maximum, this opportunity is only available when the SEC brings a civil action in federal court. However, if the bill were to be enacted, the SEC would be authorized to seek the penalties described above in either an administrative action or a civil action. Administrative proceedings offer several advantages to the SEC over civil proceedings, such as limited discovery rights. In addition, the Dodd-Frank Act authorized the SEC for the first time to seek civil penalties from any respondent in an administrative proceeding. This, together with the SEC's authority to seek higher penalties in administrative actions (if the bill is enacted), would likely increase the number of cases that the SEC would bring in administrative proceedings rather than civil proceedings.

Given that the bill has bipartisan support and was introduced at the SEC chairman's request, it is believed that the bill is likely to pass. We will continue to monitor developments.

- **See a copy of the bill**

FINRA Issues Investor Alert on Exchange-Traded Notes

On July 10, 2012, the Financial Industry Regulatory Authority ("**FINRA**") issued an Investor Alert called "Exchange-Traded Notes—Avoid Unpleasant Surprises" (the "**Investor Alert**"), outlining key features and risks of exchange-traded notes ("**ETNs**"). ETNs are unsecured debt obligations of an issuer (typically a bank or other financial institution) that trade on exchanges and pay returns that are usually linked to the performance of a market index or other benchmark, minus any specified fees.

The Investor Alert discusses certain fundamental similarities and differences between ETNs, traditional bonds and exchange-traded funds ("**ETFs**"). For example, unlike traditional bonds, ETNs typically do not pay interest to investors. Instead, the issuer promises to pay the investor a return based on the performance of the underlying index on the ETN's maturity date. Thus, similar to traditional bonds, ETNs are subject to the credit risk of the issuer (*i.e.*, if the issuer defaults on the note, the investor may lose all or a portion of its investment). ETNs are similar to ETFs in that they trade on exchanges at prices determined by the market. However, unlike ETFs, ETNs do not buy or hold assets in order to track the performance of an index.

The Investor Alert also outlines seven key risks associated with ETNs: (i) credit risk, (ii) market risk, (iii) liquidity risk, (iv) price-tracking risk, (v) holding-period risk, (vi) call, early redemption and acceleration risk and (vii) conflicts of interest. The Investor Alert warns investors that an ETN may trade at prices in the secondary market that vary, sometimes significantly, from its indicative value (which is calculated and published at the end of each day by the issuer). The Investor Alert also details certain risks unique to leveraged, inverse and leveraged inverse ETNs—particularly ones that "reset" their leverage or inverse exposure on a daily basis. FINRA cautions that these types of ETNs are intended as short-term trading tools (with holding periods as short as one day) rather than buy-and-hold investments.

In addition, the Investor Alert sets forth a list of questions that an investor should consider in order to better assess whether an ETN investment is appropriate for the investor, including whether the ETN is callable by the issuer, whether the ETN offers leveraged or inverse exposure to the underlying index or benchmark (and, if so, how frequently it resets) and the tax treatment of the ETN.

- **See a copy of the Investor Alert**
- **See a copy of FINRA's press release regarding the Investor Alert**

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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