March 21, 2012

Investment Management Regulatory Update

SEC Rules and Regulations

- SEC Amends Definition of "Qualified Client"
- SEC Staff Responds to Questions About Reporting on Part 1 of Form ADV
- SEC Announces Proposed Modifications to Form N-SAR Filing Process
- CFTC and SEC Propose Identity Theft Rules

Industry Update

- DOL Publishes Final Regulations on ERISA Fee Disclosure
- CFTC Amends Registration Rules for CPOs and CTAs and Proposes Certain Harmonizing Amendments to Rules for Registered Investment Company CPOs
- SEC Issues Risk Alert on Unauthorized Trading
- Treasury Issues Proposed FATCA Regulations
- CFTC Adopts Internal Business Conduct Rules for Swap Dealers and Major Swap Participants
- FinCEN Requests Comment on Customer Due Diligence and Beneficial Ownership Proposals

Litigation

- District Court Finds Hedge Fund Adviser Liable for Securities Fraud in Late Trading Scheme

SEC Rules and Regulations

SEC Amends Definition of "Qualified Client"

On February 15, 2012, the Securities and Exchange Commission (the "**SEC**") issued a final rule release (the "**Release**") adopting amendments (the "**Amendments**") to Rule 205-3 under the Investment Advisers Act of 1940 (the "**Advisers Act**"), which provides an exemption from the prohibition in Section 205(a)(1) of the Advisers Act against registered investment advisers entering into any investment advisory contract that charges a performance fee. Under Rule 205-3, an adviser is permitted to charge a performance fee in an investment advisory contract if the client that is a party to such contract meets the definition of "qualified client."

As required by the Dodd-Frank Act and discussed in the ***July 13, 2011 Investment Management Regulatory Update***, on July 12, 2011, the SEC issued an order raising, for natural persons, the assets-under-management and net-worth tests in the definition of "qualified client" to $1 million (from $750,000) and $2 million (from $1.5 million), respectively, in each case effective on September 19, 2011. As a result, in order to be a qualified client, a natural person (i) must have at least $1 million in assets under management with the adviser immediately after entering into the advisory contract (the "**assets-under-management test**") or (ii) must be reasonably believed by the adviser, immediately prior to entering into the advisory contract, to have a net worth (including assets held jointly with such person's spouse) of more than $2 million (the "**net-worth test**"). The Amendments codify these increases and also add to Rule 205-3 new paragraph (e) which, as proposed by the SEC in its May 10, 2011 rule proposal (the "**Proposal**"), states that the SEC will issue an order on or about May 1, 2016 and every five years thereafter further adjusting for inflation the dollar amount thresholds of the assets-under-management and net worth tests (such adjustments will be based on the Personal Consumption Expenditures Chain-Type Price Index published by the Department of Commerce). The Proposal is discussed in additional detail in the ***May 17, 2011 Investment Management Regulatory Update***.

The Amendments also amend the net worth test to exclude the value of a natural person's primary residence and debt secured by the primary residence (up to the estimated fair market value of the primary residence at the time the advisory contract was entered into). Although this change was not required by the Dodd-Frank Act, it is consistent both with the SEC's Proposal and with the revisions to the net worth standard contained in the definition of "accredited investor" in Regulation D under the Securities Act of 1933, which were mandated by the Dodd-Frank Act and are discussed in the ***January 23, 2012 Investment Management Regulatory Update***. As in the revised accredited investor definition, but reflecting a change from the Proposal, the Amendments further include a 60-day look-back provision pursuant to which any debt secured by an individual investor's primary residence that is incurred in the 60 days before the advisory contract is entered into must be treated as a liability in calculating an individual's net worth for purposes of the qualified client definition, even if the total amount of indebtedness does not exceed the estimated fair market value of the primary residence (unless the incremental indebtedness results from the acquisition of the primary residence). According to the Release, the 60-day look back is designed to discourage investors from borrowing against their primary residences for the purpose of meeting the definition of qualified client.

In addition, the Amendments establish two transition rules pursuant to which existing performance fee arrangements will not be affected by the Amendments as long as they were permissible at the time the relevant advisory contract was entered into. Specifically, under revised Rule 205-3(c)(1), if a registered investment adviser entered into an advisory contract that satisfied the performance fee rules in effect at that time, the adviser will be deemed to satisfy Section 205(a)(1), without regard to the Amendments, even with respect to money invested after such date; however, if a new investor "becomes a party" to such contract, then the rules in effect at such later time would apply in respect of such new investor.

Under revised Rule 205-3(c)(2), contractual arrangements entered into by an investment adviser at a time when the adviser was not required to be, and was not, registered with the SEC, are not subject to Section 205(a)(1) of the Advisers Act, if the adviser now registers. However, contracts entered into by an adviser after it is required to register with the SEC will be subject to Section 205(a)(1). For example, according to the Release, private fund contracts entered into before an adviser was registered would not have to comply with Section 205(a)(1), even if the existing investors make additional investments in such fund after the adviser registers; however, if a new investor "becomes a party" to such a private fund contract, or if an existing investor invests in a different fund managed by the adviser, in each case after the adviser registers, then Section 205(a)(1) would apply to those contractual arrangements.

Finally, the SEC adopted a third transition rule, which provides that, for purposes of Rules 205(c)(1) and 205(c)(2), transferring an interest in a private fund "by gift or bequest, or pursuant to an agreement related to a legal separation or divorce, will not cause the transferee to 'become a party' to the contract" and will not subject the transferee to Section 205(a)(1). According to the Release, such transfers do not involve a separate investment decision by the transferee and therefore do not necessitate the protections of the performance fee restriction.

Other than the threshold increases which took effect on September 19, 2011, the Amendments will become effective on May 22, 2012 (although investment advisers may rely on the transition rules prior to that date).

- Please see a copy of the Release
- Please see a copy of the SEC press release

SEC Staff Responds to Questions About Reporting on Part 1 of Form ADV

On February 6, 2012, the SEC's Division of Investment Management issued responses (the "**Responses**") to a number of questions regarding Part 1 of Form ADV. Part 1, which was amended by the SEC on June 22, 2011 (with effect from September 19, 2011), is subdivided into two parts: Part 1A (for investment adviser registration with the SEC) and Part 1B (for registration with state securities authorities). The Responses address questions regarding both the interplay between state and federal registration and issues with completing Item 7.B of Part 1A which deals with private fund reporting. For more information on the June 22, 2011 amendments, please see the June 29, 2011 Davis Polk Client Memorandum, ***SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940***.

State Issues

The minimum assets under management threshold for SEC registration for most U.S. investment advisers is $100 million, but $25 million for an adviser that is not subject to registration and examination in the state in which it maintains its principal office and place of business or that meets certain other criteria.

In response to a question regarding an investment adviser with $50 million in regulatory assets under management, five clients, and a principal office and place of business in a state that does not require investment advisers to register unless they have six or more clients, the SEC confirmed that the adviser would have to register with the SEC because not required to do so with the state. The SEC also clarified that, once it obtains the sixth client, the adviser would not need to withdraw its SEC registration immediately, but rather would need to assess its eligibility for SEC registration annually in preparing its annual-updating amendment. According to the SEC, while changes in regulatory assets under management or number of clients that occur between annual updating amendments would not cause an adviser to lose its eligibility for SEC registration immediately, an SEC-registered adviser is permitted to switch to state registration at any time that it is eligible. If an SEC-registered adviser reports on its annual updating amendment that it is no longer eligible for SEC registration, the adviser must switch to state registration within 180 days of the end of its fiscal year (and file Form ADV-W to withdraw its SEC registration).

Private Fund Reporting Issues

If an investment adviser advises a private fund, then the adviser must disclose certain information on Section 7.B.(1) of Schedule D with respect to such private fund. The Responses clarify the following in respect of the questions in Section 7.B.(1) of Schedule D:

- Question 8(a) requires an investment adviser to disclose whether the private fund is a "fund of funds" (the instructions to Form ADV specify that a private fund should be considered a "fund of funds" if it invests 10% or more of its total assets in other pooled investment vehicles, whether or not they are also private funds). The Responses clarify that a private fund that is a "feeder fund" is not a "fund of funds" for these purposes. Rather, according to the SEC, master-feeder arrangements and funds of funds should be treated as distinct structures for purposes of Form ADV reporting.
- Question 13 and Questions 14-16 require an investment adviser to disclose the approximate number of beneficial owners of the private fund and the approximate percentage of the fund beneficially owned by certain persons, respectively. For an investment adviser that is completing a separate Section 7.B.(1) for the master fund and each feeder fund in a master-feeder arrangement, the Responses clarify that the adviser should report the beneficial owners of *all* feeder funds in answering Questions 13-16 for the master fund.
- For private funds that rely on Regulation D of the Securities Act of 1933, Question 22 requires the private fund's Form D file number. In response to a question regarding where to locate the Form D file number, the Responses clarify that, for Form D filings submitted post-January 1, 2002,

Form D file numbers are available at http://www.sec.gov/search/search.htm under the "File/Firm Number" column after searching for the name of the private fund. (The EDGAR database may identify the filing type as "RegDex," instead of "Form D.") For a private fund that filed a Form D prior to January 1, 2002 and that did not file an amendment or update after such date, the investment adviser should make reasonable efforts to locate the number, but, if it cannot do so, is permitted to enter all nines (*e.g.* 021-9999999999).

- The instructions to Item 7.B provide that if an investment adviser uses a numerical or alphabetical code, or similar designation, for a private fund client in its books and records pursuant to Rule 204-2(d) in order to preserve anonymity, such adviser may identify the private fund in Section 7.B.(1) or 7.B.(2) of Schedule D by using the same code or designation in lieu of the fund's name. According to the Responses, an adviser that identifies a private fund client by code or similar designation in this way may also enter all nines for the Form D file number in Question 22 so as to avoid revealing the fund's identity.
- Certain questions on Schedule D, Section 7.B.(1) and Item 2 on Schedule D, Section 7.B.(2) (as well as certain sections of Form PF) require disclosure of a private fund's identification number ("**PFID**"). According to the Responses, a new PFID may be obtained at any time by selecting the "Generate a Private Fund Identification Number" option on the IARD Main screen under the "Forms" column, but an adviser should use the existing number, if any, for a fund (rather than creating a new one) and multiple advisers reporting on the same private fund must ensure that they all use the same PFID for such fund. In addition, according to the Responses, once an adviser files information regarding a private fund on Form ADV, the PFID will be publicly available on the public disclosure website (IAPD) and an adviser should use that number any time it amends such information (an adviser can also retrieve the PFID from a previous filing made through its own IARD account). The Responses clarify, however, that there is no way to retrieve a PFID that an adviser has lost if the PFID has not been used in a Form ADV or Form PF filing so the adviser would have to generate a new PFID using the method described above.
- Item 5.F and Question 11 require an investment adviser to disclose a private fund's regulatory assets under management and gross asset value, respectively. In response to a question regarding how to treat short positions, derivatives, repurchase agreements, total return swaps and other financial instruments for purposes of these questions, the Responses clarify that if the private fund has a balance sheet, the adviser is permitted to rely on the gross assets reflected there and need not assess the value of such financial instruments differently from the applicable accounting standard. For example, according to the Responses, an adviser should include a short position in a fund's assets if it is an asset on the fund's balance sheet under applicable accounting standards. If a short sale is recorded as a short sale liability, the Responses provide that it should neither be treated as an asset nor deducted from assets in calculating "gross asset value," but any proceeds received should be included in "gross asset value." However, if a fund takes a short position using a derivative and the derivative itself has a positive fair value and is recorded as an asset, then, according to the Responses, the adviser should treat the short position as an asset for purposes of "gross asset value."

  ▸ See the full staff Q&A

SEC Announces Proposed Modifications to Form N-SAR Filing Process

On February 23, 2012, the SEC released an overview (the "**Overview**") of certain proposed modifications to the Form N-SAR filing process and posted a Draft EDGAR Filing Manual (Volume II) EDGAR Filing (Version 19) (the "**Draft Manual**") reflecting the potential changes. According to the Overview, the Draft Manual remains subject to SEC approval and is being provided in advance of such approval to help the filing community anticipate the potential changes, and a final manual will be posted on the SEC's public website if and when approved.

According to the Overview, among the potential changes is the proposed retirement of both the DOS-based Form N-SAR application and the EDGAR Filer Manual, Volume III: NSAR Supplement as well as the introduction of a new online N-SAR application. Originally scheduled for April 9, 2012, these proposed changes have been postponed until July 9, 2012. Thereafter, according to the Overview, Form N-SAR would only be able to be filed using the online form available on the EDGAR Filing Website or constructed by filers according to the new EDGAR N-SAR XML Technical Specification, available at http://www.sec.gov/info/edgar.shtml.

- See the SEC's Overview
- See the Draft Manual

CFTC and SEC Propose Identity Theft Rules

On February 28, 2012, the Commodity Futures Trading Commission (the "**CFTC**") and the SEC (together, the "**Commissions**") issued a rule release proposing rules and guidelines that would require "financial institutions" and certain "creditors" (as such terms are defined in the Fair Credit Reporting Act of 1970) that fall under their respective jurisdictions (including commodity pool operators, commodity trading advisors, registered broker-dealers, registered investment companies, business development companies, employees' securities companies and registered investment advisers) and that offer or maintain "covered accounts" (as defined), to develop written identity theft prevention programs. Under the Dodd-Frank Act, the Commissions were added to the list of federal agencies that are required to issue rules to prevent identity theft. The proposed rules are substantially similar to final rules and guidelines that were issued jointly in 2007 by the Office of the Comptroller of the Currency, the Federal Reserve and other agencies. In their rule release, the Commissions noted that it is likely that most of the financial institutions and creditors covered by the proposal already comply with the existing rules regarding identity theft prevention, and therefore may only be required to supplement programs already in place.

Entities required to comply with the proposed rules would have to establish a written identity theft prevention program (a "**Program**") that is designed to detect, prevent and mitigate identity theft in connection with the opening and maintenance of covered accounts. The proposed rules would require financial institutions and creditors to implement policies and procedures reasonably designed to:

- identify and incorporate into any Program "red flags" (defined as patterns, practices or activities that indicate the possible existence of identity theft);
- detect the existence of red flags;
- appropriately respond to detected red flags in order to prevent and mitigate identity theft; and
- update any Program periodically to reflect changes in risks of identity theft to customers and to the safety and soundness of the financial institution or creditor.

The Commissions' rule release also includes guidelines that entities would have to consider when implementing and administering any Program, which generally give instructions on how to identify red flags.

In addition, the proposed rules would require, among other things, board approval of the initial written Program, senior level oversight of its development, its implementation and its administration, annual compliance reports, and steps to ensure that any service providers performing activities in connection with customer accounts employ reasonable policies and procedures designed to detect, prevent and mitigate the risk of identity theft.

The Commissions are seeking comment on a number of aspects of the proposed rules and guidelines. Comments are due on or before May 7, 2012.

Please see the March 7, 2012 Davis Polk Client Memorandum, ***CFTC and SEC Jointly Propose Identity Theft Rules***, for a more detailed discussion of the proposed rules and guidelines.

- See a copy of the Commissions' rule release
- See a copy of the SEC press release

Industry Update

DOL Publishes Final Regulations on ERISA Fee Disclosure

On February 2, 2012, the Department of Labor (the "**DOL**") published its long-awaited final regulations under Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 ("**ERISA**") regarding fee disclosures to ERISA plans (the "**Final Regulations**"). The Final Regulations, which include several changes from the interim final regulations issued in July 2010, will become effective on July 1, 2012.

In general, ERISA prohibits the furnishing of services by a party in interest to a plan unless there is an applicable exemption. Section 408(b)(2) is a widely used exemption permitting a service provider to a plan to receive compensation for its services if no more than "reasonable compensation" is paid for "necessary" services under a "reasonable" arrangement. Under the Final Regulations, in order for a contract or arrangement for services to be "reasonable," the service provider must furnish specified compensation and other information to the plan's fiduciary. According to the Final Regulations, compensation is anything of monetary value (*e.g.*, money, gifts, awards and trips) but does not include non-monetary compensation valued at $250 or less, in the aggregate, during the term of the contract. A failure to comply with the Final Regulations could cause the payment of compensation to a plan service provider to be a prohibited transaction under ERISA and the Internal Revenue Code resulting in excise taxes, the disgorgement of fees and other potential liability to the service provider. Therefore, all managers of ERISA plans and ERISA funds that are subject to these Final Regulations must ensure that they are in compliance by July 1, 2012.

Under the Final Regulations, any registered or unregistered investment adviser or asset manager of an ERISA plan or ERISA fund that, either by itself or together with an affiliate or subcontractor, reasonably expects to receive $1,000 or more in direct or indirect compensation will need to provide to the plan fiduciary disclosure that includes the following:

- A description of the fiduciary services that will be provided by the manager to the plan or plan asset fund (*i.e.*, investment advice or asset management services);
- A statement that the manager expects to provide services as a fiduciary;
- A description of all "direct" compensation to be received by the manager, its affiliates or subcontractors from the plan (*e.g*., management fees or performance-based compensation);
- A description of all "indirect" compensation, which is compensation to be received by the manager, its affiliates or subcontractors from any source other than the plan, the plan sponsor, the manager or one of its affiliates (*e.g.*, soft dollar revenue, fee sharing or rebates generated from other service providers based on assets or transactions involving ERISA assets). The description must include the expected payers and the expected services for which the indirect compensation is to be received, as well as a description of the arrangement between the payer and the service provider under which indirect compensation is to be paid. Generally, compensation paid by a plan or plan asset fund for non-fiduciary services (*e.g.*, brokerage) are not subject to the fee disclosure rules. However, when these revenues flow back to the manager

or its affiliate, the rebates are deemed to be added compensation for the manager's fiduciary services and must be disclosed;

- A description of compensation paid among the service provider, its affiliates and subcontractors (*e.g*., commissions, soft dollars and finder's fees and other incentive compensation based on business placed or retained) or charged directly against the plan's investment;
- A description of compensation paid upon termination and how prepaid amounts will be calculated and refunded;
- Disclosure of whether the manager will bill for fees or deduct directly from the plan's accounts; and
- A description of the annual operating expenses (*e.g.*, expense ratio) if the return is not fixed and any ongoing expenses in addition to annual operating expenses.

According to the Final Regulations, compensation may be disclosed as either a fixed amount or an estimate expressed as a monetary amount, formula, percentage of the plan's or ERISA fund's assets or "if the compensation cannot be expressed in such terms, by any other reasonable method." Costs of brokerage or custodial services to an ERISA fund and the costs of services provided to the underlying funds of an ERISA fund of funds do not need to be reported. The Final Regulations do not prescribe the manner in which disclosures should be presented to the plan fiduciary and do not require that all of the required disclosures be contained in the same document. However, in the Final Regulations, the DOL encourages service providers to offer the plan fiduciary a guide, summary or similar tool to assist the fiduciary in identifying all of the required disclosures in existing documents (*e.g*., a cross-referenced list indicating where the required information can be found in an operative asset management or fund agreement).

According to the Final Regulations, the disclosure must be made to the responsible plan fiduciary reasonably in advance of the date the contract or arrangement is entered into, extended or renewed, or the date of any new investment by a plan in a plan asset fund. Any changes in the initial disclosures must be disclosed under the Final Regulations no later than 60 days after the manager's awareness of the change, absent extraordinary circumstances. Contracts will not fail to meet the requirements of the Final Regulations based on errors or omissions, *provided* that the service provider made the error or omission in good faith and the error is corrected as soon as practicable but no later than 30 days following its discovery. While the Final Regulations do not apply to funds that are not subject to ERISA, if a fund becomes subject to ERISA (*e.g.*, the manager permits benefit plan investors to exceed the 25% threshold), the manager must provide its ERISA investors with the required disclosures as soon as practicable but no later than 30 days after learning that the fund's status has changed.

- See a copy of the DOL's Final Regulations
- See a copy of the DOL's fact sheet on Final Regulations
- See a copy of the DOL's summary on changes from interim final regulations

---

CFTC Amends Registration Rules for CPOs and CTAs and Proposes Certain Harmonizing Amendments to Rules for Registered Investment Company CPOs

On February 9, 2012, the CFTC adopted final rule amendments (the "**Final Rules**") relating to the registration of commodity pool operators ("**CPOs**") under the Commodity Exchange Act. Initially proposed by the CFTC in a February 2011 release that is discussed in further detail in the ***March 15, 2011 Investment Management Regulatory Update*** (the "**Proposing Release**"), the amendments will significantly narrow the relief from CPO registration currently available for advisers to, and sponsors of, private funds and investment companies registered under the Investment Company Act of 1940 ("**RICs**"). The Final Rules (other than Rule 4.27) become effective 60 days after publication in the Federal Register (the "**Effective Date**"), subject to certain conformance periods. (April 24, 2012 is 60 days following the date of such publication, although we understand that the Effective Date may be subject to change as the Final Rules may be republished due to an error in the original publication.)

Rules 4.13(a)(4) and 4.13(a)(3)

The Final Rules will rescind the exemption under CFTC Rule 4.13(a)(4) for CPOs of private funds offered only to certain highly sophisticated investors. Although the CFTC had also proposed to rescind the exemption provided by CFTC Rule 4.13(a)(3), that exemption is retained in the Final Rules. Rescission of the Rule 4.13(a)(4) exemption means that sponsors of private funds that invest in futures, commodity options and, upon the issuance of final rules defining the term "swap," most types of swaps (collectively, "**Commodity Interests**") will be required either to register with the CFTC as CPOs or to comply with the requirements of another exemption, such as Rule 4.13(a)(3), which permits limited trading in Commodity Interests. CPOs that have claimed the Rule 4.13(a)(4) exemption with respect to a fund prior to the Effective Date must comply with its rescission by December 31, 2012 with respect to such fund; otherwise, CPOs must comply by the Effective Date.

Rule 4.5 and Harmonization Release

The Final Rules will also restrict the scope of the exclusion from CPO registration for RICs under CFTC Rule 4.5. The investment adviser to a RIC that invests in Commodity Interests will be required to register with the CFTC as a CPO, unless the RIC complies with specified limitations on trading in such interests and marketing restrictions under the amended Rule 4.5 exclusion. Concurrently with its issuance of the Final Rules, the CFTC issued a separate release (the "**Harmonization Release**") proposing to amend certain disclosure, reporting and recordkeeping requirements for CPOs to address potential inconsistencies with the SEC's requirements for RICs.

Compliance with the amendments to Rule 4.5 for purposes of registration is required on the later of either December 31, 2012 or within 60 days following the adoption of final rules defining "swap" and establishing margin requirements for such instruments. CPOs required to register due to the amendments to Rule 4.5 will be subject to the CFTC's disclosure, reporting and recordkeeping requirements within 60 days following the effectiveness of final rules implementing the CFTC's proposed harmonization effort.

Other Amendments

In addition to the amendments to Rule 4.13 and Rule 4.5, the Final Rules also: (1) eliminate an exemption from the requirement to provide audited financial statements in annual reports under CFTC Rule 4.7 for commodity pools whose participants are "qualified eligible persons"; (2) incorporate by reference the accredited investor standard from Regulation D under the Securities Act of 1933 into the definition of "qualified eligible person" in Rule 4.7; (3) adopt new CFTC Rule 4.27 (see summary below), which requires registered CPOs and commodity trading advisors ("**CTAs**") to file, respectively, Forms CPO-PQR and CTA-PR with the National Futures Association; and (4) adopt a mandatory Risk Disclosure Statement for CPOs and CTAs addressing certain risks specific to swap transactions.

Rule 4.27

As adopted, Rule 4.27 (which takes effect on July 2, 2012) requires CPOs to file periodic reports on Form CPO-PQR and CTAs to report on Form CTA-PR, as summarized below. A CPO with at least $5 billion in assets under management as of June 30, 2012 must make its first filing within 60 days following September 30, 2012; CTAs and all other CPOs must make the relevant filings based on information as of December 31, 2012 in accordance with the time table described below. Rule 4.27 permits CPOs that are dually registered with the SEC to file Form PF with the SEC in lieu of filing Schedules B and C of Form CPO-PQR (but any such dual registrant would still be required to file Schedule A of Form CPO-PQR in addition to Form PF).

Schedule A of Form CPO-PQR. All registered CPOs are required to file Schedule A, which requires basic identifying information about the CPO, its commodity pools, and any service providers. A CPO that has at least $1.5 billion in assets under management as of the close of any business day during the calendar quarter (a "**large CPO**") will be required to file Schedule A quarterly within 60 days of the close of the calendar quarter. All other CPOs will be required to file Schedule A annually, within 90 days of the close of the calendar year.

Schedule B of Form CPO-PQR. Schedule B, which solicits more detailed information regarding each pool (*e.g.*, its net asset value broken down by investment strategy, types of borrowings and credit exposure, and breakdown of investments) must be filed (i) by large CPOs quarterly, within 60 days of the close of the calendar quarter, and (ii) by any CPO that had at least $150 million in assets under management as of the close of any business day during the calendar year (a "**mid-sized CPO**") annually, within 90 days of the close of the calendar year. Other CPOs are not required to file Schedule B.

Schedule C of Form CPO-PQR. Schedule C, which solicits information both on an aggregate pool basis and on an individual "large pool" basis, must be filed by large CPOs quarterly, within 60 days of the close of the calendar quarter. A "large pool" is defined generally as a pool with a net asset value of at least $500 million (either individually or together with any parallel pool) as of the close of business on any day during the quarter. Other CPOs are not required to file Schedule C.

Form CTA-PR. Only Schedule A, which solicits general demographic data about a CTA, was adopted by the Final Rules (Schedule B was not adopted). Schedule A must be filed by each CTA annually, within 45 days of the end of its fiscal year.

More information on the Rule 4.13 and Rule 4.5 amendments and on the Harmonization Release can be found 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.***

- See a copy of the Final Rules release
- See a copy of the Harmonization Release

SEC Issues Risk Alert on Unauthorized Trading

On February 27, 2012, the staff of the SEC's Office of Compliance Inspections and Examinations issued a National Examination Risk Alert (the "**Alert**") to aid investment advisers and broker-dealers in preventing and detecting "unauthorized trading" in brokerage and advisory accounts. According to the Alert, the term "unauthorized trading" is meant to refer to a broad range of activities by traders – *e.g.*, "rogue" or other unauthorized trading or trade execution in client or proprietary accounts; exceeding firm limits on position exposures, risk tolerance and losses; intentional mismarking of positions; and creating records of nonexistent transactions. The Alert defines the term "trader" to include individuals that are traders, trader assistants, portfolio managers, brokers, investment advisers, order placement personnel or trading desks, as well as mid-or back-office, risk management or other personnel.

The Alert provides a list of insights from the SEC's National Examination Program to assist firms in carrying out their supervisory and compliance obligations in respect of unauthorized trading, but specifies that the list should not be considered a safe harbor or a "checklist" because "[t]he adequacy of compliance or supervisory controls can be determined only with reference to the profile of the specific firm and the specific facts and circumstances."

The Alert identifies "[s]trong and effective business line supervision at all levels" as the most important type of control because it promotes a culture of compliance and helps to identify unauthorized trading. According to the Alert, in assessing its supervisory systems, a firm should consider, among other elements: mutually reinforcing checks and balances; an understanding by managers and supervisors of the products and strategies used by a firm's traders; discussions between traders, portfolio managers and their direct and indirect supervisors regarding, and reviews of, trading portfolios and account positions "on a holistic basis"; proper alignment of compensation packages and incentives with "responsible risk-taking"; discouraging aggregation of functions in a single person or desk; maintaining an "open door" policy focusing on prompt reporting of unrealized or unexpected losses; and periodic supervisory review of who has access to which trading books in order to confirm that the level of access is consistent with business needs. The Alert also states that it may be prudent for supervisors, as well as legal/compliance and operation risk personnel, to consider whether additional controls or heightened security, including regular and even daily or intra-day monitoring, are needed in specific situations – *e.g.,* changes in trading patterns, concentration of risk, audit trails, increased error account activity, frequent breaches of risk limits or requests for trade limit increases with the same counterparty, and in the event that anomalies are identified. According to the Alert, in some of these circumstances, a firm "may consider" taking steps to investigate, which could include reviewing personal/family investment activity and inexplicable increases in individual wealth, as well as scrutinizing emails, phone logs, text messaging and so forth.

On the topic of transferring personnel to the trading desk from other areas of a firm, the Alert highlights that such personnel may be aware of idiosyncrasies that could be used to engage in unauthorized trading activity and encourages firms "to determine that all systems access permitted as part of an employee's prior position is terminated prior to any trading by such transferred individual employee" and periodically to "verify that unneeded system access has been properly terminated." According to the Alert, firms should also consider developing "special supervisory reviews, exception reports or other tools to review transactions that feature extended settlements or 'rolls' of positions, based on frequency, length of settlement extensions or extensions that are inconsistent with normal or standard conventions applicable to the particular trading instruments." Other suggestions made by the Alert include scrutinizing inter-company transactions where trade confirmations may not be present and client authorization may be delayed, mandatory vacations for traders without remote access to trading accounts and using such opportunities to perform a special review of such traders' portfolios, periodic checks of trading strategies, business performance and risk profiles by the audit, compliance and operational risk departments, and aligning disparate systems to ensure "full picture" monitoring. The Alert also focuses generally on the importance of regular training of employees with regard to all elements of a firm's supervisory structure, policies and practices and on the need for a firm's compliance culture to be a priority for top-level senior management.

- See a copy of the Alert
- See the SEC press release

Treasury Issues Proposed FATCA Regulations

The tax provisions commonly referred to as "FATCA" use a 30% withholding tax to enforce a worldwide reporting regime designed to prevent U.S. persons from using offshore accounts to evade U.S. federal income tax. On February 8, 2012, Treasury issued a massive set of proposed regulations addressing many but by no means all aspects of the FATCA reporting and withholding regime. Although the proposed regulations would mitigate certain compliance burdens, implementing the regime remains at best a daunting prospect for U.S. withholding agents and, even more so, for many "foreign financial institutions," as broadly defined (including foreign investment entities, such as hedge funds and private equity funds). A more detailed summary of the proposed regulations can be found in the March 7, 2012 Davis Polk Client Memorandum, ***Summary of the Proposed FATCA Regulations*.**

CFTC Adopts Internal Business Conduct Rules for Swap Dealers and Major Swap Participants

On February 23, 2012, the CFTC adopted final rules regarding the internal business conduct of swap dealers and major swap participants under the Dodd-Frank Act. The rules combine five separate CFTC proposals and address:

- reporting, recordkeeping and daily trading records requirements;
- conflicts of interest involving research and clearing activities;
- chief compliance officer designation and duties; and
- risk management and operational requirements.

The adopted rules are largely similar to the rules proposed by the CFTC at the end of 2010, with a small number of changes in response to comments. Some of these changes will have significant ramifications for swap entities. Most importantly, the CFTC has restricted many of the risk management requirements, recordkeeping requirements and chief compliance officer duties to the "swaps activities" of a swap entity rather than applying them to all of a swap entity's activity. The rules, however, remain quite burdensome in many ways. For example, swap entities must make and maintain records of all oral or written communications that lead to the execution of a swap and must tape all telephone conversations that include such information.

Please see the March 12, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Internal Business Conduct Rules for Swap Dealers and Major Swap Participants***, for additional detail on the final rules.

FinCEN Requests Comment on Customer Due Diligence and Beneficial Ownership Proposals

On February 29, 2012, the Financial Crimes Enforcement Network ("**FinCEN**") released an advance notice of proposed rulemaking ("**ANPRM**") on the development of customer due diligence ("**CDD**") and beneficial ownership regulations. According to the ANPRM, the potential regulations would "codify, clarify, consolidate, and strengthen" existing CDD regulations and expectations and would expand existing regulations by requiring financial institutions to identify the beneficial ownership of all accountholders, subject to limited exceptions. Although FinCEN notes that a CDD obligation is already implicit in the Bank Secrecy Act ("**BSA**"), the ANPRM reflects its concern that "there is a lack of uniformity and consistency in the way financial institutions address these implicit CDD obligations and collect beneficial ownership information within and across industries." According to the ANPRM, FinCEN is currently considering developing such regulations to apply to banks, brokers or dealers in securities, mutual funds, futures commission merchants, and introducing brokers in commodities, but will consider expanding the scope to include all financial institutions subject to its regulation.

The ANPRM sets forth the following four elements that would need to be included in an effective CDD program: (i) initial due diligence on each customer, including customer identification and identity verification "as appropriate on a risk basis"; (ii) an obligation to understand the purpose and nature of, and anticipated activity of, each account, in order to assess risk and identify and report suspicious activity; (iii) subject to limited exceptions, identification of the beneficial owners of all customers, and identity verification pursuant to a risk-based approach; and (iv) ongoing monitoring of all customer relationships and additional CDD, as appropriate, based on such monitoring, in order to identify and report suspicious activity.

With respect to clause (iii) above, which is the only one of the four elements that FinCEN considers to be a new regulatory obligation, the ANPRM provides that FinCEN is considering a potential additional definition of "beneficial ownership" to supplement the circumstances under which the BSA currently requires beneficial ownership information to be obtained. The definition would include, for entities, (1) either (a) each individual who, directly or indirectly, owns more than 25% of the equity interests of the entity or (b) if there is no individual that is a 25% owner under clause (a), then the individual who, directly or indirectly, has at least as great an equity interest as any other individual, and (2) "the individual with greater responsibility than any other for managing or directing the regular affairs of the entity." In addition, according to the ANPRM, FinCEN is considering alternative definitions of the term "verification" in the context of clause (iii) and seeks to establish procedures that would be "reasonable and practicable" enough to enable a financial institution to form "a reasonable belief that [it] knows the identity or status . . . of the beneficial owner." Further, the ANPRM states that FinCEN would expect to provide guidance regarding "low-risk" customers and steps to be taken in the event that a financial institution is unable to identify, or verify the identity of, a beneficial owner.

FinCEN is seeking comments on numerous aspects of the ANPRM, including whether a different definition of "beneficial owner" would be appropriate, how the risks posed by beneficial owners are currently handled and any difficulties in doing so, and whether additional rulemaking on the issue of beneficial ownership is needed. Comments are due on or before May 4, 2012.

- See a copy of the ANPRM
- See a copy of FinCEN's press release

Litigation

District Court Finds Hedge Fund Adviser Liable for Securities Fraud in Late Trading Scheme

On February 14, 2012, in a case brought by the SEC, the U.S. District Court for the Southern District of New York found Pentagon Capital Management PLC ("**Pentagon**"), a London-based hedge fund adviser, and its Chief Executive Officer Lewis Chester (together, the "**Defendants**") guilty of securities fraud for engaging in late trading of U.S. mutual funds. *SEC v. Pentagon Capital Management Plc.,* No. 08 Civ. 3324 (S.D.N.Y. Feb. 14, 2012). Although the SEC also claimed that the Defendants engaged in securities fraud against U.S. mutual funds by using various market timing devices, the court found in favor of the Defendants on that claim.

According to the court, the Defendants willfully defrauded mutual funds from February 2001 through September 2003 by engaging in a late trading scheme through broker-dealer Trautman Wasserman & Company, Inc. ("**TW&Co.**") that "was broad ranging over the course of several years and in no sense isolated." Late trading involves placing orders to trade mutual fund shares after 4:00 p.m. ET when most funds calculate their net asset value ("**NAV**") but receiving a price based on the NAV determined as of such earlier time. This practice, according to the court, is "a form of backwards pricing that misleads the recipient fund into believing that the trade was made prior to the close of the markets." The court found that Chester was aware that late trading was impermissible, that he paid TW&Co. extra for accommodating late trading, and that he knew that "TW&Co. falsely stamped time-sheets as if orders were placed before 4 p.m.," thereby impermissibly misleading the mutual funds.

Unlike late trading, which according to the court, was "per se fraudulent" during the time period in question, the court found that the SEC failed to "establish[] that market timing rules prior to September, 2003 were sufficiently clear as to permit liability" or "that the funds that [Pentagon] traded prohibited market timing (however defined), or that Defendants violated an articulated fund rule with any specific trade." Therefore, although finding that the Defendants had a "general intent to deceive" by engaging in market-timing practices such as "reentering funds after kick outs and cloning accounts, as well as utilizing numerous and changing accounts and brokers and registered representative numbers in order to ensure their trades were under the funds' radars," the court concluded that the SEC "failed to establish the requisite scienter" in connection with the Defendants' market-timing activities.

Based solely on their late trading conduct, therefore, the court found the Defendants in violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The court ordered the Defendants, together with Pentagon Special Purpose Fund, Ltd., to disgorge $38,416,500 of profits plus prejudgment interest and to pay an additional $38,416,500 in civil penalties, and also enjoined the Defendants from future violations of Section 17(a), Section 10(b) and Rule 10b-5 thereunder.

- See a copy of the court's opinion
- See a copy of the SEC's press release

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.

Erin K. Cho	202 962 7077	erin.cho@davispolk.com
Mary Conway	212 450 4959	mary.conway@davispolk.com
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
Gregory S. Rowland	212 450 4930	gregory.rowland@davispolk.com
Danforth Townley	212 450 4240	danforth.townley@davispolk.com
Caroline R. Adams	212 450 4061	caroline.adams@davispolk.com