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SEC Rules and Regulations

SEC Staff Responds to Questions About the Family Office Rule

On January 19, 2012, the staff of the SEC's Division of Investment Management released responses ("**Responses**") to frequently asked questions about Rule 202(a)(11)(G)-1, the so-called "family office rule," under the Investment Advisers Act of 1940 (the "**Advisers Act**"). Effective August 29, 2011, the family office rule defines the term "family office" for purposes of Section 202(a)(11)(G) of the Advisers Act, which was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and excludes "family offices" from the definition of an investment adviser.

Under the rule, a family office is defined as any firm that (i) provides investment advice only to *family clients*, (ii) is *wholly owned by family clients* and is *exclusively controlled* (directly or indirectly) by one or more family members and/or family entities (*i.e.*, any family trust or estate, non-profit or charitable organization or other family entity qualifying as a family client under the rule, other than *key employees* and their trusts) and (iii) does not hold itself out to the public as an investment adviser. For further discussion of the family office rule, 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***.

Questions Addressing Ownership and Control. In response to a question regarding whether a family office with a seven-member board of directors (four family members and three non-family members), with each director having equal voting power and no minority veto power, would satisfy the requirement that the family office be "exclusively controlled" by family members and/or family entities, the SEC confirmed that the requirement would be met as long as there were no special shareholder or other arrangement giving a non-family member/family entity control over the office's management or policies. However, if the office's board consisted entirely of non-family members and non-family entities all of which were appointed by family members with the power to appoint, terminate or replace the directors, such a family office would not satisfy the exclusive control requirement, according to the Responses, unless the office's governing documents "provide that matters relating to the management or policies of the family office must be decided by shareholders that are family members or family entities." With respect to ownership, the staff indicated that ownership by a non-family client of non-voting shares of a family office would cause the office to fail to meet the definition of "family office" because it would not be "wholly owned" by family clients.

Questions Addressing Key Employees. Under the family office rule, the term "family client" generally includes, among others, "key employees" (and, under certain circumstances, former key employees) and key employee trusts, although key employees are not permitted to make additional investments through the family office following termination of their employment. According to the Responses, the term "key employee" includes only key employees of a family office (or an affiliated family office serving the same family) and not those of a family-owned operating company. The staff also clarified that the term "family client" includes the trust of a *former* key employee "as long as no new funds are transferred to the trust after the key employee became a former key employee." In addition, according to the Responses, permissible assets of a family office include all of the assets of a former key employee invested through the family office as of August 29, 2011 (*i.e.*, the effective date of the family office rule), plus any investments that the key employee was contractually obligated to make and that relate to a family office-advised investment existing before such date.

Questions Addressing Family Members. Under the family office rule, the term "family client" includes "family members" which is defined as all lineal descendants of a common ancestor (*e.g.*, adopted children, step-children and foster children) and such descendants' spouses and spousal equivalents, *provided* that the common ancestor is no more than 10 generations removed from the youngest generation of family members. The staff clarified in its Responses that the definition of "family member" does not include in-laws of a lineal descendant (nor does the definition of "family client") or the "descendents of a stepchild whose parent later divorced the family member step-parent," or the spouse of a step-child that married, or a child born to, the step-child *after* the step-child became a "former family member." The step-child, however, remains a family client (as a "former family member") and therefore can continue to receive advisory services from the office. According to the staff's Responses, "spousal equivalents" include "same-sex domestic partners as well as opposite sex partners that have determined not to marry even though they live together in a relationship generally equivalent to married couples" and individuals in a same-sex couple that qualifies as a domestic partnership under state law.

Questions Addressing Non-Advisory Services. The staff's Responses also respond to two questions regarding a family office's provision of non-advisory services. First, the staff stated that the provision of "non-advisory services (such as catering, tax filing, accounting, housekeeping)" to non-family members would not affect whether an office meets the definition of "family office." Second, in the case of a charitable organization that is otherwise a family client but which receives funds and securities from a third-party contributor, the staff said that the receipt of such assets would not affect the analysis of whether the organization qualifies as a "family client" if the office does not give investment advice with respect to those assets because it separates such assets from the assets that the family office manages, provides only administrative services to the third-party account that holds such assets and agrees with the contributor that any investment advice regarding the third-party account will be given by an outside investment adviser hired by the contributor. In both cases, however, the staff cautioned that the term "investment advice" is broadly construed under the Advisers Act and that a family office should "consider carefully" and "consult with its legal counsel" regarding whether any of its services would, in fact, constitute investment advice within the meaning of the Advisers Act.

Question Addressing Grandfathering Provision. The family office rule includes a grandfathering provision pursuant to which any office not registered or required to be registered under the Advisers Act on January 1, 2010 would be included in the definition of family office if it meets all of the criteria of the rule but for the provision of investment advice to certain clients, including (i) natural persons who, at the time of their investment, are officers, directors or employees of the family office that have invested with the family office before January 1, 2010 and are "accredited investors" and (ii) any company owned exclusively and controlled by one or more family members. The staff's Responses clarify that family office employees who do not meet the definition of "key employee" but that satisfy clause (i) above would be permitted to make new investments in the office as long as they meet the criteria set forth in the grandfathering provision.

- See a copy of the staff's Responses

SEC Staff Gives Guidance on Registration of a Registered Adviser's Related Entities

On January 18, 2012, the staff of the SEC's Division of Investment Management responded to a letter submitted by the Subcommittee on Hedge Funds of the American Bar Association (the "**ABA**") requesting interpretive guidance regarding registration under the Advisers Act for related entities of a registered investment adviser in light of new rules promulgated under the Dodd-Frank Act. In a no-action letter to the ABA (the "**No-Action Letter**"), the staff (1) confirmed the relief from registration granted in a December 8, 2005 letter to the ABA's Subcommittee on Private Investment Entities (the "**2005 Staff Letter**") for special purpose vehicles ("**SPVs**") established by a registered adviser to act as the general partner or managing member of a private fund and (2) provided relief from registration for certain advisers in control relationships with a registered adviser. For discussion of the 2005 Staff Letter, please see the ***December 2005 Investment Management Regulatory Update***.

The No-Action Letter confirms the position taken in the 2005 Staff Letter that the staff would not recommend enforcement action if an SPV set up by a registered adviser does not separately register with the SEC, in reliance on the adviser's registration, as long as the following conditions are met:

- the adviser establishes the SPV to serve as general partner or managing member of a private fund advised by the adviser;
- the SPV's formation documents designate the adviser as manager of the private fund's assets;
- the SPV's investment advisory activities are subject to the Advisers Act and the SPV itself is subject to SEC examination (the SPV would essentially be a registered adviser and therefore would have to comply with all relevant Advisers Act requirements); and
- the SPV, its employees and persons acting on its behalf are subject to the registered adviser's supervision and control (including its code of ethics and compliance policies) and accordingly are "persons associated with" the registered adviser under Section 202(a)(17) of the Advisers Act.

As set forth in the 2005 Staff Letter, the staff confirmed that an SPV meeting the foregoing conditions would not be required to file its own Form ADV, although the Form ADV of the registered adviser would, for instance, need to contain any disciplinary history that the SPV would have disclosed on its Form ADV had the SPV registered separately. The No-Action Letter clarifies that such relief is not limited to a registered adviser that has only one SPV and would not change if the SPV has directors independent of the registered adviser so long as they are the only persons acting on behalf of the SPV who are not subject to the registered adviser's supervision and control.

In addition, the No-Action Letter provides that the staff would not recommend enforcement action if an adviser files (or amends) a single Form ADV (the "**filing adviser**") on behalf of itself and each adviser under its control or under common control (each, a "**relying adviser**") "where the filing adviser and each relying adviser collectively conduct a single advisory business." According to the No-Action Letter, in the absence of contrary facts, the staff would view advisers as conducting a "single advisory business" when:

- The advisers advise only (a) private funds and (b) "separate account clients that are qualified clients and otherwise eligible to invest in the private funds advised and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds."
- Each relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control and are thus "persons associated with" the filing adviser.
- The filing adviser's principal office and place of business are in the United States and accordingly the client dealings of the filing adviser and each relying adviser are subject to the Advisers Act, irrespective of whether the adviser or the client is a United States person. (This requirement is meant to prevent advisers from designating a non-U.S. adviser as the filing adviser and taking the position that a U.S.-based relying adviser's dealings with non-U.S. clients are not subject to the substantive provisions of the Advisers Act.)
- Each relying adviser is subject to SEC examination and its advisory activities are subject to the Advisers Act (*i.e.*, the relying adviser is itself a registered adviser and must comply with the relevant provisions of the Advisers Act).
- The same code of ethics and written policies and procedures govern the conduct of both the filing adviser and each relying adviser and are administered by the same chief compliance officer, as if the advisers formed part of the same entity (allowing for the fact that there may be different obligations in different jurisdictions).
- The single Form ADV discloses the advisers' reliance on the No-Action Letter and identifies each relying adviser as a "(relying adviser)," and a separate Section 1.B., Schedule D is completed for each relying adviser. In addition, the Form ADV must disclose all relevant information regarding both the filing adviser and any relying adviser (*e.g.*, disciplinary and ownership information), and such information must be reflected in any other reports or filings required to be made under the Advisers Act (*e.g.*, Form PF).

The No-Action Letter also makes clear that in order to file a single Form ADV, neither the filing adviser nor any relying adviser may be prohibited from registering with the SEC by Section 203A of the Advisers Act (*i.e.*, each adviser must, for example, have sufficient assets under management or else must qualify for an exemption from such requirement).

The No-Action Letter purports to express no view as to the factors for determining whether related advisers are "operationally integrated" for purposes of the SEC's June 22, 2011 release, *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less than $150 million in Assets Under Management, and Foreign Private Advisers,* which is discussed in the ***June 29, 2011 Davis Polk Client Memorandum, SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940***. According to the No-Action Letter, failure to meet the conditions for relief set forth above would not preclude a determination that two or more advisers are "operationally integrated."

- See a copy of the No-Action Letter
- See a copy of the ABA's letter requesting relief

Investment Advisers Should Carefully Consider SEC's Pay-to-Play Rule During Election Season

During the current U.S. presidential campaign season, investment advisers should pay particular attention to the SEC's prohibition on "pay-to-play" practices by investment advisers. As discussed in detail in the ***July 14, 2010 Investment Management Regulatory Update***, Rule 206(4)-5 (the "**Pay-to-Play Rule**") under the Advisers Act provides that an investment adviser is prohibited from receiving compensation for advisory services provided, either directly or through an investment fund, to a "government entity" (*i.e.*, any state or political subdivision thereof, including public pension funds, public university endowments, and other collective government funds, among others) for a two-year "time out" period after the investment adviser or any of its "covered associates" makes a political "contribution" to an "official" of the government entity.

The definition of "covered associate" includes the investment adviser's general partner, managing member or any "executive officer" or person with similar status or function, any employee who solicits a government entity for the adviser (or directly or indirectly supervises such employee) and any political action committee controlled by the investment adviser or a covered associate. "Contribution" is broadly defined to include anything of value provided for the purpose of influencing a federal, state or local election and includes, for example, the payment of campaign debts and inaugural expenses for state or local office. The term "official" is also broadly defined as "any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate or successful candidate for elective office of a government entity, if the office: (i) [i]s directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (ii) [h]as authority to appoint any person who is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity."

The Pay-to-Play Rule applies not only to political contributions made to elected officials of state or local government entities but also to contributions made to a candidate for federal office if the candidate is an official of a government entity by virtue of the state or local elected office which he or she currently holds. In other words, contributions to the federal campaign of a state or municipal official—*e.g.*, the former presidential campaign of Rick Perry, Governor of Texas, or the potential vice presidential campaign of Chris Christie, Governor of New Jersey—could trigger the two-year "time out" if such official is in a position to have direct or indirect influence over the hiring of investment advisers for the government entity. Because violating the Pay-to-Play Rule can result in the loss of compensation for the investment adviser for two years, before making any contribution to a federal campaign or allowing any covered associate to make a contribution, an adviser should thoroughly analyze whether the particular candidate has the authority to influence the hiring decisions of a government entity and whether the Pay-to-Play Rule is otherwise implicated. The applicability of Municipal Securities Rulemaking Board Rule G-37, which similarly prohibits municipal securities broker-dealers from participating in "pay-to-play" practices, should also be considered.

Industry Update

CFTC Adopts Final Rules Regulating Swaps

The CFTC has recently adopted a number of final rules relating to the regulation of swaps. On January 11, 2012, the CFTC adopted a rule on the treatment of cleared swap customer collateral (the "**Customer Collateral Rule**") that implements the "legal segregation, operational commingling" model ("**LSOC Model**") of customer collateral protection. The LSOC Model is designed to eliminate customer exposure to "fellow customer risk." Under the LSOC model, if a customer of a futures commission merchant ("**FCM**") defaults on a cleared swap margin obligation and the FCM is not able to satisfy the defaulting customer's obligations, the derivatives clearing organization has no recourse to funds of the FCM's non-defaulting customers. For more information on the Customer Collateral Rule, see the January 23, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Final Rule on Protection of Cleared Swap Customer Collateral***.

The CFTC also recently finalized a rule (the "**Business Conduct Rule**") establishing business conduct standards for swap dealers ("**SDs**") and major swap participants ("**MSPs**") in their dealings with counterparties. In general, the Business Conduct Rule prohibits SDs and MSPs from engaging in fraud, deception or manipulation and requires communication with counterparties to be fair and balanced and based on good faith and fair dealing. The Business Conduct Rule also includes specific obligations for dealings with U.S. government entities, ERISA plans and other "Special Entities." More information on the Business Conduct Rule can be found in the January 27, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Business Conduct Rule for Swap Dealers***.

In addition, the CFTC has issued final rules specifying the registration process for SDs and MSPs and establishing a new reporting regime for swaps under the Dodd-Frank Act. More information on these rules can be found in the Davis Polk Client Memoranda, ***CFTC Establishes Registration Process for Swap Entities; Key Registration Requirements To Be Set Later*** and ***CFTC Adopts Rules Establishing Swap Reporting Regime***.

New Tax Regulations Address Withholding on "Dividend Equivalents"

Many investment funds obtain exposure to U.S. equity securities through "notional principal contracts" (*i.e.*, "swaps"). Section 871(m) of the Internal Revenue Code, enacted in 2010, imposes U.S. withholding tax on "dividend equivalents" paid or credited to foreign counterparties (*e.g.*, non-U.S. funds and/or their non-U.S. investors, depending on their U.S. tax status) under certain financial instruments, including swaps that have certain characteristics (such swaps, "**specified NPCs**"). Temporary Treasury regulations released on January 19, 2012 extend the currently operative definition of a specified NPC through the end of 2012. For payments beginning on January 1, 2013 (including on instruments entered into prior to that date), proposed Treasury regulations, also released on January 19, 2012, would among other things substantially revise the definition of a specified NPC and extend withholding under Section 871(m) to dividend-equivalent payments on a variety of equity-linked instruments other than swaps. More information on the temporary regulations and the proposed regulations can be found in the January 20, 2012 Davis Polk Client Newsflash, ***New Regulations Address Withholding on "Dividend Equivalents"***.

FINRA Amends Proposed Rule 5123 Regarding Disclosure and Filing Obligations in Private Placements

On January 19, 2012, the Financial Industry Regulatory Association ("**FINRA**") filed with the SEC an amendment (the "**Amendment**") to proposed Rule 5123 which FINRA filed with the SEC on October 5, 2011. As discussed in the ***November 18, 2011 Investment Management Regulatory Update***, Rule 5123, if approved by the SEC, would establish certain disclosure and filing requirements for private placements in which FINRA members participate, subject to significant exceptions. The Amendment incorporates FINRA's revisions and clarifications made in response to comments received on the Rule 5123 proposal.

"Private Placement" Definition. The Amendment clarifies that, consistent with FINRA Rule 5122, the term "private placement" means "a non-public offering of securities conducted in reliance on an available exemption from registration" under the Securities Act of 1933 (the "**Securities Act**"). Specifically, Rule 5123 would not apply to securities offered or sold pursuant to various exemptive provisions of the Securities Act—namely, Sections 4(1), 4(3) and 4(4) (which generally exempt secondary transactions) and Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing), and 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions)—or Section 1145 of the U.S. Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise exempt from registration under Securities Act Section 3(a)(10)).

Disclosure and Filing Requirements. As an alternative to requiring that each participating member file a disclosure document with FINRA, the Amendment would permit a member that is designated to make such filing to file the disclosure document on behalf of members identified in the filing. The Amendment also clarifies that a member would need to deliver the disclosure document only to investors to whom the member makes the sale (and not to any other investors). In a private placement where no disclosure document is used, the Amendment would eliminate the requirement that a disclosure document be delivered to each investor and filed with FINRA. Instead, the Amendment would require any member selling securities (or any member acting on behalf of such selling member) to make a notice filing no later than 15 calendar days after the date of first sale that identifies the participating members and the private placement and that states that no disclosure document was used.

Exemptions. The Amendment clarifies the following:

- whether an exemption from filing is available to a particular member should be evaluated based solely on the sales made by such member without regard to sales made by any other member;
- the exemption for offerings of non-convertible debt or preferred securities is available for issuers that meet the transaction eligibility criteria for registering primary offerings of non-convertible securities on Form S-3 or F-3; and
- offerings exempt from the filing requirements of FINRA Rule 5110 are exempt from Rule 5123.

The Amendment also adds several additional types of offerings that would be exempt from Rule 5123:

- offerings sold to knowledgeable employees (as defined in Rule 3c-5 under the Investment Company Act of 1940), eligible contract participants (as defined in Section 3(a)(65) of the Securities Exchange Act of 1934) and accredited investors described in Securities Act Rule 501(a)(1), (2), (3) or (7) (*i.e.*, institutional accredited investors);
- business combination transactions (as defined in Securities Act Rule 165(f));
- offerings of registered investment companies;
- standardized options (as defined in Securities Act Rule 238); and
- offerings of debt securities sold by members pursuant to Section 4(2) of the Securities Act as long as the maturity does not exceed 397 days and the securities are issued in minimum denominations of $150,000 (or the equivalent).

According to the SEC's release, comments on proposed Rule 5123, as amended, including whether the SEC should approve or disapprove the rule, should be submitted no later than February 27, 2012.

- See a copy of FINRA's filing with the SEC
- See a copy of the SEC release
- See a copy of FINRA's letter to the SEC

SEC Issues Alert on Investment Adviser Use of Social Media and Charges Investment Adviser

On January 4, 2012, the SEC charged Anthony Fields, sole proprietor of Anthony Fields & Associates ("**AFA**"), an Illinois-based registered investment adviser, and of Platinum Securities Brokers, a broker-dealer, with offering to sell more than $500 billion in fictitious securities on LinkedIn, a social media website. According to the SEC's order instituting administrative proceedings, Fields made multiple fraudulent offers and provided false and misleading information concerning AFA's assets under management, clients, and operational history to the public through its website and in SEC filings. Fields also allegedly failed to maintain required books and records and to implement adequate compliance policies and procedures, and held himself out to be a broker-dealer although not registered as such. According to Robert B. Kaplan, Co-Chief of the SEC Enforcement Division's Asset Management Unit, quoted in an SEC press release, the SEC's action against Fields reflects its "determination to pursue fraudulent activity on new and evolving platforms," including social media.

Also on January 4, 2012, the SEC issued two alerts – an adviser alert and an investor alert – as well as an investor bulletin, each addressing social media risks. Issued by the SEC's Office of Compliance

Inspections and Examinations, the adviser alert, entitled ***Investment Adviser Use of Social Media*** (the "**Adviser Alert**"), notes that registered investment advisers using social media should adopt policies and procedures addressing such use, which must comply with the antifraud, compliance and recordkeeping provisions of the federal securities laws. According to the Adviser Alert, in reviewing the use of social media by various advisers, the staff has observed that, although many advisers have compliance policies and procedures dealing with social media use, often such policies are not specific to social media (*i.e.*, they apply to advertisements, client communications or electronic communications generally) and do not specify the types of permissible social networking or address solicitors' use of social media.

Among the factors identified by the SEC staff as ones that "an investment adviser may want to consider when evaluating the effectiveness of its compliance program" are: (i) guidelines for solicitors and investment advisory representatives (each, an "**IAR**") regarding what types of social media are permissible and what type of use is appropriate (*e.g.*, an exclusive list of permissible sites and/or prohibiting certain functionalities); (ii) restrictions on content to address the risk that content may implicate fiduciary duties and other regulatory issues; (iii) guidelines for effectively monitoring social media sites (*e.g.,* frequency and whether a pre-approval process rather than an after-the-fact review should be utilized); (iv) the rapidly-evolving functionalities of social media sites; (v) information security risks and appropriate firewalls to protect sensitive customer information; and (vi) guidelines to prevent the advertising practices of a firm-wide social media site from violating the Advisers Act where an adviser is part of a larger enterprise.

In addition, the Adviser Alert states that advisers "may consider" policies and procedures to address third-party posting on their social media sites (*e.g.*, the posting of testimonials and safeguards to avoid any federal securities law violations). According to the Adviser Alert, "depending on the facts and circumstances, the use of 'social plug-ins' such as the 'like' button could be a testimonial under the Advisers Act" since such use could be "an explicit or implicit statement of a client's or clients' experience with an investment adviser or IAR."

The Adviser Alert also notes that investment advisers "may consider" adopting recordkeeping policies and procedures relating to social media communications to address, among other factors: the retention period for required records; the accessibility and maintenance of records; the format of records (electronic vs. paper); employee training programs; periodic test checking to ensure employee compliance; and use of third parties to ensure that records are consistent with recordkeeping requirements.

In addition to the Adviser Alert, the Office of Investor Education and Advocacy Issued an investor alert, entitled ***Social Media and Investing – Avoiding Fraud***, and an investor bulletin, entitled ***Social Media and Investing – Understanding Your Accounts***, which describe fraudulent investment schemes involving social media that investors should be aware of and provide tips for establishing accounts on social media websites in order to protect privacy and avoid fraud.

- See a copy of the SEC's press release
- See a copy of the SEC's order against Fields

Treasury Form SHC March 2nd Deadline Approaching

The U.S. Department of Treasury Form SHC ("**Form SHC**"), a quinquennial report of U.S. ownership of foreign securities, must be filed by U.S. resident custodians and U.S. resident end-investors (organizations that invest in foreign securities for their own portfolios or on behalf of others) that hold foreign portfolio securities with an aggregate fair market value of $100 million or more as of December 31, 2011. Form SHC's final forms and instructions include in the definition of "U.S. resident" entities incorporated or legally established or licensed in the United States, including branches, subsidiaries and affiliates of foreign entities located in the United States. Corporations incorporated in the United States are considered to be U.S. residents even if they have no physical presence in the United States. Form

SHC is required to be filed with the Federal Reserve Bank of New York (the "**FRBNY**"), acting as fiscal agent for the U.S. Department of Treasury, by March 2, 2012.

A U.S. investment adviser, as a U.S. resident end-investor, generally must file a consolidated Form SHC report for its own foreign portfolio securities holdings (which include foreign equities, short-term debt securities and long-term debt securities), and the foreign portfolio securities holdings of its U.S. subsidiaries and any U.S. resident fund that such investment adviser manages or sponsors, if on a consolidated basis, the U.S. investment adviser meets or exceeds the $100 million reporting threshold. According to Form SHC's final forms and instructions, equity securities include common and preferred stock, depositary receipts and shares, fund shares or limited partnership interests or other ownership interests in foreign-resident funds, including mutual funds, money market funds, hedge funds, private equity funds and other funds. A general partnership interest in a foreign resident entity, an interest in 10% or more of a foreign resident entity's voting securities or other controlling interest are not considered equity under Form SHC and should not be reported (but limited partner ownership interests are reportable). Direct investments, including investments in real estate, should also not be reported.

U.S. resident end-investors that meet or exceed the $100 million reporting threshold on a consolidated basis are generally required to complete Schedule 1—which includes the reporting entity's basic information, Schedule 2—which includes detailed information on the reporting entity's foreign portfolio securities holdings, and Schedule 3—which reports the summary amounts for all foreign securities entrusted to the U.S. resident custodian.

The FRBNY notified some organizations of the requirement to file Form SHC by sending 'may' or 'must' letters to such organizations. For an organization that received a 'may' letter (*i.e.*, a letter from the FRBNY stating that the organization may be required to report) but does not meet the $100 million reporting threshold, only a return of the notice of receipt is required. For an organization that received a 'must' letter (*i.e.*, a letter from the FRBNY stating that the organization must report) but does not meet the $100 million reporting threshold, a filing of the notice of receipt and Schedule 1 is required. Organizations that have not received any such letter from the FRBNY are nonetheless required to submit Form SHC if the organization's foreign securities holdings meet or exceed the reporting threshold.

- See a copy of Form SHC and instructions

Senate and House Pass Legislation Targeting Insider Trading by Government Officials

Congress recently passed the Stop Trading on Congressional Knowledge Act (the "**STOCK Act**"), which extends insider trading laws to members of Congress, their staffs, and other government officials and prohibits them "from using nonpublic information derived from their positions for personal benefit, and for other purposes." The Senate passed its version of the bill on February 2, 2012, by a vote of 96 to 3. On February 9, 2012, the House approved its version by a vote of 417 to 2. While the two versions are similar with respect to securities trading by members of Congress, they differ in other respects, especially regarding political intelligence, as discussed below.

Although lawmakers are not exempt from insider trading laws, applying those laws to such individuals was previously "without direct precedent" and thought to "present some unique issues," particularly with respect to the duties that were owed, as Robert Khuzami, Director of the SEC's Division of Enforcement, acknowledged while testifying before Congress about the STOCK Act last year. Accordingly, the STOCK Act amends Section 21A of the Securities Exchange Act of 1934 to clarify that members of Congress and their staffs, as well as executive branch employees and judicial officers, each "owes a duty arising from a relationship of trust and confidence to . . . the [U.S.] Government, and the citizens of the United States with respect to material, nonpublic information derived from such person's position . . . or gained from the performance of such person's official responsibilities."

The STOCK Act includes additional measures requiring members of Congress and others to disclose the terms of their mortgages; accelerating the disclosure requirements for lawmakers and other officials engaged in certain securities transactions; mandating online filing for, and public availability of, financial disclosure forms filed by legislators and other officials; prohibiting executives at Fannie Mae and Freddie Mac from receiving bonuses while the companies are in conservatorship; and expanding the list of felony convictions which would cause a member of Congress to forfeit his or her pension.

There are notable differences between the two versions of the STOCK Act. Perhaps most significantly for the private sector, the House omitted measures included by the Senate seeking to regulate Washington's burgeoning political intelligence industry for the first time. Broadly, "political intelligence" refers to nonpublic information learned from Washington insiders about pending or prospective legislative, regulatory, or other policy matters. The Senate bill focuses on individuals who obtain such information from certain federal officials with the intent to use that information "in analyzing securities or commodities markets, or in informing investment decisions." It would require these individuals (called "political intelligence consultants") and the companies who employ them (*e.g.*, hedge funds, private equity firms, and other investment outfits) to register under the Lobbying Disclosure Act of 1995 (the "**LDA**"), comply with the LDA's reporting requirements, and be subject to the LDA's disclosure and enforcement provisions. The income and expense thresholds in the LDA's registration requirements would be extended to political intelligence consultants and their employers, but unlike lobbyists, who are exempt from the LDA if they spend less than 20 percent of their time over a three-month period providing lobbying services, even one "political intelligence contact" would make an individual a political intelligence consultant and bring him or her within the LDA's scope. Both versions of the STOCK Act call for the Comptroller General to prepare a report, within one year, on the prevalence and impact of political intelligence as well as the legal and practical issues that might be raised by requiring the disclosure of political intelligence activities.

Also omitted from the House bill was the Public Corruption Prosecution Improvements Act, which the Senate had approved to, among other things, enhance the maximum sentences available for corruption convictions, clarify the bribery and gratuities statutes, broaden prosecutorial power with respect to public corruption cases, and rework and restore the honest services provision, which the Supreme Court had declared to be overly broad in *Skilling v. United States*, 130 S. Ct. 2896 (2010).

The House added to the STOCK Act as well, approving one provision that would prohibit lawmakers and certain government officials from participating in IPOs "in any manner other than is available to members of the public generally," and another that would extend post-employment negotiation restrictions to certain officials in the executive and judicial branches.

A conference committee will have to reconcile the different versions of the STOCK Act before it becomes law.

We will continue to monitor developments.

- See a copy of the bill passed by the House
- See a copy of the bill passed by the Senate
- See a copy of Khuzami's congressional testimony regarding the STOCK Act

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Deadline Approaching for Massachusetts Data Privacy Act Requirement

The Massachusetts Data Privacy Act (the "**Act**") requires any person or entity that owns or licenses personal information about a Massachusetts resident to ensure that its third party service providers are contractually obligated to implement and maintain appropriate security measures to protect personal information. The foregoing does not apply with respect to all service providers, but only with respect to those who receive, store, maintain, process or otherwise are permitted access to personal information through their provision of services to a person or entity that owns or licenses the personal information. The Act defines "personal information" as a Massachusetts resident's last name and first name or first initial, in combination with: (i) social security number, (ii) driver's license number or state-issued identification card number or (iii) financial account number, or credit or debit card number; provided, however, that "personal information" excludes information lawfully obtained from publicly available information. Any necessary contractual amendments must be effective on or before March 1, 2012. The Act imposes other requirements on persons or entities that own or license personal information about a Massachusetts resident, full compliance with which has been required since March 1, 2010.

Litigation

SEC Brings Insider Trading Charges Against Two Connecticut-Based Investment Advisers and Settles with One

On January 18, 2012, the SEC brought charges in the Southern District of New York against two Connecticut-based hedge fund investment advisers, Diamondback Capital Management LLC and Level Global Investors, L.P., and against seven individuals, for engaging in an insider trading scheme involving shares of Dell, Inc. and Nvidia Corporation that generated more than $78 million in illicit gains. *SEC v. Adondakis, et al*., No. 12 Civ 0409 (S.D.N.Y. Jan. 18, 2012). The SEC charged each of the defendants with violating Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The SEC also charged each individual defendant with aiding and abetting violations of Section 10(b) and Rule 10b-5. The charges are part of an ongoing investigation involving a November 2010 FBI raid of the Diamondback and Level Global offices that is discussed in the ***December 17, 2010 Investment Management Regulatory Update***.

According to the SEC's complaint, in 2008, a Dell insider communicated material nonpublic information regarding Dell's quarterly earnings information and other performance data to Sandeep Goyal, an analyst at an unidentified investment adviser, and he, in turn, communicated the information to Jesse Tortura, an analyst at Diamondback. Tortura allegedly tipped both Todd Newman, a portfolio manager at Diamondback, and Spyridon Adondakis, an analyst at Level Global, as well as Jon Horvath, a hedge fund analyst, and Danny Kuo, a vice-president and fund manager at an unidentified investment adviser. Adondakis then allegedly provided the information to Anthony Chiasson, one of Level Global's two founding partners. According to the SEC, Newman and Adondakis each used the inside information to trade Dell securities on behalf of Diamondback and Level Global funds, respectively, thereby reaping approximately $3.8 million in profits for Diamondback and approximately $57 million in profits for Level Global. According to the SEC, Tortura and Newman compensated Goyal for providing the information "by arranging for Diamondback to direct soft dollar payments totaling at least $175,000 to a brokerage account in the name of a nominee of Goyal." The SEC also alleged that Horvath communicated the inside information to a portfolio manager to whom he reported at an unidentified hedge fund, which resulted in approximately $1.4 million in profits for the hedge fund and that Kuo caused a hedge fund managed by the adviser by which he was employed to execute trades in Dell securities that resulted in approximately $180,000 in profits and avoided losses.

The SEC's complaint also alleges that in 2009, Kuo obtained material nonpublic information concerning Nvidia's calculation of its revenues, gross profit margins and other financial information. Kuo allegedly caused a hedge fund managed by the adviser by which he was employed to execute trades in Nvidia stock and passed the information on to Tortura and Adondakis who, in turn, tipped Newman and Chiasson. According to the SEC, Newman executed trades in Nvidia stock on behalf of Diamondback and Chiasson executed trades on behalf of Level Global. These trades allegedly realized collective profits and avoided collective losses of more than $15.8 million.

According to the complaint, the SEC is seeking disgorgement of ill-gotten gains plus prejudgment interest, financial penalties and a permanent injunction from future violations of the federal securities laws. An SEC press release quotes Robert Khuzami, Director of the SEC's Division of Enforcement, as stating that the individuals in this case are "not low-level employees succumbing to temptation by seizing a chance opportunity" but rather are "sophisticated players who built a corrupt network to systematically and methodically obtain and exploit illegal inside information again and again at the expense of law-abiding investors and the integrity of the markets."

On January 23, 2012, the SEC announced that Diamondback had agreed to pay more than $6 million in disgorgement and a civil penalty of $3 million to settle the charges. According to the SEC press release, under the proposed settlement which must be approved by S.D.N.Y. Judge Paul G. Gardephe, Diamondback would consent to be permanently enjoined from future violations of federal anti-fraud laws.

- See a copy of the SEC's complaint
- See a copy of the SEC's press release announcing the charges
- See a copy of the SEC's press release announcing Diamondback's proposed settlement

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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