Investment Management Regulatory Update

January 22, 2013

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SEC Rules and Regulations

SEC Lifts Moratorium on Approving Actively Managed ETFs That Invest in Derivatives

On December 6, 2012, Norm Champ, the director of the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**"), announced in a speech that the SEC will no longer defer consideration of exemptive requests under the Investment Company Act of 1940 (the "**Investment Company Act**") relating to actively managed exchange-traded funds ("**ETFs**") that make use of derivatives, provided that they include certain representations in their exemptive applications. This announcement ends the SEC's nearly three-year moratorium on the approval of actively managed ETFs that invest in derivatives.

Background. As reported in the ***April 6, 2010 Investment Management Regulatory Update***, the SEC announced on March 25, 2010 that it would be conducting a comprehensive review of the use of derivatives by mutual funds, ETFs and other investment companies and that it would defer consideration of exemptive requests under the Investment Company Act relating to actively managed ETFs and leveraged ETFs that would make significant investments in derivatives. ETF sponsors that obtained relief after the moratorium were required to represent that the ETFs would not invest in any options contracts, futures contracts or swap agreements. ETF sponsors that had obtained relief prior to the moratorium were allowed to continue offering ETFs that invested in derivatives.

Lifting of the Moratorium. In his December 6 speech, Champ stated that the SEC will now process exemptive applications for actively managed ETFs that intend to use derivatives, provided that their applications include the following two representations: (i) that the ETF's board periodically will review and approve the ETF's use of derivatives and how the ETF's investment adviser assesses and manages risk with respect to the ETF's use of derivatives and (ii) that the ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant SEC guidance.

On the same day as Champ's speech, the SEC issued a no-action letter to 18 actively managed ETFs that were previously granted exemptive relief based upon their representations that they would not invest in options contracts, futures contracts or swap agreements. The SEC stated that it would not recommend enforcement action against such ETFs if they made such investments, provided that they comply with the two representations stated above.

Notably, Champ stated in his speech that the moratorium on leveraged ETFs that use derivatives remains in place.

- **See a copy of Champ's speech**
- **See a copy of the SEC's no-action letter**

SEC Extends Temporary Rule 206(3)-3T Regarding Principal Transactions with Certain Advisory Clients

On December 20, 2012, the SEC adopted a final rule that amended Rule 206(3)-3T (the "**Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**") to extend the date on which the Rule will expire from December 31, 2012 to December 31, 2014. The Rule is a temporary rule that establishes an alternative means for registered investment advisers that are also registered with the SEC as broker-dealers ("**Dual Registrants**") to comply with Section 206(3) of the Advisers Act when they act in a principal capacity in certain transactions with certain of their non-discretionary advisory clients. This two-year extension of the Rule, initially proposed by the SEC on October 9, 2012, was previously reported on in the ***November 27, 2012 Investment Management Regulatory Update***.

As previously reported ***therein*** and in the ***September 13, 2010 Investment Management Regulatory Update*** and the ***October 2007 Investment Management Regulatory Update***, the Rule generally allows Dual Registrants to trade on a principal basis with non-discretionary advisory accounts if, among other things: (i) the adviser discloses conflicts of interest associated with principal transactions and the manner in which such adviser addresses those conflicts, (ii) the client executes a blanket consent prospectively authorizing principal transactions, (iii) before the execution of each principal transaction, the adviser informs the client of the capacity in which it may act with respect to such transaction and obtains the client's consent (either written or orally), (iv) at or before completion of each such transaction, the adviser sends the client written confirmation of the principal transaction and (v) at least annually, the adviser provides the client with reports of principal transactions executed in reliance on the Rule.

- **See a copy of the SEC's final rule release**

Industry Update

Annual Affirmation Requirement for Certain Exempt CPOs and CTAs

On December 3, 2012, the National Futures Association (the "**NFA**") issued a notice that provides guidance on the annual affirmation requirement for certain persons currently operating under an exemption or exclusion from registration with the Commodity Futures Trading Commission (the "**CFTC**") as a commodity pool operator ("**CPO**") or a commodity trading advisor ("**CTA**"). Beginning with the calendar year ending December 31, 2012, any person that claims an exemption or exclusion from CPO registration under CFTC Regulation 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3) or 4.13(a)(5) or from CTA registration under CFTC Regulation 4.14(a)(8) must annually affirm the applicable exemption or exclusion within 60 days of the calendar year-end. The annual affirmation for any such exemption or exclusion claimed in 2012 is due within 60 days after December 31, 2012. The affirmation must be completed electronically on the NFA's Exemption System at **http://www.nfa.futures.org/NFA-electronic-filings/exemptions.html**.

The failure to make such affirmation will be deemed by the CFTC as a request to withdraw such person's applicable exemption or exclusion and will result in an automatic withdrawal of such exemption or exclusion once the 60-day period has elapsed. For registered CPOs or CTAs, such a withdrawal will result in the person being subject to the CFTC Part 4 requirements for the applicable commodity pool regardless of whether such person remains eligible for the relevant exemption or exclusion. For non-registered operators or advisors, the withdrawal of an applicable exemption or exclusion may subject such person to enforcement action by the CFTC.

The NFA will send an annual email reminder of the affirmation requirement to the email contact on file in the NFA's Exemption System. Thus, persons should ensure that such email contact information is current and promptly update it to reflect any changes during the year.

For more information on CFTC Regulations 4.5 and 4.13(a)(3), please see the ***February 23, 2012 Client Memorandum: CFTC Adopts Amendments to Registration Exemptions for CPOs and CTAs and Proposes Harmonization Rules for Registered Fund CPOs***, the ***September 26, 2012 Investment Management Regulatory Update*** and the ***December 20, 2012 Investment Management Regulatory Update***.

- **See a copy of the NFA's notice**

Bill to Merge SEC and CFTC Introduced in the House of Representatives

On November 29, 2012, then-Representative Barney Frank (D-Mass.) and Representative Mike Capuano (D-Mass.) introduced a bill in the House of Representatives that, if enacted, would merge the SEC and the CFTC into a single regulatory body called the Securities and Derivatives Commission (the "**SDC**") that would oversee securities, derivatives, options, futures and related markets and instruments. According to the bill, the transfer of such functions would not alter any SEC or CFTC rule, regulation, proceeding or lawsuit pending or existing at the time of the bill's enactment and, other than under limited circumstances, employees of the SEC and CFTC would not be adversely affected. The President would appoint five commissioners to the SDC for five-year terms, at least one of whom must have "knowledge of the agricultural commodities market." If enacted, the bill would impose a fee on each futures, option or swap agreement, contract or transaction in order to cover the costs of the SDC related to such instruments. The bill has been referred to various House subcommittees.

- **See a copy of the bill**

Litigation

District Court Dismisses ICI and Chamber of Commerce Challenge to CFTC Amendments Affecting Registered Investment Companies

On December 12, 2012, the U.S. District Court for the District of Columbia granted the CFTC's motion to dismiss the joint suit filed against it by the Investment Company Institute and the U.S. Chamber of Commerce (collectively, the "**plaintiffs**"). The plaintiffs challenged the amendments to CFTC Rule 4.5 that significantly restrict the scope of the exclusion from CPO registration for investment companies registered under the Investment Company Act. Adopted by the CFTC in February 2012, the amendments effectively reinstated the conditions for meeting the CFTC Rule 4.5 exclusion that had been in effect prior to August 2003, including trading and marketing limits, with certain modifications that are discussed in the February 23, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Amendments to Registration Exemptions for CPOs and CTAs and Proposed Harmonization Rule for Registered Fund CPOs***.

In their complaint filed in April 2012, the plaintiffs had alleged, among other things, that the CFTC violated the Commodity Exchange Act (the "**CEA**") and the Administrative Procedure Act (the "**APA**") by failing to perform the proper cost-benefit analysis in promulgating the amendments to CFTC Rule 4.5. For a further discussion of the plaintiffs' complaint, please see the ***April 19, 2012 Investment Management Regulatory Update***. The court concluded that the CFTC had fulfilled its responsibilities under the CEA and the APA to evaluate the costs and benefits of CFTC Rule 4.5. The court noted that the CFTC had specifically addressed each of the following five factors when evaluating the cost-benefit analysis: (i) considerations of protection of market participants and the public, (ii) considerations of the efficiency, competitiveness and financial integrity of futures markets, (iii) considerations of price discovery, (iv) considerations of sound risk management practices and (v) other public interest considerations. The CEA requires that the CFTC consider these five factors when evaluating the costs and benefits of the CFTC's proposed rules. The court also noted that any challenge to any new compliance obligation that results from registration as a CPO of a registered investment company will not be ripe for review until the CFTC adopts final rules harmonizing the CFTC's and the SEC's compliance requirements for registered investment companies.

The plaintiffs have filed a notice of appeal to the Court of Appeals for the D.C. Circuit. We will continue to monitor developments in this area.

- **See a copy of the plaintiffs' complaint**
- **See a copy of the court's opinion**
- **See a copy of the court's order**

SEC Settles Charges Against a Business Development Company and Its Executives for Overvaluing Assets and for Internal Control Failures

On November 28, 2012, the SEC announced the settlement of charges against KCAP Financial, Inc. ("**KCAP**"), Dayl W. Pearson, its president and chief executive officer, Michael I. Wirth, its chief financial officer, and R. Jonathan Corless, its chief investment officer, for materially overstating the value of KCAP's assets and for failing to implement adequate internal controls over financial reporting. KCAP is a closed-end fund that is regulated as a business development company under the Investment Company Act. According to the SEC's press release, the charges against KCAP, Pearson, Wirth and Corless represent the first enforcement action against a public company for failing to properly fair value its assets in accordance with FAS 157.

According to the SEC, during the 2008-2009 financial crisis, KCAP failed to record and report the fair value of its investments in debt securities and collateralized loan obligations ("**CLOs**") in accordance with FAS 157 and generally accepted accounting principles by not taking into account certain market-based activity. FAS 157 requires that assets be fair valued based on an "exit price" that reflects the price that would be received in an orderly sale of the assets between market participants. According to the SEC, fair value is a market-based measurement under FAS 157. The SEC alleged that, for the fourth quarter of 2008, Pearson and Corless valued KCAP's investments in debt securities (which they had deemed to be illiquid) based solely on an enterprise value methodology. Such methodology did not take into account numerous price quotes and actual trades involving several of such debt securities and did not calculate or inform KCAP investors of the exit price for such debt securities. Additionally, the SEC alleged that Wirth valued KCAP's two largest CLO investments at cost, rather than taking into account then-existing market conditions as had been done when valuing KCAP's other CLO investments. According to the SEC, the use of such valuation methodologies caused KCAP to materially overstate the fair value of its assets. The SEC further alleged that KCAP's public filings were materially misleading because they reported that the two CLO investments had been valued using a discounted cash flow model that incorporated market data.

KCAP restated its financial statements in May 2010 for all four quarters of 2008 and the first two quarters of 2009 using different valuation methodologies. According to the SEC, the restatement revealed that the net asset value of the debt securities and CLO investments in KCAP's portfolio had been overstated by approximately 27% for fiscal year 2008. In addition, KCAP's restatement acknowledged material weaknesses with respect to its internal controls for valuing assets.

Based on this conduct, the SEC alleged that Pearson, Wirth and Corless each caused KCAP to violate the reporting, books and records and internal controls provisions of the Securities Exchange Act of 1934 (the "**Exchange Act**"), including Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) thereof and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder. The SEC also alleged that (i) Pearson, Wirth and Corless each violated Rule 13b2-1 under the Exchange Act by causing KCAP's internal books and records to reflect materially overstated fair values and (ii) Pearson and Wirth each violated Rule 13a-14 under the Exchange Act by signing public filings with certifications that KCAP had sufficient internal controls over financial reporting.

Without admitting or denying the SEC's findings, KCAP, Pearson, Wirth and Corless agreed to settle the charges. The SEC ordered the parties to cease and desist from future violations of the relevant provisions of the Exchange Act and ordered them to pay civil penalties ($50,000 for each of Pearson and Wirth and $25,000 for Corless).

According to the SEC's press release, "[w]hen market conditions change, funds and other entities must properly take into account those changed conditions in fair valuing their assets….This is particularly important for BDCs like KCAP, whose entire business consists of the assets that it holds for investment."

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

SEC Settles Charges Against Investment Adviser for Misleading Use of Hypothetical Back-Tested Performance Models

On December 18, 2012, the SEC announced the settlement of charges against New England Investment and Retirement Group, Inc. ("**NEINV**"), a registered investment adviser, and Nicholas John Giacoumakis, the president and sole owner of NEINV, for circulating misleading performance reports to clients and prospective clients and for failing to implement adequate written policies and procedures relating to the distribution of performance information to clients and prospective clients.

NEINV had created various model portfolios in which clients could invest. According to the SEC, on several occasions, NEINV provided clients and prospective clients with reports purporting to compare the historical performance of a NEINV model to a benchmark. However, the reports did not represent the past performance of NEINV's models, but rather were generated by evaluating how the current investments of a NEINV model would have performed had the model held its current investments throughout the entire time period in the report. According to the SEC, the models did not exist throughout the entire time period in the reports and the models' holdings had changed during the period in which the models did exist. Moreover, the reports did not disclose that the model results were hypothetical and not actual past performance. According to the SEC, Giacoumakis was responsible for distributing and presenting the reports to several clients and prospective clients of NEINV.

In addition, according to the SEC, during the relevant time period, NEINV failed to implement written policies and procedures reasonably designed to prevent its employees from presenting performance information to clients or prospective clients in a manner that violated the Advisers Act. NEINV's compliance manual contained a section that described Rule 206(4)-1 of the Advisers Act (which relates to advertisements by investment advisers) but included no policies or procedures specifically addressing the presentation of performance information, especially performance of NEINV's models. The SEC alleged that NEINV took no steps to implement the manual or otherwise to prevent its employees from presenting performance information in a way that violated the Advisers Act. Based on this conduct, the SEC alleged that Giacoumakis caused NEINV to violate Section 206(4) of the Advisers Act and Rules 206(4)-1 and 206(4)-7 thereunder.

Without admitting or denying the SEC's findings, NEINV and Giacoumakis agreed to settle the charges. The SEC censured NEINV and ordered NEINV and Giacoumakis to cease and desist from future violations of the relevant provisions of the Advisers Act and to jointly pay civil penalties of $200,000. In addition, NEINV agreed to (i) notify its existing clients of the SEC's order, (ii) post the SEC's order on the homepage of its website, (iii) retain the services of an independent compliance consultant to conduct a review of the NEINV compliance policies and procedures relevant to the publication, circulation or distribution of performance reports and (iv) abide by the recommendations of such consultant.

- **See a copy of the SEC's order**

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

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Yukako Kawata	**212 450 4896**	**yukako.kawata@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Julie E. Parker	**212 450 4899**	**julie.parker@davispolk.com**

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