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SEC Rules and Regulations

SEC Staff Responds to Form ADV Questions Regarding Exempt Adviser Reporting and Financial Industry Affiliations

The Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") recently issued responses (the "**Responses**") to several questions regarding Form ADV. On March 19, March 26, and March 30, 2012, the SEC issued Responses to questions regarding reporting on Parts 1A and 2A of Form ADV, including by investment advisers that are exempt from registration under the Investment Advisers Act of 1940 (the "**Advisers Act**") because they either (i) solely advise one or more venture capital funds (Section 203(l) of the Advisers Act) or (ii) solely advise private funds and have assets under management in the United States of less than $150 million (Section 203(m) of the Advisers Act) (collectively, "**exempt reporting advisers**"). Although exempt from registration with the SEC, exempt reporting advisers are nevertheless required to submit reports to the SEC by completing certain items of Part 1A. For more information on the reporting requirements of exempt reporting advisers and on Form ADV generally, 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***.

Reporting by Exempt Reporting Advisers

First, the SEC considered a question regarding reporting by an exempt reporting adviser that advises, on a discretionary basis, private funds and has day-to-day responsibility for managing the private funds, other than with respect to responsibility for hiring and firing the funds' advisers and overseeing the exempt reporting adviser's management which is carried out by the private funds' general partner, managing member or similar special purpose entity (collectively, the "**SPE**"); otherwise, the SPE exercises no discretionary authority over the funds' assets. According to the Responses, the exempt reporting adviser would be permitted to include on its Form ADV any SPE that would otherwise be required to file its own reports as an exempt reporting adviser (without the SPE having to file separately) if the following conditions are met: (1) the SPE does not engage in any activities other than those described above that would cause it to be considered an "investment adviser" and (2) the SPE serves as the SPE only for private funds or other pooled investment vehicles that are advised by the exempt reporting adviser or its "related persons."

Second, in the event that an exempt reporting adviser includes one or more SPEs on its Form ADV, the Responses make clear that the exempt reporting adviser's report on Form ADV would have to include all of the information that would be included if each SPE filed a separate report on Form ADV. In other words, the exempt reporting adviser would have to respond to the Form ADV questions in such a way that the responses related to, and included the relevant information regarding, both the exempt reporting adviser itself and each SPE. In addition, the Responses specify that the exempt reporting adviser's Form ADV report would have to provide executive officer and ownership information for each SPE on Schedules A and B and identify the SPE to which such information corresponds by identifying the relevant SPE in the "Title or Status" column of Schedule A.

In addition, the SEC considered a question regarding reporting by an exempt reporting adviser that, for legal, regulatory or tax reasons, establishes one or more SPEs for the private funds it advises that have neither employees nor other persons acting on their behalf other than officers, directors, partners or employees of the exempt reporting adviser and that retain and exercise discretionary authority over the private funds' assets (although certain management responsibilities are delegated to the exempt reporting adviser). According to the Responses, such an exempt reporting adviser would be permitted to include (in the same manner described above) on its Form ADV any SPE that would otherwise be required to file its own reports as an exempt reporting adviser (without the SPE having to file separately) if the SPE (1) acts as the SPE only for private funds or other pooled investment vehicles advised by the exempt reporting adviser, (2) is controlled by the exempt reporting adviser, (3) is subject to the Advisers Act in respect of its investment advisory activities, (4) has no employees or other persons acting on its behalf other than officers, directors, partners or employees of the exempt reporting adviser, and (5) along with its officers, directors, partners, employees and persons acting on its behalf, is subject to the exempt reporting adviser's supervision and control.

Reporting of Financial Industry Affiliations

Item 7.A of Form ADV Part 1A and Item 10 of Form ADV Part 2A require an investment adviser to disclose information regarding its "related persons." The term "related person" means an adviser's "advisory affiliates" and all persons under common "control" with the adviser. An "advisory affiliate" is defined as, among other things, all persons directly or indirectly controlling or controlled by the adviser. In addition, Item 11 of Part 1A requires disclosure about the disciplinary history of the investment adviser and its advisory affiliates.

In the context of these provisions of Form ADV, the SEC considered a question regarding the treatment of operating companies in which private equity and venture capital funds advised by an investment adviser take a significant ownership interest and of which persons associated with the adviser participate in the management in connection with the funds' investment. The Reponses clarify that the SEC would not recommend enforcement action against an investment adviser if the adviser does not treat such operating companies as advisory affiliates even though the adviser may "control" the operating companies, unless (in the case of Item 7.A and Item 10) a business relationship exists between the investment adviser and the operating company unrelated to the fund's investment that creates a conflict of interest between the adviser and one of the funds.

- See the Responses

SEC Staff Issues Guidance on Issues of Interest to Investment Advisers and Investment Companies

During March 2012, the staff of the SEC's Division of Investment Management supplemented its Investment Management Staff Issues of Interest posting on the SEC's website (the "**Posting**") to address the following topics: (a) advisory contracts for newly registered and registering advisers; (b) use of tender option bond financings by investment companies registered under the Investment Company Act of 1940 (the "**Investment Company Act**") (such companies, "**RICs**"); (c) the status of persons under the Investment Company Act and the Advisers Act that provide advice solely on non-securities matters; and (d) auditor verification of securities owned by business development companies ("**BDCs**").

Advisory Contracts for Newly Registered and Registering Advisers. Under the Advisers Act, registered investment advisers (and those required to register) are prohibited from "entering into, extending, renewing or performing under an advisory contract" that does not include (i) a statement that the contract may not be assigned by the adviser without the client's consent (Section 205(a)(2)); and (ii) if the adviser is a partnership, a statement that the adviser will inform its clients of any change in membership within a reasonable time (Section 205(a)(3)).

Because many previously exempt investment advisers are now required to register with the SEC as a result of amendments to the Advisers Act promulgated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") and such new registrants may have contracts in place that do not include the provisions required by Sections 205(a)(2) and 205(a)(3), the Posting clarifies that the staff would not recommend enforcement action under those sections against a registrant that was neither registered nor required to register when it entered into an advisory contract if the adviser does not amend the contract to include the requisite provisions as long as (i) the adviser "undertakes to operate and perform under the advisory contract as if it contained [these] provisions," (ii) the adviser informs the client (and each investor in a private fund client) that it is undertaking to do so, (iii) the contract was entered into or last amended before the adviser applied for registration, and (iv) the Section 205(a)(2)/(3) provisions will be included in any future amendment of the contract. By way of explanation, the Posting acknowledges that amending existing contracts to include the relevant provisions could require client consent which might be "impracticable" to obtain in a timely fashion and states that the relief provided is meant to "minimize the disruption to the contracts" of new registrants.

Funds Using Tender Option Bond Financings. According to Section 18(f)(1) of the Investment Company Act, it is unlawful for an open-end RIC "to issue any class of senior security or to sell any senior security of which it is the issuer, except that any such registered company shall be permitted to borrow from any bank . . . ." Under Section 18(g), the term "senior security" is defined as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends" and "senior security representing indebtedness" means "any senior security other than stock." Section 18 generally requires open- and closed-end RICS to have 300% asset coverage for any "senior security representing indebtedness" following their issuance of such security.

According to the Posting, an open- or closed-end RIC may seek secured financing by depositing a tax-exempt or other bond into a special purpose trust (a "**TOB Trust**"), which then issues two types of securities: floating rate notes ("**floaters**") and a residual security junior to the floaters ("**inverse floaters**"). The floaters are sold to money market funds and other investors, and the inverse floaters together with the cash proceeds from the sales of the floaters are deposited in the RIC, which then uses the proceeds to acquire additional securities. The inverse floater grants the RIC the right to any remaining value after the TOB Trust satisfies its obligations, and the TOB Trust's obligations on the floaters are guaranteed by a third-party liquidity provider.

According to the Posting, a tender option bond financing of this kind implicates Section 18 and "involves the issuance of a senior security by a fund unless the fund segregates unencumbered liquid assets (other than the bonds deposited into the TOB Trust) with a value at least equal to the amount of the floaters plus accrued interest, if any."

Advisers Providing Advice Solely on Non-Securities Matters. Having previously considered various questions regarding the status under the Advisers Act and the Investment Company Act of persons that provide advice only regarding matters that do not involve securities (*e.g.*, commodities, diamonds, precious metals, coins and stamps), the staff clarified in its Posting that a non-securities adviser would generally not meet the definition of "investment adviser" under the Advisers Act but may meet the definition under the Investment Company Act. Because Section 202(a)(11) of the Advisers Act defines the term "investment adviser" as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, ***as to the value of securities or as to the advisability of investing in, purchasing, or selling securities***, or who, for compensation and as part of a regular business, ***issues or promulgates analyses or reports concerning securities***," a non-securities adviser would not meet such definition, according to the staff (and therefore would not be required to register under the Advisers Act), regardless of whether it provides advice on non-securities matters to a RIC or a BDC.

In contrast, Section 2(a)(20) of the Investment Company Act defines the "investment adviser" of an investment company as a person "who pursuant to contract with such company regularly furnishes advice to such company ***with respect to the desirability of investing in, purchasing or selling securities or other property***, or is empowered to determine what ***securities or other property*** shall be purchased or sold by such company." Therefore, according to the Posting, a non-securities adviser to a RIC or a BDC may meet the Investment Company Act definition and, if so, would be subject to the provisions of the Investment Company Act that apply to investment advisers (*e.g.*, Sections 15 and 17).

Auditor Verification of Securities Owned by BDCs. RICs must comply with Section 30(g) of the Investment Company Act, which requires a RIC's financial statements contained in its annual report to be accompanied by certificates of independent public accountants. Under Section 30(g) and the SEC's Accounting Series Release No. 118, these certificates must state that "that such independent public accountants have verified securities owned, either by actual examination, or by receipt of a certificate from the custodian." Although the requirements of Section 30(g) do not apply to BDCs, the Posting sets forth the staff's view that a BDC's auditor "plays an important role . . . in preventing a BDC's assets from being lost, misused or misappropriated" and, therefore, it is best practice for a BDC's auditor to verify all of the BDC's securities by "actual examination or by receipt of a certificate from the custodian, and affirmatively to state in the audit opinion whether the auditor has confirmed the existence of all such securities."

- See a copy of the Posting

Upcoming Deadline for Compliance with Pay-to-Play Rule's Prohibition on Payments to Certain Third-Party Solicitors

Beginning on June 13, 2012, Rule 206(4)-5 (the "**Pay-to-Play Rule**") under the Advisers Act will, among other things, prohibit registered investment advisers, certain advisers exempt from registration (so-called "exempt reporting advisers"), foreign private advisers, and their "covered associates" from providing or agreeing to provide, directly or indirectly, a "payment" to a third party to "solicit" a "government entity" for investment advisory services on behalf of such adviser, *unless* such third party is a "regulated person." In a June 22, 2011 rule release (the "**Release**"), the SEC extended the compliance date from September 13, 2011 to June 13, 2012 (the "**Compliance Date**").

The Pay-to-Play Rule defines the term "payment" broadly as "any gift, subscription, loan, advance, or deposit of money or anything of value" and defines "solicit," with respect to investment advisory services, as "communicat[ing], directly or indirectly, for the purpose of obtaining or retaining a client for, or referring a client to, an investment adviser." Under the Pay-to-Play Rule, the term "regulated person" means (i) a registered investment adviser that is in compliance with the Pay-to-Play Rule, (ii) a broker-dealer registered with the SEC that is a member of Financial Industry Regulatory Authority ("**FINRA**"), and (iii) a "municipal advisor" registered with the SEC under Section 15B of the Securities and Exchange Act of 1934 (the "**Exchange Act**") and subject to the rules of the Municipal Securities Rulemaking Board (the "**MSRB**"), *provided* that, in the case of clauses (ii) and (iii), FINRA and the MSRB have rules that prohibit broker-dealers and municipal advisors, respectively, from engaging in distribution or solicitation activities if certain political contributions have been made ("**Political Contribution Rules**") and the SEC, by order, finds that such rules impose on such persons substantially equivalent or more stringent restrictions than, and are consistent with the objectives of, the Pay-to-Play Rule.

To date, neither FINRA nor the MSRB have adopted any Political Contribution Rules for broker-dealers or municipal advisors, respectively. Accordingly, unless FINRA or the MSRB adopts such rules (and the SEC finds that they impose substantially equivalent or more stringent restrictions than, and are consistent with the objectives of, the Pay-to-Play Rule) by the Compliance Date (or such later date, in the event that the SEC further extends the date for compliance), registered investment advisers, exempt reporting advisers, foreign private advisers, and their covered associates will be prohibited as of such date from entering into an agreement to pay, or making any payments to, a third-party solicitor to solicit a government entity for investment advisory services, unless the solicitor is itself a registered investment adviser. In response to frequently asked questions (the "**FAQs**"), however, the SEC has indicated that "trailing payments" made after the Compliance Date to a solicitor that does not qualify as a "regulated person" would not violate the Pay-to-Play Rule, if the adviser obtained the government-entity client with the solicitor's assistance prior to the Compliance Date, *provided* that the solicitor does not solicit (including communications to retain) the government-entity client after the Compliance Date, and *provided further* that the compensation arrangement is not structured to evade the Pay-to-Play Rule's restrictions.

According to the FAQs, June 13, 2012 is also the date for compliance with certain record-keeping provisions of the Pay-to-Play Rule, including the requirement (found in Rule 204-2(a)(18)(i)(D) under the Advisers Act) for a registered investment adviser, regardless of whether it has a government entity as a client at such time, to maintain a record of the names and business addresses of all regulated persons whom the adviser pays or agrees to pay, directly or indirectly, to solicit a government entity for investment advisory business on behalf of the adviser.

Prior to making any payment to, or agreement with, a third-party solicitor on or following the Compliance Date, therefore, advisers will need to consider carefully what policies and procedures should be established to ensure compliance with the Pay-to-Play Rule, and should also consider, in this context, the requirements of Rule 206(4)-3 under the Advisers Act (the "cash solicitation rule") that apply to the relationship between a registered adviser and its third-party solicitors.

- See a copy of the Release
- See a copy of the FAQs

Industry Update

The STOCK Act Is Enacted, Banning Insider Trading by Government Officials

On April 4, 2012, President Obama signed into law the Stop Trading on Congressional Knowledge Act (the "**STOCK Act**"), which explicitly extends insider trading laws to certain government officials. The STOCK Act was passed by the U.S. Senate on March 22, 2012 by a vote of 96 to 3 and by the U.S. House of Representatives on February 9, 2012 by a vote of 417 to 2. Although the Senate had previously passed its own version of the bill on February 2, 2012 (the "**Senate Version**"), which differed in some key respects from the version approved by the House, the Senate ultimately approved (and President Obama signed) the House version. Both the House and Senate versions are discussed in the ***February 21, 2012 Investment Management Regulatory Update***.

The STOCK Act amends Section 21A of the Exchange Act to clarify that members of Congress and their staffs, as well as executive branch employees and judicial officers and judicial employees, each "owes a duty arising from a relationship of trust and confidence to the United States 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" and that members of Congress and their staffs also owe such a duty to Congress. In addition, the STOCK Act requires that reports of securities transactions by such government officials and certain other federal agency officials and employees be publicly disclosed online either 30 days after receiving notification of a transaction for the individual's account, or else 45 days after the transaction.

Because the STOCK Act imposes a duty on government officials, if such an official were to provide material nonpublic information to another person (*e.g.*, an investment adviser or its employees), traditional tipper/tippee principles could apply. In other words, the recipient of such information (*i.e.*, the "tippee") could be liable for trading on material nonpublic information if the tippee knew or should have known that the official (*i.e.*, the "tipper") provided the information in violation of a fiduciary duty to the tipper's source. If, in exchange for a "personal benefit," a tipper discloses material nonpublic information in violation of a duty not to, the tipper could be liable if the tippee trades using such information. Because the STOCK Act does not define "personal benefit," it remains to be seen whether a public official's disclosure of information for non-monetary benefits (such as goodwill or a reputational boost) could trigger insider trading liability under a tipper/tippee theory. For more information on the STOCK Act, including further discussion of potential tippee liability, see the March 30, 2012 Davis Polk Client Memorandum, ***The STOCK Act: Implications for Trading on Political Information***.

As enacted, the STOCK Act omits measures originally included in the Senate Version that sought to regulate Washington's "political intelligence" industry. Broadly, "political intelligence" refers to nonpublic information gleaned from Washington insiders about pending or prospective legislative, regulatory, or other policy matters. The Senate Version would have required so-called "political intelligence consultants" and the companies that employ them (*e.g.*, hedge fund and private equity fund advisers) to register under the Lobbying Disclosure Act of 1995 (the "**LDA**"), to comply with the LDA's reporting requirements, and to be subject to the LDA's disclosure and enforcement provisions. Although the STOCK Act was enacted without such provisions, the STOCK Act directs the Comptroller General, within one year of enactment, to prepare a report on the prevalence and impact of political intelligence as well as the legal and practical issues that would be implicated by the sale of political intelligence and by requiring disclosure by those who engage in political intelligence activities.

We will continue to monitor developments.

- See a copy of the STOCK Act

FSOC Adopts Final Rule on Designation of Systemically Important Nonbank Financial Companies and the Federal Reserve Proposes Rule on Whether Companies Are "Predominantly Engaged in Financial Activities"

On April 3, 2012, the Financial Stability Oversight Council (the "**FSOC**") issued a final rule and interpretive guidance setting forth the process by which it will designate a nonbank financial company as systemically important under the Dodd-Frank Act. Although the final rule contains some noteworthy modifications and clarifications, it adopts without substantial change the proposal from October 2011, including a three-stage designation process and quantitative screening criteria for the first stage of the analysis ("**Stage I**"). Among the clarifications is guidance that permits the FSOC, in applying the Stage I quantitative thresholds to investment funds (including private equity and hedge funds), to consider the aggregate risks posed by separate funds managed by the same adviser, particularly where the funds' investments are identical or highly similar. According to the FSOC's interpretive guidance, although the Stage I thresholds will be applied to all types of nonbank financial companies, private equity and hedge funds and asset management companies "may pose risks that are not well-measured by the quantitative thresholds approach." Accordingly, the guidance states that the FSOC will use the information disclosed to the SEC on Form PF and other data in "consider[ing] whether to establish an additional set of metrics or thresholds tailored to evaluate hedge funds and private equity firms and their advisers." In addition, according to the guidance, the FSOC, its member agencies and the Office of Financial Research are currently analyzing whether asset managers pose threats to the financial stability of the United States and, if so, whether supervision by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") and prudential standards are appropriate ways to mitigate such threats or whether other regulatory measures should be employed. The guidance goes on to state that the FSOC "may develop additional guidance regarding potential metrics and thresholds relevant to determinations regarding asset managers, as appropriate." Please see the April 4, 2012 Davis Polk Client Memorandum, ***FSOC Issues Final Rule on Designation of Systemically Important Nonbank Financial Companies***, for a summary of the modifications and clarifications contained in the final rule, and please see the October 17, 2011 Davis Polk Client Memorandum, ***FSOC Releases Proposed Rules on Designation of Systemically Important Nonbank Financial Companies***, for a summary of the proposed rule.

In addition, on April 2, 2012, the Federal Reserve issued a Supplemental Notice of Proposed Rulemaking (the "**Supplemental NPR**") and request for comment on the scope of activities that are considered financial for purposes of determining whether a company is "predominantly engaged in financial activities" such that it may be designated as a systemically important nonbank financial company under the Dodd-Frank Act. The Supplemental NPR enlarges the scope of companies potentially subject to systemic designation by the FSOC from that contemplated in the February 11, 2011 Notice of Proposed Rulemaking, to include, for example, mutual fund companies, futures commission merchants, and private equity firms. Comments on the Supplemental NPR are due on or before May 25, 2012. For a more detailed discussion of the Supplemental NPR, please see the April 9, 2012 Davis Polk Client Memorandum, ***Federal Reserve Issues Supplemental Notice of Proposed Rulemaking on Requirements for Determining Whether Companies are Predominantly Engaged in Financial Activities.***

CFTC Adopts Swap Clearing Documentation, Timing and Risk Management Rules

On March 20, 2012, the Commodity Futures Trading Commission (the "**CFTC**") finalized a package of rules related to swap clearing. The rules set standards for:

- the arrangements that swap dealers ("**SDs**"), major swap participants (together with swap dealers, "Swap Entities") and futures commission merchants ("**FCMs**") that clear swaps for customers and derivatives clearing organizations ("**DCOs**") have with respect to clearing customers;

- timing of acceptance or rejection of trades for clearing by DCOs and clearing members that are FCMs or Swap Entities (“**Clearing Members**”);
- risk management procedures of Clearing Members; and
- swap processing.

For a more detailed discussion, please see the April 5, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Swap Clearing Documentation, Timing and Risk Management Rules***.

SEC Enters Into Memoranda of Understanding with Cayman Islands and European Regulatory Counterparts

On March 23, 2012, the SEC announced its establishment of two supervisory cooperation arrangements, one with the Cayman Islands Monetary Authority (“**CIMA**”) and one with the European Securities and Markets Authority (“**ESMA**”), designed to improve oversight of certain regulated entities operating across national borders including investment advisers, investment fund managers and investment companies. Specifically, the SEC entered into a memorandum of understanding with CIMA (the “**Cayman MOU**”) and a memorandum of understanding with ESMA (the “**European MOU**”), which, according to the SEC, will facilitate better information flow about such entities. According to an SEC press release, Ethiopis Tafara, Director of the SEC’s Office of International Affairs, has noted that the memoranda will “help the SEC build closer relationships with its counterparts to cooperate and consult on each other’s oversight activities in ways that may help prevent fraud in the long term or lessen the chances of future financial crises.”

Each of the Cayman MOU and the European MOU (together, the “**MOUs**”) provides that it is “a statement of intent to consult, cooperate and exchange information in connection with the supervision and oversight of” cross-border regulated entities. The MOUs generally allow the SEC, CIMA or ESMA, as applicable, to request information from its counterparty in order to ensure that a regulated entity is in compliance with the authority’s laws and regulations and, when necessary, to work with local authorities in conducting on-site visits or inspections of regulated entities operating in the counterparty’s jurisdiction. According to the Cayman MOU, the SEC and CIMA should inform each other of regulatory, enforcement and other material events that could impact a cross-border regulated entity. The MOUs state that they do not create any legally binding obligations, confer any rights, supersede any domestic laws or alter the terms of existing cooperation arrangements.

- See a copy of the SEC press release
- See a copy of the Cayman MOU
- See a copy of the European MOU

Litigation

ICI and Chamber of Commerce Challenge CFTC Amendments Restricting the Exclusion from CPO Registration for Advisers to RICs

On April 17, 2012, the Investment Company Institute (the “**ICI**”) and the Chamber of Commerce of the United States of America filed a joint suit in the U.S. District Court for the District of Columbia against the CFTC, challenging amendments to CFTC Rule 4.5 that significantly restrict the exclusion from registration as a commodity pool operator (“**CPO**”) under the Commodity Exchange Act for advisers to investment companies registered under the Investment Company Act of 1940 (“**RICs**”). Adopted by the CFTC on February 9, 2012, the amendments effectively reinstate the conditions for meeting the 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 Proposes Harmonization Rules for Registered Fund CPOs***.

According to the complaint, the CFTC violated the Commodity Exchange Act and Administrative Procedure Act in promulgating these amendments because it failed to perform the proper cost-benefit analysis and did not explain in sufficient detail why the 2003 rationale for eliminating the trading and marketing limits was no longer applicable. Noting that "[i]nvestment companies and their advisers already are among the most highly regulated entities in the financial industry," the ICI and the Chamber of Commerce claim that the CFTC's amendments subject RICs to "an additional, vast regulatory apparatus that significantly compounds the regulatory oversight already provided by the SEC . . . and by FINRA" but are not supported by any meaningful analysis. In addition, the complaint alleges, among other things, that the CFTC failed to give the public a sufficient opportunity to participate in the rule-making process.

We will continue to monitor developments.

- See a copy of the complaint

SEC Charges Two Investment Advisers and a Broker-Dealer with Fraud for Misleading Fund Investors in connection with Secondary Market Trading of Pre-IPO Shares

On March 14, 2012, the SEC brought two separate actions against two investment advisers, the individuals managing them, and an affiliated broker-dealer for misrepresentations made to investors in funds set up to trade in the pre-initial public offering ("**IPO**") shares of certain technology companies on the secondary market. According to its press release, the SEC's actions result from a "yearlong investigation of the fast-growing business of trading pre-IPO shares on the secondary market." In another action stemming from its investigation, also brought on March 14, 2012, the SEC charged SharesPost Inc., an online service that matches buyers and sellers of pre-IPO stock, with failing to register as a broker-dealer in connection with certain securities transactions.

According to the SEC, Frank Mazzola, Felix Investments, LLC ("**Felix**"), a registered broker-dealer in New York City of which Mazzola is principal and owner, and Facie Libre Management Associates, LLC ("**Facie Libre**" and, collectively with Mazzola and Felix, the "**Defendants**"), an investment adviser to two funds affiliated with Felix that is managed in part by Mazzola, established several investment funds starting in November 2009 to purchase the pre-IPO securities of Facebook, Twitter, and Zynga. According to the SEC's complaint, the offering memoranda for two of the funds disclosed that Felix, as exclusive placement agent, would receive 5% of the gross proceeds raised in the Facebook offering and that Facie Libre would earn 5% of any distributions of proceeds once an investor's entire capital contribution had been returned and 10% after an investor had received 200% of its contribution. However, the Defendants allegedly failed to disclose a referral fee agreement that Felix had entered into with another broker-dealer to share in commissions generated on the sale of Facebook shares by Facebook shareholders and other fund investors. The SEC alleged that the self-dealing implicit in this arrangement harmed investors and created a conflict that caused Mazzola and Facie Libre to act contrary to the interests of the funds and their investors. The SEC further alleged that the Defendants misrepresented other material facts – *e.g.*, the Defendants failed to disclose that Facebook refused to transfer ownership of 133,000 shares that investors had been told the funds already owned; the Defendants told investors that Facie Libre could acquire Facebook stock at $66 per share but ultimately was able to acquire it only at a higher price; and the Defendants falsely told investors that the funds were "approved" to invest in Facebook. Mazzola also allegedly misled an investor by representing that a fund had invested in Zynga stock even though it had not done so and induced another investor to invest in a fund set up to hold Twitter stock by making false claims about the company's expected financial results.

Based on these allegations, the SEC charged the Defendants with securities fraud for violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act of 1933 (the

"**Securities Act**"). Mazzola and Facie Libre were also charged with violating Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit fraudulent acts by an investment adviser to a pooled investment vehicle. The SEC seeks to prohibit the Defendants from engaging in further securities fraud and to require disgorgement and payment of financial penalties.

Separately, the SEC brought an administrative proceeding against EB Financial Group, LLC, an unregistered investment adviser to two funds (the "**EB Funds**") established to invest in the pre-IPO securities of Facebook and other technology companies, and Laurence Albukerk, who is the sole owner and managing member of EB Financial. According to the SEC, the offering materials given to prospective fund investors "misrepresented and failed to disclose the full amount of compensation" that EB Financial and Albukerk would earn in connection with the EB Funds' purchase of Facebook stock. Although the offering materials indicated that investors would pay only a services fee and a distribution fee, Albukerk allegedly also earned a broker's fee on the acquisition of Facebook shares from original shareholders. In addition, Albukerk allegedly used an entity managed by his wife to purchase Facebook stock from existing shareholders and then sold interests in that entity to the EB Funds while marking up the price.

Albukerk and EB Financial agreed to settle the SEC's charges without admitting or denying the findings and to pay disgorgement and prejudgment interest of $210,499 and a penalty of $100,000. According to the SEC, Albukerk and his firm violated Section 17(a)(2) of the Securities Act, which prohibits the receipt of money by means of any untrue statement or omission of material fact, and Section 206(4) of the Advisers Act and Rule 206-4(8) thereunder.

- See a copy of the SEC's press release
- See a copy of the complaint against Mazzola, Felix and Facie Libre
- See a copy of the order against Albukerk and EB Financial

U.S. Supreme Court Holds that the Section 16(b) Short-Swing Liability Statute of Limitations is Not Tolled by an Insider's Failure to File a Section 16(a) Disclosure Report

On March 26, 2012, the U.S. Supreme Court unanimously held that the two-year statute of limitations (the "**SOL**") within which to bring a "short-swing" liability claim under Section 16(b) of the Exchange Act is not tolled until an "insider" (*i.e.*, a director, officer or beneficial owner of more than 10% of a class of equity securities of an issuer) files a disclosure report under Section 16(a) of the Exchange Act and, in so doing, reversed the ruling of the U.S. Court of Appeals for the Ninth Circuit. *Credit Suisse v. Simmonds*, --- S. Ct. --- 2012, WL 986812 (10-1261) (Mar. 26, 2012). According to the Court, the Ninth Circuit's holding was not supported by the text of Section 16(b), which states that a short-swing liability claim must be brought within two years of "the date such [short-swing] profit was realized," rather than the date on which an insider files a Section 16(a) disclosure report.

The Section 16(b) short-swing rules effectively prohibit a private fund from short-term trading of an issuer's equity securities once the private fund acquires beneficial ownership of 10% or more of a class of registered equity securities (*i.e.*, becomes an insider) of the issuer. Under Section 16 of the Exchange Act, an insider is subject to both (i) Section 16(a) of the Exchange Act, which requires filing of public disclosure reports of the insider's stock ownership and trading activities, and (ii) Section 16(b) of the Exchange Act, a strict liability statute that allows the issuer of registered equity securities (or any of the issuer's security-holders acting on its behalf) to recover short-swing profits realized by an insider from the purchase and sale, or sale and purchase, of those securities within any six-month period. For further detail on the Court's holding, see the March 30, 2012 Davis Polk Client Newsflash, ***U.S. Supreme Court Holds that the Statute of Limitations for Section 16(b) Short-Swing Liability Claims Is Not Tolled***.

- See a copy of the Court's opinion

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