Davis Polk
CLIENT NEWSLETTER

July 14, 2010

Investment Management Regulatory Update

Industry Update

House Passes Dodd-Frank Wall Street Reform and Consumer Protection Act

After much anticipation, the House passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Bill**") on June 30, 2010. The Bill remains to be passed by the Senate and signed by President Obama before becoming law. Enactment of the Bill would result in a paradigm shift in the way the financial sector is regulated. Some changes in the financial regulatory regime would impact asset managers directly, whereas others would affect their counterparties and competitors and thereby change the conditions under which asset managers engage in their business.

Bearing in mind that the general nature of the Bill leaves many important elements unknown until final regulations are promulgated, this summary highlights key areas of relevance in the Bill for the asset management industry. This summary is not intended to be comprehensive and recognizes that the Bill contains other provisions not discussed herein that may also affect asset managers. For a more comprehensive summary of the Bill, including the provisions discussed below, please see the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010***.

Investment Adviser Registration Requirements

The most notable change contained in the Bill with respect to investment adviser registration requirements is the elimination, effective one year after enactment, of the "private investment adviser" exemption for advisers with fewer than 15 clients contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). Many unregistered investment advisers who currently rely on the "private investment adviser" exemption would thus be required to register unless an alternative

registration exemption applied. Significant registration exemptions established by the Bill, on varying time frames, include exemptions for venture capital advisers, for advisers who act solely as an adviser to private funds and have assets under management in the United States of less than $150 million and for certain foreign private advisers with small U.S. client bases. The first two of these categories of exempt advisers would still be subject to recordkeeping and reporting requirements as determined by the U.S. Securities and Exchange Commission (the "**SEC**") to be necessary or appropriate in the public interest and for the protection of investors.

Enactment of the Bill would thus ultimately require a broader range of investment advisers to register with the SEC than are currently registered; however, certain smaller advisers would have to deregister and instead register with the states. Currently-registered advisers may derive an indirect benefit from the Bill, as the required registration of many of their competitors may result in a more level playing field. While all investment advisers are subject to the anti-fraud provisions of the Advisers Act, registered investment advisers are subject to a host of additional compliance obligations, including the requirements to appoint a chief compliance officer, to establish a compliance program and a code of ethics and to comply with custody and recordkeeping requirements.

Minimum Assets for SEC Adviser Registration

The Bill also contains a provision that would shift the regulatory burden of monitoring many smaller advisers to the states so that the SEC may instead focus its examination resources on larger investment advisers. Effective one year after enactment, the minimum assets under management threshold for SEC registration for most U.S. investment advisers (that do not manage registered investment companies or business development companies) would be:

- $100 million in general, but
- $25 million for advisers that would either (i) not be subject to registration and examination in the state in which they maintain their respective principal offices and places of business or (ii) otherwise be required to register with 15 or more states.

Thus, advisers with more than $100 million in assets under management should not be affected by this re-allocation of federal and state authority. It would, however, require many investment advisers with assets between $25 million and $100 million that are currently registered with the SEC to withdraw their SEC registrations and instead register with their home states (and potentially other states in which they have clients), which could prove more costly or administratively burdensome than registering solely with the SEC.

Investment Adviser Recordkeeping Requirements

The Bill would also impose new recordkeeping and reporting requirements on investment advisers regarding the private funds that they manage, and subjects private fund advisers to enhanced SEC scrutiny and audit. For instance:

- Advisers to private funds would be required to maintain records and reports regarding each private fund advised by the adviser that include: (i) amount of assets under management, (ii) use of leverage, (iii) counterparty exposure, (iv) trading and investment positions, (v) valuation policies and practices, (vi) types of assets held, (vii) side arrangements or side letters, (viii) trading practices and (ix) other information deemed by the SEC, in consultation with the Financial Stability Oversight Council (the "**Council**"), to be necessary and appropriate in the public interest, and for the protection of investors or for the assessment of systemic risk.
- The Bill requires the SEC to promulgate rules requiring each investment adviser to a private fund to file reports containing such information as the SEC deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

- The Bill modifies the current Advisers Act prohibition limiting the SEC's ability to require investment advisers to disclose the identity, investments or affairs of their clients by adding an exception enabling the SEC to require the disclosure of such information "for purposes of assessment of potential systemic risk."
- All records of private funds maintained by a registered investment adviser, not just those required to be maintained by law, would be subject to periodic and special examination by the SEC.
- Information provided to the SEC, as well as information provided by the SEC to the Council, under these new recordkeeping and reporting requirements is expressly carved out from Freedom of Information Act ("**FOIA**") disclosure.

Thus, enactment of the Bill would subject investment advisers to augmented recordkeeping and reporting requirements.

Accredited Investor and Qualified Client Standards

The Bill provides that, apparently upon enactment of the Bill and for four years following the enactment of the Bill, the accredited investor net worth threshold for natural persons is $1 million, excluding the value of the investor's primary residence. One year after enactment, the SEC would become authorized to conduct an initial review of the definition of "accredited investor" as applied to natural persons, and to promulgate rules adjusting the provisions of the definition, provided that the SEC may not modify the net worth threshold. For example, the SEC could modify the annual income test under such definition. Not earlier than four years after enactment and at least every four years thereafter, the SEC would be required to review the entirety of the definition of "accredited investor" as applied to natural persons, and would be authorized to modify the definition "as appropriate for the protection of investors, in the public interest, and in light of the economy," provided that any net worth threshold for natural persons must exceed $1 million, excluding the value of an investor's primary residence.

The Bill also requires the SEC to adjust for inflation, within one year after enactment and every five years thereafter, the assets under management and net worth tests for determining a client's status as a "qualified client" to whom an investment adviser may charge a performance fee pursuant to Rule 205-3 under the Advisers Act.

Heightened "accredited investor" and "qualified client" standards would shrink the pool of investors eligible to invest in funds that rely on Section 3(c)(1) of the Investment Company Act of 1940 (the "**Investment Company Act**").

Volcker Rule

Subject to certain exceptions and transition periods, the Volcker Rule prohibits any "banking entity" from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund. It also requires systemically important nonbank financial companies that engage in such activities to carry additional capital and comply with certain other quantitative limits on such activities. For a detailed summary of the Volcker Rule, see the Davis Polk Client Memorandum ***Senate-House Conference Agrees on Final Volcker Rule***.

"Sponsoring" a fund means (i) serving as general partner, managing member, or trustee of a fund, (ii) in any manner selecting or controlling (or to have employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a fund or (iii) sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variant of the same name. "Banking entity" is defined as any insured bank or thrift, company that controls an insured bank or thrift, company that is treated as a bank holding company under the International Banking Act, and any affiliate or subsidiary of such an entity.

Notwithstanding this prohibition, subject to certain limitations, as well as any additional restrictions that the regulators may impose, banking entities may sponsor a private equity or hedge fund, provided that (i)

the banking entity provides bona fide trust, fiduciary or investment advisory services, (ii) the fund is offered only in connection with the provision of such services, and only to persons who are customers of such services of the banking entity, (iii) the banking entity and its affiliates do not engage in "covered transactions" with such funds, as defined in Section 23A of the Federal Reserve Act, and the banking entity complies with the prohibitions and restrictions in Section 23B of the Federal Reserve Act as if the banking entity were a member bank and the fund were its affiliate, (iv) the banking entity does not guarantee the obligations or performance of the fund or any fund in which such fund invests, (v) the banking entity does not share with the fund the same name or variant thereof, (vi) no director or employee of the banking entity takes or retains an ownership interest in the fund unless such person is "directly engaged in providing investment advisory or other services" to the fund, (vii) certain disclosure is made to investors in the fund that losses in the fund would be borne solely by investors in the fund and (viii) the banking entity does not invest in the fund other than in the form of a seed investment or other *de minimis* investment, provided that in either case (a) the banking entity "actively" seeks unaffiliated investors to reduce or dilute its investment, (b) the investment is reduced to not more than 3% of the total ownership of the fund within one year after the fund's establishment (with the possibility of a two-year extension) and thereafter is maintained at not more than 3% and (c) the investment is "immaterial" to the banking entity, as defined by regulators pursuant to rulemaking, but in no case may the aggregate of all the banking entity's permitted seed and other *de minimis* investments exceed 3% of the banking entity's Tier 1 capital.

The Volcker Rule does not become effective until approximately two years following enactment (technically, the earlier of (i) 12 months after the issuance of final rules, which must be issued within 15 months of enactment at the latest, and (ii) two years after enactment). Following the effective date is a two-year transition period, subject to the possibility of three one-year extensions, during which existing fund activities and investments must be conformed. Investments in certain "illiquid funds" may also be eligible for an additional extension of up to five years, but only "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010." Note that regulators must issue rules for the transition periods within six months of enactment, well before the deadline for issuing the other implementing rules.

The full scope of the changes necessary to conform a banking entity's private fund business to the Volcker Rule requirements will only become clear after the implementing regulations have been issued.

Systemic Regulation Regime

The Bill provides a general framework for systemic regulation, and the actual content of the regime will remain unknown until developed through regulation. In general, the Bill requires regulators to issue regulations within 18 months after enactment, although it is possible that the regulators will act in a much shorter time period.

As a general matter, the systemic risk regime is not created with investment advisers as a first strike target. In determining whether to designate a nonbank financial company (such as an investment adviser) as systemically important, the Council is required to consider factors including the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse. In addition, the Bill's safe harbor provisions, which direct the Federal Reserve to set forth criteria to exempt certain types of nonbank financial companies from the systemic risk regime, might also provide an avenue to exclude investment managers.

An investment adviser may be designated as systemically important in its own right, or may be affected by the systemic regulation regime as an affiliate of a systemically important company. Systemically important companies include bank holding companies with assets of $50 billion or more, which are subject to enhanced prudential standards automatically, and nonbank financial companies, which are subject to enhanced prudential standards only upon designation as systemically important by the Council.

The Federal Reserve is required to establish enhanced risk-based capital, leverage and liquidity requirements, overall risk management requirements, resolution plans, credit exposure reporting,

concentration limits and early remediation requirements to apply to systemically important companies. The Federal Reserve may, but is not required to, establish additional prudential standards, including: contingent capital requirements, enhanced public disclosure requirements, short-term debt limits and other prudential standards that it, on its own or pursuant to Council recommendations, deems appropriate.

In designing enhanced prudential standards, the Federal Reserve must take into account a variety of factors, including those applicable to systemic importance designations and whether the company owns an insured depository institution, and adapt its recommendations "in light of any predominant line of business of such company, including assets under management for which particular standards may not be appropriate." This industry- and activity-specific language will be crucial in mitigating the effects of the systemic regulation on investment advisers.

In addition, some tailoring of capital requirements and leverage limits may be possible in the systemic regulatory regime. The Federal Reserve, in consultation with the Council, may determine that the risk-based capital requirements and leverage limits are not appropriate because of a systemically important company's activities or structure and instead apply other standards consistent with the recommendation that result in appropriately stringent controls. The interaction of this provision with the Collins Amendment, which requires the appropriate Federal banking agencies to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, depository institution holding companies and systemically important nonbank financial companies, is unclear.

The systemic risk regime also creates the Office of Financial Research ("**OFR**"), a body within the Treasury Department that supports the Council member agencies, including by collecting data on behalf of the Council and providing data to Council members. The OFR is empowered to collect data from all financial companies, not just those subject to the systemic risk regime, and it has subpoena power to collect this data. The extent to which information submitted to the Office would be kept confidential, made public or subject to the Freedom of Information Act, is complex, and the bill is internally inconsistent.

For a detailed summary of Systemic Regulation, see the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010***.

New Securities Rules, Including Short Sales and Custody of Client Assets

Short Sales. The Bill requires the SEC to adopt rules for public disclosure of the amount of short sales by institutional investment managers subject to section 13(f) of the Securities Exchange Act of 1934, which would be disclosed at a minimum every month. Such a rule could lead to increased administrative costs relating to short sales for institutional investment managers.

Custody of Client Assets. Under the Bill, the SEC is provided with discretionary rulemaking authority to require registered investment advisers to take steps to safeguard client assets over which the advisers have custody. The Bill indicates that such custody rules may, among other things, provide for verification of client assets by independent public accountants. Furthermore, the GAO is required to conduct a study regarding (i) the compliance costs associated with Rules 204-2 and 206(4)-2 promulgated pursuant to the Advisers Act, relating to custody of client funds or securities by investment advisers and (ii) the additional costs associated with eliminating subsection (b)(6) of Rule 206(4)-2 relating to operational independence, and submit a report regarding the same to Congress within three years of the date of enactment.

Derivatives Clearing, Exchange Trading, Margin and Capital Requirements

The derivatives title of the Bill authorizes the CFTC and the SEC to determine whether particular swaps must be cleared, and prohibits persons from entering into uncleared swaps for which such a determination has been made unless an exemption applies. A swap counterparty that is not a "financial entity" may elect to enter into a swap on an uncleared basis if it is hedging or mitigating commercial risks, and notifies the applicable regulator regarding how it generally meets its obligations in respect of swaps

that are not cleared. Public companies must obtain approval from a committee of their board of directors in order to avail themselves of this exemption.

The Bill also requires that swaps which are subject to the clearing requirement described above be effected on a regulated exchange or swap execution facility, unless no exchange or facility makes the swap available for trading.

These requirements may increase the cost of funds' derivatives trades through, among other means, clearing house requirements to post initial margin. Moreover, the Bill requires the registration of swap dealers and major swap participants and imposes a wide variety of requirements on such parties, including capital requirements and margin with respect to uncleared swaps. Irrespective of whether a fund is itself required to register as a swap dealer or major swap participant, many of its counterparties are likely to be required to do so, which may indirectly lead to increased costs for the fund due to these capital, margin and other requirements.

Swaps Pushout

The Bill contains a swaps pushout rule that prohibits "Federal assistance," including certain access to the Federal Reserve discount window and FDIC insurance, to swap dealers and non-insured depository institutions that are major swap participants. Insured depository institutions are not subject to this prohibition if they limit their swaps activity to hedging or similar risk mitigation or to swaps involving rates or reference assets that are permissible for investment by a national bank, but excluding uncleared credit default swaps. Insured depository institutions are explicitly allowed to have a swaps entity affiliate, so long as Sections 23A and 23B of the Federal Reserve Act and other regulatory rules are complied with. The swaps pushout rule is effective two years after the effective date of the derivatives title, which will be effective 360 days after its enactment, and requires the appropriate Federal banking agency, in consultation with the SEC and CFTC, to permit insured depository institutions up to 24 months after the effective date to divest the swaps entity or cease the activities that require registration as a swaps entity. The regulators must take various factors into account in determining the appropriate transition period, which could be less than 24 months. The transition period may also be extended by the appropriate Federal banking agency, after consultation with the SEC and CFTC, for an additional one-year period. For a more detailed description of the swaps pushout rule, please see the Davis Polk Client Memorandum ***Senate-House Conference Agrees on Swap Pushout Rule***. The swaps pushout rule may force funds that enter into swaps to transact with new counterparties on certain of their swaps and to evaluate the creditworthiness of these new nonbank counterparties.

Position Limits and Large Swap Trader Reporting

The Bill requires the CFTC, the SEC and markets to establish position limits (subject to hedge exemptions) for certain futures, options and swaps, subject to specified criteria, and authorizes the regulators to grant exemptions from these limits.

The Bill requires traders who exceed thresholds with respect to swap positions established by the CFTC or the SEC, as applicable, to file reports in formats to be prescribed. Such large swap traders may become subject to certain requirements to maintain records for inspection by the CFTC and SEC. Such position limits and reporting requirements could impact private funds that trade heavily in derivatives, or otherwise maintain, significant derivatives positions.

Compensation and Governance Reform

Executive Compensation. The Bill provides that federal regulators, including the SEC, must, within nine months of enactment of the Bill, jointly prescribe regulations to (i) require covered financial institutions, including investment advisers, to report the structures of all incentive-based compensation arrangements and (ii) prohibit incentive-based payment arrangements that are determined to encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss to the covered

financial institution. Covered financial institutions with assets of less than $1 billion are excluded. Clarification regarding the methodology for determining the value of an institution's assets would likely be provided through the regulatory implementation process.

Proxy Access. The Bill also provides the SEC with discretionary rulemaking authority to issue rules permitting shareholders to use an issuer's proxy solicitation materials to nominate director candidates. The SEC may determine the appropriate standards and procedures for proxy access and can exempt certain issuers. These proxy access rules would apply to public portfolio companies of private equity funds and, unless carved out by the SEC, to registered investment companies.

Fiduciary Duties

Unlike earlier proposals, the Bill does not impose a new fiduciary duty on broker-dealers or investment advisers, but instead:

- requires the SEC to undertake a study of any gaps, shortcomings or overlaps in the standard of conduct and supervision of broker-dealers and investment advisers that provide *personalized investment advice about securities to retail customers*; and
- provides the SEC with discretionary rulemaking authority to:
  - require investment advisers that provide *personalized investment advice to retail customers* to act in the best interest of the customer without regard to the financial or other interest of the investment adviser providing the advice (provided that the SEC may not define customer to include an investor in a private fund managed by an investment adviser where the private fund has entered into an advisory contract with the adviser); and
  - apply to broker-dealers that provide *personalized investment advice to retail customers* the standard of conduct applicable to an investment adviser providing personalized investment advice to retail customers.

To the extent the SEC imposes a standard of conduct on broker-dealers for retail transactions, it may impact mutual fund sales practices. Such a standard of conduct could result in more standardized sales loads, in an attempt to limit the risk that might be associated with recommending funds with higher sales loads.

Effect of the U.S. Financial Reform Legislation on Foreign Investment Adviser Registration

On June 30, 2010, the House passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Bill**"). For a summary of the entirety of the Bill, please see the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010***. Title IV of the Bill ("**Title IV**") addresses the regulation of advisers to private funds and, among other things, broadens the scope of private fund advisers subject to federal registration and imposes enhanced recordkeeping and reporting requirements on private fund advisers with respect to the private funds that they manage. The following update summarizes the impact of Title IV on the registration requirements for foreign investment advisers.

General Registration Requirement Absent an Applicable Exemption

Effective one year after enactment, the Bill eliminates the "private investment adviser" exemption contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). At present, this exemption from registration is available to foreign investment advisers who, among other things, have had fewer than 15 U.S. clients over the preceding 12 months and who do not hold themselves out generally to the U.S. public as investment advisers. Most unregistered foreign investment advisers that

have U.S. clients currently rely on the "private investment adviser" exemption on the basis of having fewer than 15 U.S. clients and thus, upon the elimination of such exemption, they will be required to register as investment advisers if they provide investment advice to any U.S. clients and do not qualify for any other registration exemption.

Possible Registration Exemptions

- *Foreign Private Adviser Exemption*. The Bill provides a narrow registration exemption for any "foreign private adviser," defined as any investment adviser who:
  - has no place of business in the United States;
  - has, in total, fewer than 15 clients and investors in the United States in private funds advised by the adviser;
  - has aggregate assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million, or such higher amount as the U.S. Securities and Exchange Commission (the "**SEC**") may, by rule, deem appropriate in accordance with the purposes of the Advisers Act; and
  - does not:
    - hold itself out generally to the U.S. public as an investment adviser;
    - act as an investment adviser to any registered investment company (a "**RIC**") under the Investment Company Act of 1940 (the "**Investment Company Act**"); or
    - act as a business development company under Section 54 of the Investment Company Act (a "**BDC**").

  The Bill defines the term "private fund" to mean an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Many funds advised by foreign investment managers rely on these exemptions when offering in the United States.

- *Certain Private Fund Advisers Exemption*. Another registration exemption in the Bill that may possibly be available to foreign investment advisers is the "certain private fund advisers" exemption. The Bill mandates that the SEC provide such an exemption to any investment adviser that (i) acts *solely* as an adviser to private funds and (ii) has assets under management in the United States of less than $150 million. The SEC must further require, however, that such advisers maintain such records and provide to the SEC such annual or other reports as the SEC determines necessary or appropriate in the public interest or for the protection of investors.

  The full scope and application of the "certain private fund advisers" exemption will remain unclear until implementing regulations are promulgated by the SEC. Further, as this exemption would only be available to advisers who *solely* advise private funds, and not separate accounts, it would conceivably be more useful for private equity fund advisers, who are less likely to manage separate accounts than hedge fund advisers.

  Because the "certain private fund advisers" exemption is to be promulgated by an SEC rule, rather than by statute, the industry would be afforded the opportunity to comment on the exemption prior to promulgation.

- *Mid-sized Private Fund Advisers*. The bill requires the SEC, in prescribing regulations to carry out the registration requirements of Section 203 of the Advisers Act, with respect to investment advisers managing "mid-sized private funds," to take into account the size, governance and investment strategy of such funds to determine whether they pose systemic risk and to provide registration and examination procedures with respect to such advisers that reflect the level of

systemic risk posed by such funds. The Bill does not define the term "mid-sized private funds." The scope of this provision of the Bill will remain unclear until the actual implementing regulations are proposed by the SEC.

Minimum Assets for SEC Adviser Registration

The Bill also contains a provision that would shift the regulatory burden of monitoring many smaller advisers to the states so that the SEC may instead focus its examination resources on larger investment advisers. Effective one year after enactment, the minimum assets under management threshold for SEC registration for most U.S. investment advisers (*i.e.*, advisers that have their principal offices and places of business in a U.S. state) would be:

- $100 million in general, but
- $25 million for advisers that would either (i) not be subject to registration and examination in the state in which they maintain their respective principal offices and places of business or (ii) otherwise be required to register with 15 or more states.

This reallocation of state and federal responsibility should not affect most foreign advisers with U.S. clients, because such advisers do not have their principal offices and places of business in a U.S. state.

Conclusion

In general, the Bill may require many foreign investment advisers who have previously been exempt from registration to register with the SEC as an investment adviser. Under the Bill, unless another exemption applies, a foreign investment adviser generally will be required to register if the adviser (i) manages at least $25 million in assets attributable to U.S. clients or U.S. investors in its private funds or (ii) has 15 or more clients or investors in the United States in its private funds, although there is some interpretive ambiguity as to whether the registration requirements would apply to a foreign adviser whose only U.S.-attributable assets were managed through private funds organized outside the United States. If a foreign adviser advises *solely* private funds and has assets under management in the United States of less than $150 million, it may also qualify for a limited exemption that will be promulgated by the SEC, in which case the adviser would be subject to fewer requirements than it would under SEC registration.

SEC Denies No-Action Relief, Requiring Broker-Dealer Registration for Entity Providing Investor Referral Services

On May 17, 2010, the SEC denied no-action relief to Brumberg, Mackey & Wall, P.L.C. ("**BMW**"), a law firm, in response to BMW's request for assurance that it need not register as a broker-dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") as a result of its agreement to provide certain investor referral services to Electronic Magnetic Power Solutions, Inc. ("**EMPS**") in exchange for transaction-based compensation.

Section 15(a)(1) of the Exchange Act provides that it is unlawful for any "broker or dealer . . . to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered with the SEC pursuant to Section 15(b) of the Exchange Act. Under the Exchange Act, a broker is defined as "any person engaged in the business of effecting transactions in securities for the account of others." The SEC has repeatedly taken the view that transaction-based compensation is a "hallmark of broker-dealer activity."

BMW and EMPS sought no-action relief for an arrangement whereby BMW would introduce prospective investors to EMPS in exchange for receiving a percentage of the amounts invested by such investors in EMPS. In its request for no-action relief, BMW stated that it would not (i) engage in any negotiations between EMPS and the investors, (ii) provide any investor with any information which may be used as a basis for negotiations with EMPS, (iii) make any recommendations concerning the terms and conditions

of any agreement between EMPS and the investors or (iv) provide any assistance to either party with respect to investments in EMPS.

The SEC, however, was not persuaded by these representations on the part of BMW and responded that the introduction of investors to EMPS with a potential interest in investing in EMPS's securities implies that both "pre-screening" the investors for eligibility as well as "pre-selling" the securities of EMPS to gauge interest will occur. In addition, the transaction-based compensation would create a "heightened incentive for BMW to engage in sales efforts." The SEC, therefore, denied no-action relief.

This no-action letter may evidence a renewed interest on the part of the SEC in broker-dealer registration. Indeed, following the release of the letter, Andrew Donohue, director of the SEC's Division of Investment Management, urged those associated with a broker-dealer but not registered with the SEC to "carefully consider" whether they are entitled to registration exemptions under the federal securities laws.

- See a copy of the no-action letter

Staff Provides Guidance on Recent Amendments to the Money Market Fund Rule

On May 25, 2010 and June 25, 2010, the staff of the SEC's Division of Investment Management responded to questions relating to the SEC's recent amendments (the "**Amendments**") to Rule 2a-7 (the "**Rule**") promulgated under the Investment Company Act of 1940 (the "**Investment Company Act**"), which regulates money market funds, and to new Rule 30b1-7 under the Investment Company Act, which requires money market funds to report portfolio information on Form N-MFP. See the ***March 9, 2010 Investment Management Regulatory Update*** for an overview of the Amendments. The May 25, 2010 staff responses provide guidance to money market funds with regard to various aspects of the Rule, including liquidity, stress testing, National Recognized Statistical Rating Organizations ("**NRSROs**") and asset backed securities. The June 25, 2010 staff responses provide guidance with respect to completing Form N-MFP. Below is a discussion of several notable aspects of the staff's guidance in those areas. (Capitalized terms refer to defined terms in the Rule.)

- *Liquidity* – In a master-feeder structure, the staff indicated, a taxable money market feeder fund cannot look-through to the portfolio of the master fund in order to comply with the Daily Liquid Asset requirement. Nonetheless, the staff indicated that a feeder fund can comply with that requirement by investing in a master fund that guarantees redemptions in one day or by the feeder fund holding 10% of its Total Assets in cash or in other securities that will mature within one day that are not deemed to be investment securities for purposes of Section 12(d)(1)(E) of the Investment Company Act. The staff also indicated that a money market fund may choose any reasonable time to determine its Total Assets, Daily Liquid Assets and Weekly Liquid Assets provided that (i) the determinations are made at least once every business day and (ii) the fund consistently makes the determinations at the same time or times.
- *Stress Testing* – The amended Rule requires a money market fund to adopt stress testing procedures that test its ability to withstand specific hypothetical events. The staff explained that a money market fund that invests solely in direct obligations of the U.S. government is not required to stress test for downgrades or defaults in those securities if the board of the fund has determined such stress events were not relevant to that particular fund. In addition, a money market fund would not have to stress test for the risk of "breaking the buck" on the upside. The staff also explained that the Rule also requires the board of a money market fund to adopt procedures for periodic testing at such intervals as the board determines reasonable and that reports of such testing be provided to the board at its next scheduled meeting.
- *NRSROs* – The amended Rule requires the board of a money market fund to designate four NRSROs that rate the fund's securities. The staff clarified, however, that a board does not have to designate four NRSROs that rate each type of security a fund may hold. The staff explained

that as long as one designated NRSRO rates one type or class of securities in which the fund invests, that NRSRO will count toward the four NRSRO requirement. In addition, the staff indicated that a money market fund does not need to rely on NRSRO ratings for government securities.

- *Asset Backed Securities ("**ABS**")* – In performing credit risk evaluation for asset backed securities, the amended Rule requires the board to "perform the legal, structural and credit analyses required to determine that the particular ABS involves appropriate risk for the money market fund." In essence, the staff explained, the board must consider all elements relevant (and only those relevant) to its analysis in evaluating such risk.

Certain aspects of the staff's guidance specific to the completion of Form N-MFP are discussed below:

- *Value of Capital Support Agreements* – The staff explained that if a capital support agreement does not relate to a particular security, it should not be reflected in the value of any particular security but rather the value of such capital support agreement itself should be disclosed on Form N-MFP. The staff further explained that if an affiliate has agreed to provide sufficient capital to bring a money market fund's net asset value ("**NAV**") to a specified level, the value of the capital support agreement should be the amount necessary to bring the fund's NAV to that specified level.
- *Master-Feeder Funds* – The staff indicated that, for purposes of Form N-MFP, a feeder fund must only disclose its investment in the master fund and not the master fund's portfolio holdings. The staff explained that a feeder fund should determine its weighted average maturity, weighted average life, maturity date and final legal maturity date in accordance with Rule 2a-7(d)(8) promulgated under the Investment Company Act.
- *Money Market Funds and Regulation D* – The staff explained that in filing Form N-MFP, a fund will not be deemed to violate the general solicitation and advertising prohibition of Regulation D provided such fund limits the information on Form N-MFP to the required information and does not otherwise use the Form N-MFP filing to offer its securities publicly or condition the market for such offering.

The staff plans to update this guidance from time to time.

- ▸ See a copy of the staff's release on Rule 2a-7
- ▸ See a copy of the staff's release on Rule 30b1-7 and Form N-MFP

Financial Crisis Inquiry Commission's "Hedge Fund Industry Market Risk Survey"

On June 22, 2010, Financial Crisis Inquiry Commission (the "**FCIC**"), established by the Fraud Enforcement and Recovery Act of 2009, sent its Hedge Fund Industry Market Risk Survey via email to an undisclosed number of hedge fund advisers. According to the letter accompanying the survey, the FCIC is "seeking to compile time-series data to track the development of the financial crisis and to gain a deeper understanding of what happened, as measured by specific quantitative metrics rather than the qualitative discourse that has prevailed to date." The survey seeks data from January 1, 2007 to the present, on an aggregate basis, for all funds and accounts managed by the adviser. While completing the survey is putatively voluntary, the letter notes that the FCIC will consider using its subpoena power to compel unresponsive hedge fund managers to submit the requested information.

The survey itself requests hedge fund data to be submitted to the National Opinion Research Center ("**NORC**"), with the understanding that it will be treated as confidential and not disclosed publicly. NORC will, in turn, render the data anonymous prior to its transmission to the FCIC. If the FCIC uses its subpoena power to compel responses from a hedge fund, the information would not go through the NORC but would go directly to the FCIC and would not be anonymous, though the FCIC indicates that it

would nonetheless use its "best efforts" to maintain confidentiality. The FCIC has indicated that it may include a list of participating firms when it publishes the results.

The requested data spans numerous topics, including (i) outstanding dollar amount of repos and reverse repos, (ii) commercial paper holdings, (iii) leverage, (iv) derivatives exposure broken-out by type (*e.g.*, foreign exchange, interest rate, equity or commodity-linked), (v) prime brokerage arrangements, (vi) short-selling activity, including specifically with respect to securities of American International Group, Bear Stearns, Lehman Brothers and Merrill Lynch, (vii) RMBS and CDO holdings and (viii) redemption requests.

SEC Discusses Examination and Enforcement Developments

Speaking at recent events, various SEC officials have commented on developments in the Commission's enforcement programs and on related news.

At a recent ALI-ABA compliance panel, John Walsh, Chief Counsel and Associate Director of the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") discussed a pilot program of pre-exam reviews spearheaded by the SEC's Chicago Regional Office whereby SEC examiners will conduct a long due diligence process of registrants before arriving onsite for examinations. Mr. Walsh indicated that this new process will allow examiners to understand a registrant's business and risks better before entering its premises. Mr. Walsh also indicated that the SEC's Office of Market Intelligence is building a searchable database for tips, complaints and referrals ("**TCRs**") which will allow OCIE to move more quickly than it has in the past in response to TCRs that deserve immediate action.

At the same event, Robert Kaplan, the new co-chief of the SEC's Division of Enforcement, Asset Management Unit, noted that the Division of Enforcement is focused on three key areas: (i) consistent and accurate disclosure, (ii) valuation and performance advertising and (iii) quality, and selective distribution, of information. Please see the ***February 5, 2010 Investment Management Regulatory Update*** discussing the creation of this unit. Mr. Kaplan separately noted that enforcement of Regulation FD, which relates to selective disclosure of material nonpublic information, continues to be a focus area in the context of hedge funds.

Separately, speaking at a recent Practising Law Institute program on enforcement, Robert Khuzami, Director of the SEC's Division of Enforcement, indicated that the staff has also been focused on issues of failure to disclose and selective disclosure, especially with respect to the mortgage and credit crises. Mr. Khuzami also fielded inquiries concerning *SEC v. Cuban*, the insider trading case which the SEC is currently appealing to the Fifth Circuit, as previously reported in the ***November 11, 2009 Investment Management Regulatory Update***. He reiterated the SEC's position that a duty of confidentiality also encompasses a duty to refrain from acting on inside information. Regarding the SEC's position on the use of "big boy" letters, he cautioned that, if market participants rely on them, they do so at their own risk.

SEC Rules and Regulations

SEC Adopts Rule to Curb "Pay-to-Play" Practices

On June 30, 2010, the SEC unanimously voted to approve a new rule, Rule 206(4)-5 (the "**Final Rule**"), as well as amendments to certain existing rules, under the Investment Advisers Act of 1940 (the "**Advisers Act**") that would curb "pay-to-play" practices by investment advisers seeking to provide investment advisory services to public pension funds and other government clients. "Pay-to-play" practices generally refer to situations when an investment adviser seeking to provide services to a government client makes a political contribution to an elected official in a position to influence the selection of the investment adviser, or to a candidate for such a position, to gain an improper advantage in the hiring process of the investment adviser. As SEC Chairman Mary L. Schapiro noted at the SEC's

June 30, 2010 open meeting (the "**Open Meeting**"), such "pay-to-play" practices can result in "public plans and their beneficiaries [receiving] sub-par advisory performance at a premium price." The Final Rule is based upon that originally proposed in August 2009 (the "**Proposed Rule**"). See the ***August 5, 2009 Investment Management Regulatory Update*** for an overview of the Proposed Rule.

The Final Rule applies to both registered investment advisers and unregistered investment advisers who rely on the exemption currently available under Section 203(b)(3) of the Advisers Act for any investment adviser who does not hold itself out to the public as an investment adviser and had fewer than 15 clients during the last 12 months. The Final Rule does not apply to investment advisers exempt from registration pursuant to other sections of 203(b) such as 203(b)(1) and 203(b)(2) dealing with intrastate advisers and advisers with only insurance company clients, respectively.[1]

Investment advisers will need to modify or adopt comprehensive compliance policies in response to the SEC's Final Rule. Those advisers currently complying with the rules adopted by the Municipal Securities Rulemaking Board in 1994 (MSRB rules G-37 and G-38 (the "**MSRB Rules**")) that prohibited municipal securities dealers from participating in "pay-to-play" practices will recognize the similarity of the Final Rule with many of the requirements of the MSRB Rules, and, therefore, may have an easier transition complying with the Final Rule. In addition, investment advisers must also consider a myriad of separate and distinct laws, rules and requirements imposed on investment advisers and registered broker-dealers that act as placement agents, such as state laws, federal election laws and rules imposed by various government clients. See, for example, the ***January 7, 2010***, ***March 9, 2010***, ***April 6, 2010***, ***May 10, 2010 and June 10, 2010 Investment Management Regulatory Updates*** on recent federal and state developments regarding "pay-to-play" practices.

We set forth below (i) a summary of certain notable aspects of the Final Rule, (ii) a comparison of the Final Rule to the Proposed Rule and (iii) a list of certain key compliance dates.

Notable Provisions of the Final Rule

- *Two-Year "Time Out".* The Final Rule, modeled after the MSRB Rules, prohibits an investment adviser, either directly or through a pooled investment vehicle, from providing advisory services *for compensation* to a government entity for a two-year "time out" period after the investment adviser or certain of its advisory personnel makes a political contribution to an "official" of a "government entity".

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[1] The House passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Bill**") on June 30, 2010. The Bill remains to be passed by the Senate and signed by President Obama before becoming law. Once enacted, the Bill is expected to eliminate the "private adviser exemption" contained in Section 203(b)(3) as well as the intrastate adviser registration exemption of 203(b)(1) following a one-year transition period. For an overview of the Bill, see the July 9, 2010 Davis Polk memorandum entitled ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010***. The Bill contains significant registration exemptions, including exemptions for venture capital advisers and the requirement that the SEC promulgate an exemption for advisers who act solely as an adviser to private funds and have assets under management in the United States of less than $150 million. It is unclear how the enactment of the Bill will affect the applicability of the Final Rule to current unregistered investment advisers presently covered by the Final Rule who remain unregistered in reliance on one of the new exemptions that will apply to it after the Bill is enacted, as well as investment advisers currently exempt from the Final Rule in reliance on the intrastate adviser exemption.

Additionally, the Bill is expected to change the SEC's minimum assets under management registration threshold for state-regulated investment advisers to $100 million in general, but $25 million for advisers who (1) would not be subject to registration and examinations by their home states or (2) would otherwise be required to register with 15 or more states. This change in the minimum assets threshold is expected to increase the number of state-registered advisers. In accordance with Section 203A of the Advisers Act, state-registered advisers are not required to be registered with the SEC and therefore would not be subject to the Final Rule.

An "official" is defined broadly 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 the 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."

A "government entity" is defined as "any state or political subdivision of a state, including: (i) [a]ny agency, authority, or instrumentality of the state or political subdivision; (ii) [a] pool of assets sponsored or established by the state or political subdivision or any agency, authority or instrumentality thereof, including, but not limited to a "defined benefit plan" as defined in section 414(j) of the Internal Revenue Code (26 U.S.C. 414(j)), or a state general fund; (iii) [a] plan or program of a government entity; and (iv) [o]fficers, agents, or employees of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity." This broad definition of "government entity" captures not only public pension funds, but also public university endowments and other collective government funds such as "529" college savings plans and "403(b)" and "457" retirement plans.

The SEC's final release clarifies that it is the scope of the authority of the office of the elected official, rather than the influence actually exercised by that individual, that would determine whether such official would be considered to have a direct or indirect influence over the decision to hire an investment adviser. For example, a state pension fund's board of directors, which has the authority to hire an investment adviser, may consist of appointees by the governor as well as members of the state legislature. Under the Final Rule, the governor, as well as each state legislator serving on the board, would be considered an "official" of the "government entity". Thus, contributions made to either a candidate for governor or an incumbent governor would trigger the two-year "time out."

Although the Final Rule's restriction on political contributions targets contributions made to elected officials of *state or local* government entities, political contributions made by advisers and covered associates to candidates for federal office could also trigger the two-year "time out" if the candidate is currently an "official" of a "government entity" by virtue of the state or local elected office which he or she currently holds.

Advisory personnel covered by the Final Rule ("**covered associates**") include the investment adviser's general partner, managing member or executive officers or other individuals with a similar status or function; employees hired to solicit government entities for the adviser and the direct or indirect supervisors of such employees; and any political action committee ("**PAC**") controlled by the investment adviser or such covered associates. The SEC expanded the definition of "executive officer" from the Proposed Rule to broadly encompass all executive officers of the adviser (*i.e.*, the president, vice president and officers and other persons that perform a policy-making function) rather than only those executive officers who perform or supervise advisory services or solicitation for the adviser. The SEC left open the possibility that a "covered associate" could include executive officers and/or employees of an investment adviser's parent company, stating that the determination ultimately depends on the individual's activities and the conflict of interest issues raised by such activities, rather than the position of the officer or employee within the corporate structure.

The two-year "time out" would remain in effect after the covered associate leaves the employ of the advisory firm. The Final Rule also imposes a two-year "look back" requirement on an investment adviser's hiring process, requiring attribution of a contribution made by a covered associate to any future investment adviser who engages such person within two years after the date of such contribution. However, the two-year "look back" does not apply to contributions made by a natural person more than six months prior to being promoted to, or hired as, a covered

associate, unless such person, after becoming a covered associate, solicits clients on behalf of the investment adviser. In scaling back the Proposed Rule's two-year "look back" requirement to six months in the case of covered associates whose contributions are less likely to be involved in "pay-to-play", the SEC agreed with several commenters, including Davis Polk & Wardwell LLP ("**Davis Polk**"), that a two-year "look back" requirement in such case could prevent advisers from otherwise "hiring qualified individuals who have made unrelated political contributions." Those individuals, however, cannot solicit government clients for some period of time after they become a covered associate.

To ensure that the withdrawal by an investment adviser does not harm the government client, an investment adviser subject to the two-year "time out" may, subject to its fiduciary obligations, be required to provide advice to the government client for no compensation for "a reasonable period of time" to allow the government client to replace the investment adviser. The SEC's final release declined to set a specific time period for this requirement, but instead noted that the duration of a "reasonable period of time" depends "in part on such matters as applicable law, the [government] client's customary process of finding and engaging advisers and the types of assets managed by the adviser."

A *de minimis* exception permits a covered associate to make contributions of up to $350 per election per candidate if the covered associate is entitled to vote for such candidate, and up to $150 per election per candidate if the covered associate is *not* entitled to vote for such candidate. A second exception is available for inadvertent contributions of $350 or less to an elected official or candidate for whom the covered associate making the contribution is *not* entitled to vote, provided that the adviser discovers the contribution within four months after the date of such contribution and causes it to be returned within 60 calendar days following the discovery. The investment adviser may rely upon this second exception no more than two or three times in any calendar year (depending on the size of the adviser), and only once for each covered associate, regardless of the time period.

- *Acquisition of Asset Managers*. The "look back" requirement discussed above would apply in the context of a merger or acquisition of advisory firms—*i.e.,* the contributions of covered associates of an acquired firm are attributed to the acquiring or surviving firm, potentially triggering the two-year "time out". In its final release, the SEC specifically declined to exclude the "look back" requirement in such cases due to the concern that mergers and acquisitions of investment advisers could raise identical "pay-to-play" concerns (*e.g.,* an acquired adviser could have made political contributions "designed to benefit the acquiring adviser"). The SEC indicated that the adviser may seek exemptive relief in such cases, which may be appropriate so long as the merger or acquisition was not an attempt to circumvent the political contribution restrictions of the Final Rule.
- *Banning the "Bundling" of Contributions*. The Final Rule prohibits an investment adviser and its covered associates from soliciting or coordinating contributions from any person or PAC to an elected official of a government entity who is in a position to influence the selection of the adviser and to which the investment adviser is providing or seeking to provide investment advisory services. This prohibition on "bundling" also extends to the solicitation and coordination of payments to political parties in the state or locality of the government client where the investment adviser is seeking advisory business.
- *Modification of Wholesale Placement Agent Ban*. In response to a number of commenters, including Davis Polk, the SEC made a key change to the Proposed Rule's imposition of a wholesale ban on the payment to any third-party solicitor by an investment adviser to solicit government clients on its behalf (the "**Placement Agent Ban**"). The Final Rule prohibits an investment adviser or any covered associate, directly or indirectly, from providing or agreeing to provide payment to a third party (such as a solicitor or placement agent) to solicit a government

client on its behalf, *unless* such third party is a "regulated person." A "regulated person" is defined as an SEC-registered investment adviser in compliance with the political contribution restrictions of the Final Rule or an SEC-registered broker-dealer that is a member of a registered national securities association, such as the Financial Industry Regulatory Authority ("**FINRA**"), that imposes substantially equivalent "pay-to-play" restrictions on its members. In explaining its rationale for this change, the SEC agreed with several commenters, including Davis Polk, that a rule containing such an exception could deter "pay-to-play" violations by third-party solicitors as effectively as that which was contemplated by the Proposed Rule, while continuing to allow placement agents governed by an already-existing regulatory scheme to provide valuable and legitimate services to both advisers and public pension funds.

As previously reported in the ***April 6, 2010 Investment Management Regulatory Update***, FINRA intends to promulgate rules that would subject registered broker-dealers to "pay-to-play" restrictions comparable to the Final Rule. At the Open Meeting, the SEC announced a one-year transition period intended to give FINRA the opportunity to propose, and for the SEC to consider, comparable "pay-to-play" rules for registered broker-dealers to those proposed by the SEC applicable to investment advisers. However, the SEC warned that if FINRA fails to adopt comparable "pay-to-play" restrictions, or, as Chairman Schapiro stated, if the SEC later determines that "third party placement agents continue to inappropriately influence the selection of investment advisers for government clients, even under such enhanced rules," then the SEC could reconsider a "full ban" in the future.

The SEC's final release states that registered investment advisers who compensate other registered investment advisers qualifying as "regulated persons" in exchange for soliciting government clients would need to adopt policies and procedures pursuant to Rule 206(4)-7 of the Advisers Act that are reasonably designed to monitor the "regulated person" status of such hired advisers, including policies and procedures for the vetting of candidates as well as ongoing review.

The Final Rule does not bar government entities from paying a pension consultant or other third party to recommend particular investment advisers for the management of public funds.

- *Covered Investment Pools*. The Final Rule applies to investment advisers providing or seeking to provide advisory services to government clients, either directly or as an investment adviser to a covered investment pool in which a government client invests. "Covered investment pools" include private funds (*e.g.,* hedge funds, private equity funds, venture capital funds and collective investment trusts) as well as registered investment companies (each, a "**RIC**") that are investment options of a participant-directed plan or program of a government entity (*e.g.,* "529" college savings plans and "403(b)" and "457" retirement plans). The SEC's final release narrows the scope of RIC advisers subject to the Final Rule to advisers of participant-directed government plans only, in response to the concern of commenters, including Davis Polk, that advisers to RICs that are not pre-selected by government clients may, as a practical matter, be unable to determine whether it manages any government client assets.
- *Restricting Indirect Contributions and Solicitations*. The Final Rule contains a "catch-all" provision designed to prevent circumvention of the Final Rule, prohibiting the investment adviser and its covered associates from engaging indirectly (such as through spouses, lawyers or companies affiliated with the adviser) in "pay-to-play" practices that the Final Rule prohibits directly.
- *Recordkeeping*. For compliance purposes, the SEC adopted amendments to Rule 204-2 under the Advisers Act that require registered investment advisers that have government clients or that provide investment advisory services to a covered investment pool in which a government entity invests to maintain prescribed records detailing, among other things, direct and indirect political contributions made by the adviser and its covered associates to government officials (including candidates) and payments to state or local political parties or to PACs. For registered investment

advisers that have government clients, such adviser is required to maintain prescribed lists of all covered associates as well as government clients to which the adviser provides or has provided investment advisory services for the past five years (but not a record of any such government clients before the Effective Date).

Each registered investment adviser, regardless of whether it currently has a government client, must maintain a prescribed list of all "regulated persons" whom the investment adviser engages as a third-party solicitor or placement agent. Similarly, registered advisers to covered investment pools, including RICs, must make and keep a list of government entities that, within the past five years, invest or have invested in a covered investment pool to which the adviser provides or has provided investment advisory services, including any government entity that selects a covered investment pool to be an option of a plan or program of a government entity, such as "529" college savings plans and "403(b)" and "457" retirement plans.

In response to the concern of commenters, including Davis Polk, of excessive costs and burdens associated with recordkeeping, the Final Rule no longer contains a requirement that registered investment advisers maintain records of government clients to whom the adviser is "seeking to provide" (but has not actually provided) advisory services. In a further effort to avoid unnecessary burden in connection with recordkeeping, Section 204-2(h)(1) of the Final Rule provides that any book or record made, kept and preserved in compliance with the MSRB's Rules that is "substantially the same" as the book or record required to be made, kept and preserved under the Final Rule, will be deemed to satisfy the recordkeeping requirements of the Final Rule.

Comparison to the Proposed Rule

In keeping with the SEC's intention that it be broadly "prophylactic" in nature, the Final Rule retains much of the substance of the Proposed Rule, particularly with respect to the restrictions on political contributions and the solicitation of contributions by investment advisers.

However, the Final Rule also contains several important changes from the Proposed Rule reflecting the SEC's consideration of over 250 comment letters received, as well as its efforts to reduce the costs and burdens of compliance by investment advisers subject to the Final Rule. One key change from the Proposed Rule is the replacement of the wholesale Placement Agent Ban with a modified approach that allows advisers to engage the services of registered investment advisers or registered broker-dealers subject to a substantially equivalent "pay-to-play" regulatory scheme. This change reflects the SEC's acceptance of a less restrictive means of deterring the "pay-to-play" practices of third-party solicitors, and is conditioned upon the adoption of acceptable "pay-to-play" rules by FINRA during the one-year transition period. At the Open Meeting, Commissioner Elisse B. Walter stated that FINRA has indicated that it expects to act within this timeframe.

Other significant changes include the reduction of the two-year "look back" requirement to six months, in the case of covered associates whose contributions are less likely to be involved in "pay-to-play," as well as narrowing the scope of RIC advisers subject to the Final Rule to advisers of participant-directed government plans only. In each case, the SEC responded to the concern of commenters, including Davis Polk, that the breadth of the Proposed Rule with respect to these issues should be narrowed to make compliance less costly and burdensome, while still addressing the SEC's "pay-to-play" concerns.

A significant aspect of the Final Rule that did not change from the Proposed Rule is the Final Rule's reliance on the exemptive relief process regarding inadvertent political contributions made by advisers or their covered associates. Although the Final Rule contains automatic exceptions for certain *de minimis* and returned contributions, as discussed above, it otherwise requires an adviser to seek exemptive relief from the SEC for any other inadvertent political contributions. Therefore, as Commissioner Troy A. Paredes noted in his speech at the Open Meeting, the exemptive relief process "serves as the primary means for moderating the rule's impact." Paredes urged that the Final Rule's "exemptive process needs to be meaningful" in order to "ensure that the 'pay-to-play' prohibition, as applied in practice, strikes

appropriate balances that advance the interests of advisers, their government clients and public pension plan beneficiaries alike."

Key Compliance Dates

The Final Rule will become effective 60 days after publication in the Federal Register (the "**Effective Date**"). As of the date of this *Investment Management Regulatory Update*, publication in the Federal Register is expected to occur shortly.

- *Restrictions on Political Contributions*. Except as noted below, investment advisers subject to the Final Rule must be in compliance with the restrictions on political contributions within six months after the Effective Date. The Final Rule's two-year "time out" restriction will not apply to, and the Final Rule's prohibition on soliciting and coordinating contributions will not be triggered by, contributions made *prior to* the date which is six months after the Effective Date. Similarly, these prohibitions do not apply to contributions made *prior to* the date which is six months after the Effective Date by a new covered associate to which a "look back" requirement applies. The SEC noted that the Final Rule is not intended to affect contributions that advisory personnel have already committed to make for the 2010 elections.
- *Recordkeeping.* To permit the SEC to examine for compliance with the Final Rule, investment advisers subject to the amended recordkeeping requirements under amended Rule 204-2 (as discussed above) must be in compliance with such recordkeeping requirements within six months after the Effective Date; provided, however, that advisers to RICs that are covered investment pools must be in compliance with the amended recordkeeping rules within one year after the Effective Date. Advisers that engage "regulated persons" to solicit government clients for advisory services on their behalf must keep a list of such "regulated persons" beginning one year following the Effective Date.
- *Third-Party Solicitors*. Advisers must be in compliance with the prohibition on paying third-party solicitors, other than "regulated persons", one year after the Effective Date. Prior to this compliance date, advisers are not prohibited from making payments to third-party solicitors regardless of whether such solicitors are "regulated persons".
- *RICs*. Advisers to RICs that are covered investment pools must comply with the Final Rule within one year after the Effective Date. Therefore, in the case of advisers to covered investment pools that are RICs, the Final Rule's two-year "time out" restriction will not apply to, and the Final Rule's prohibition on soliciting and coordinating contributions will not be triggered by, contributions made *prior to* the date which is one year after the Effective Date. Similarly, these prohibitions do not apply to contributions made *prior to* the date which is one year after the Effective Date by a new covered associate to which a "look back" requirement applies.
  - See a copy of the SEC release setting forth the Final Rule
  - See a copy of the SEC press release
  - See a webcast of the SEC open meeting on June 30, 2010
  - See a copy of Davis Polk's comment letter to the SEC

Litigation

Hedge Fund Manager Settles Insider Trading Case with the SEC

Recently, after being charged by the SEC with insider trading in Microsoft Corporation ("**Microsoft**") securities, Pequot Capital Management, Inc. ("**Pequot**") and its Chairman and CEO, Arthur J. Samberg, agreed to pay a settlement of nearly $28 million.

According to the SEC's complaint, in April 2001, amidst a prevailing belief that Microsoft's earnings would fall short of the company's estimates for the third quarter, Samberg contacted David E. Zilkha, then a Microsoft employee who had recently agreed to accept an offer for employment at Pequot, soliciting nonpublic information regarding Microsoft's earnings. Zilkha quickly found out from colleagues at Microsoft that the company would meet or beat its estimates for the quarter and informed Samberg, who then traded in Microsoft options on behalf of funds managed by Pequot.

Later that month, Microsoft announced its third-quarter earnings, which, consistent with Zilkha's information, beat the company's estimates. As a result of the subsequent increase in Microsoft's stock price, the value of funds managed by Pequot increased by more than $14.7 million, with Pequot and Samberg, according to the complaint, profiting by about $4.1 million from their interests in the funds.

The SEC initially began investigating Pequot's trading of Microsoft securities in 2005 but closed the investigation after failing to obtain direct evidence that material nonpublic information had been communicated to Samberg at the time of the alleged insider trading. It was not until January 2009 that the SEC claimed to have acquired such evidence, when it was provided with purportedly inculpatory emails that were located on a hard drive in the possession of Zilka's ex-wife. The SEC subsequently charged Pequot and Samberg with "fraud in connection with the purchase or sale of securities, in violation of Section 10(b) of the Securities Exchange Act of 1934…and Rule 10b-5 thereunder." The SEC's action was brought in the U.S. District Court for the District of Connecticut.

In settling the charges with the SEC, Pequot and Samberg agreed to pay about $18 million in disgorgement of trading profits and prejudgment interest and another $10 million in penalties. Additionally, Samberg agreed to be barred from associating with any investment adviser, except as necessary to wind down Pequot, which was once one of the world's largest hedge funds. Meanwhile, the SEC will pursue its case against Zilkha in an administrative proceeding.

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

Federal District Court Dismisses Suit Challenging Asset-Based Compensation Paid to Mutual Fund Distributor

On June 8, 2010, Judge Phyllis J. Hamilton of the U.S. District Court for the Northern District of California dismissed a derivative suit brought by shareholders of several Franklin Templeton mutual funds against the funds' distributor, Franklin/Templeton Distributors, Inc. ("**Franklin**") and the funds' trustees that alleged, among other things, that the funds' payment of asset-based compensation to broker-dealers was unlawful under the Investment Advisers Act of 1940 (the "**Advisers Act**") and, consequently, in violation of Section 47(b) of the Investment Company Act of 1940 ("**Investment Company Act**"). *Smith v. Franklin/Templeton Distributors,* No. C 09-4775 PJH (N.D. Cal. June 8, 2010).

As opposed to commission-based compensation paid to brokers in conjunction with transactions in fund shares, asset-based compensation generally consists of periodic payments to brokers based on a percentage of the net asset value of the shares sold by the broker. The plaintiff asserted that the use of an asset-based compensation structure to pay broker-dealers fees for distributing mutual fund shares pursuant to Rule 12b-1 under the Investment Company Act ("**12b-1 fees**") constituted "special compensation" under Section 202(a)(11)(C) of the Advisers Act, which would prevent the broker-dealer recipients from relying upon the exception from registration as investment advisers provided by this section of the Advisers Act. Because the broker-dealers were not registered as advisers, the plaintiff contended, the 12b-1 fees that they received from the fund were paid illegally. To support its analysis, the plaintiff relied upon the ruling in *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007) ("***Financial Planning***"), which struck down an SEC rule exempting from regulation as investment

advisers broker-dealers that provide investment advisory services and receive fee-based compensation. See the ***April 2007 Investment Management Regulatory Update*** for a discussion of *Financial Planning*.

The plaintiff further argued that Section 36(a) of the Investment Company Act imposes on the trustees of a fund, as well as fund service providers, a fiduciary duty to the fund and its shareholders, and that Rule 38a-1 under the Investment Company Act, in furtherance of that duty, tasks mutual fund trustees with the responsibility to actively monitor service providers, including the distributor/underwriter, for compliance with federal securities laws. The plaintiff argued that part of such an obligation would include voiding any unlawful contractual commitments, which was how it categorized Franklin's asset-based fee arrangement with its broker-dealers, and that failing to take such action would be in violation of Section 47(b) of the Investment Company Act.

Section 47(b) provides that a contract made in violation of any provision of the Investment Company Act "or any rule, regulation or order thereunder" is voidable by either party.

In their motion to dismiss the complaint, the defendants argued that Section 47(b), the only section that the plaintiff alleged was violated, is solely a remedial provision, and that a Section 47(b) claim must be based on a violation of another provision. The court agreed with the defendants, explaining that Section 47(b) provides a mechanism for equitable relief when there is a violation of some other section of the Investment Company Act, or violation of a rule, regulation or order under the Investment Company Act, but does not otherwise provide a private right of action or basis of liability. The court also rejected the plaintiff's broad interpretation of Rule 38a-1, finding that Rule 38a-1 requires a fund to "adopt and implement written policies and procedures that are designed to prevent violation of the federal securities laws by the fund," but does not create any requirement that funds ensure that broker-dealers who receive compensation for distributing mutual fund shares comply with the Advisers Act registration requirements. The court thus found that since the facts alleged by plaintiff did not constitute a violation of Rule 38a-1, or any other violation of the Investment Company Act, there was no basis for a claim under section 47(b). Furthermore, the court called *Financial Planning* "irrelevant" and distinguished the fees at issue in that case, noting that those fees were paid for services to customers, including fees for investment advice, whereas the fees at issue in the plaintiff's claim were paid in connection with the distribution of fund shares.

The court left the door open to the plaintiff to continue fighting Franklin's 12b-1 fees. It dismissed the Section 47(b) claim with leave to amend while stating that, in the event the plaintiff is unable to state a claim under Section 47(b), the court would not exercise supplemental jurisdiction over the remaining state law claims.

- See a copy of the court'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.

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