Investment Management Regulatory Update

SEC Rules and Regulations

SEC Proposes Rule Adjusting Performance Fee Asset Thresholds in the Definition of “Qualified Client”

On May 10, 2011, the SEC issued a proposal providing notice that the SEC intents to issue an order that would amend rule 205-3 under the Investment Advisers Act of 1940 (the “**Advisers Act**”) to adjust the dollar amounts of the assets-under-management and net worth tests in the definition of "qualified client." Under the proposed rule, the assets under management and net worth prongs of the definition of "qualified client" would be adjusted from $750,000 to $1,000,000 and $1,500,000 to $2,000,000, respectively.

Section 418 of the Dodd-Frank Act amends Section 205(e) of the Advisers Act to provide that, by July 21, 2011, and every 5 years thereafter, the SEC must adjust for inflation any dollar amount threshold contained in SEC rules issued under Section 205(e).

Currently, rule 205-3 under the Advisers Act provides that a registered investment adviser may charge a performance fee to a client if such client is a “qualified client.” The definition of "qualified client" under rule 205-3 includes, among others, (i) a person or a company that has at least $750,000 in assets under management with the adviser immediately after entering the advisory contract and (ii) a person or a company that the adviser reasonably believes, immediately prior to entering into the advisory contract, has a net worth (including assets held jointly with such person’s spouse) of more than $1,500,000.

Under the proposed rules, these standards would be modified to $1 million for the assets-under-management test and $2 million for net worth test. According to the proposal, the revised dollar amounts take into account inflation by reference to the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce (“**PCE Index**”). In determining whether an investor in a private fund meets the new assets-under-management threshold, the proposal indicates that a registered investment adviser could include all assets the client is contractually obligated to invest in such fund (e.g., uncalled capital commitments), provided that the adviser has a reasonable basis to conclude that the investor will be able to meet such contractual obligations.

The proposal would also amend the net worth standard in the definition of "qualified client" under rule 205-3 to exclude the value of a natural person's primary residence and debt secured by the property (up to the fair market value of the property), in accordance with the recent SEC proposal to implement the revised net worth standard in the definition of accredited investor that was created by the Dodd-Frank Act. For a more detailed discussion of the new accredited investor definition, please see the ***February 14, 2011 Investment Management Regulatory Update***.

The proposal also implements the requirement that the SEC adjust for inflation these dollar amount thresholds every five years after July 21, 2011. According to the proposal, the PCE Index would serve as the inflation index upon which these adjustments would be measured.

The proposal includes a transition rule that provides that the heightened dollar amount tests would not apply retroactively to performance fee arrangements already in place.

The proposal does not indicate when the new rules would be effective, but notes that the SEC "will allow an appropriate time period before requiring compliance with the new standards."

Comments on the proposal are due by July 11, 2011.

- See a copy of the proposal
- See a copy of the SEC's press release

Industry Update

Banking Regulators and the CFTC Propose Swap Margin and Capital Rules

On April 12, 2011, U.S. banking regulators proposed rules regarding the capital and margin requirements for uncleared swaps entered into by bank swap entities. On April 14, 2011, the CFTC released proposed rules governing margin requirements for uncleared swaps entered into by non-bank swap entities. The CFTC's proposed rules are similar, but are not identical, to the margin rules proposed by the banking regulators. The margin rules proposed by the banking regulators are summarized in the Davis Polk Client Memorandum ***Regulators Propose Swap Margin and Capital Rules***. Both sets of rules require the swap dealers and major swap participants ("**swap entities**"), under each of the CFTC's and U.S. bank regulators' respective jurisdictions, to collect margin from most counterparties. Although swap entities are not required to post margin to their own counterparties (subject to limited exceptions), the requirement that swap entities collect margin from other swap entities in practice requires swap entities to post margin to these entities.

The Davis Polk Client Newsflash ***CFTC Releases Swap Margin Proposal*** provides an update on the Davis Polk Client Memorandum summarizing the margin rules proposed by the banking regulators and includes an overview of the differences between the CFTC's and the banking regulators' proposals (such as differences in the treatment of nonfinancial end user counterparties and differences in the models to be used for calculating initial margin).

While the CFTC's proposing release indicates that the comment period on the margin rules will expire 60 days after publication of the proposal in the Federal Register, the CFTC has separately stated that such comment period may be extended. Comments on the banking regulators' proposal are due by June 24, 2011.

Massachusetts Plans to Regulate Expert-Network Firms

On April 20, 2011, the Secretary of the Commonwealth of Massachusetts, William F. Galvin, announced that the state plans to regulate expert-network firms, making it the first state in the country to do so. Generally, expert-network firms connect consultants, including current and former employees of publicly traded companies, with investment managers in order to provide information about companies. The activities of certain expert-network firms are currently at the center of an ongoing insider-trading investigation by the federal government. For more information about recent enforcement actions involving expert-network firms, please see the ***December 17, 2010 Investment Management Regulatory Update***.

Galvin explained in an email statement that the proposed regulations would require *state-registered* investment advisers who use expert-network firms to acquire written certification assuring that the firms they use (i) are not subject to any confidentiality restrictions and (ii) will not provide confidential information to the investment advisers employing them. In the same statement, Galvin said “these firms tout their compliance systems but policies are often not followed and the systems can be ineffective.” Galvin explained that the proposed regulation is intended to prevent the use of expert-network firms to facilitate the disclosure of inside information. The announcement from Galvin comes after a Massachusetts hedge fund manager, James A. Silverman, was charged last month by state officials with trading on inside information regarding a company’s clinical trials obtained using the expert-network firm Guidepoint Global LLC.

According to Galvin, a public hearing on the regulations is scheduled for June 23, 2011. Following the public hearing and a public comment period, according to Galvin, the regulations will take effect.

Governor Cuomo Bans Elected Officials, Lobbyists and Placement Agents from NYCRF and “Pay-To-Play”

In a press release issued on April 26, 2011, New York Governor Andrew Cuomo announced that he is directing the New York State Insurance Department to issue permanent regulations banning placement agents, lobbyists and, for the first time, elected officials from conducting any pension fund business with the New York State Common Retirement Fund (“**NYCRF**”). The new regulations also impose a higher standard of conduct and ban contributions to the New York State Comptroller.

According to the press release, the new regulations would:

- Impose a permanent ban on elected officials, lobbyists and all placement agents, whether paid or unpaid [from New York State pension fund business].
- Institute a higher standard of conduct: The new regulation would prohibit (i) improper relationships between pension fund officials and an investment firm’s personnel or agents, (ii) “revolving door” employment by investment firms of former public pension fund officials and employees and (iii) improper gifts by investment firms to public pension fund employees and officials.
- Prohibit investment firms from, directly or indirectly, making campaign contributions, charitable contributions or gifts to the New York State Comptroller.

According to the press release, these new regulations would make permanent and strengthen the temporary ban on placement agents, which has been in effect since June 18, 2009. For more information on the temporary ban, please see the ***July 1, 2009 Investment Management Regulatory Update***.

- ► See a copy of Governor Cuomo’s press release

International Financial Policymakers Warn of Financial Stability Risks Posed by ETFs

The Financial Stability Board (the "**FSB**") and the International Monetary Fund (the "**IMF**") have each recently issued separate reports discussing the financial stability risks posed by exchange-traded funds ("**ETFs**"). Citing the strong growth and innovation of the ETF industry in recent years, the reports warn of increased challenges to ETFs that could impact financial stability, such as counterparty risk and liquidity risks.

Both reports categorize ETFs broadly into two types of structures: ETFs that replicate an index return by reconstituting the basket of physical securities underlying the index ("**physical ETFs**") or ETFs that synthetically replicate the index returns using swaps or other derivatives ("**synthetic ETFs**"). The reports note that while leveraged or inverse variations of ETFs are a fast-growing segment of the ETF industry, they currently account for a small fraction of the market.

The reports indicate that synthetic ETFs account for nearly half of the ETFs in Europe, while physical ETFs are the dominant form in the U.S. Both reports attribute the lower prevalence of synthetic ETFs in the United States partly to regulatory constraints. The SEC announced in March 2010 its decision to review the use of derivatives by ETFs and to defer consideration of exemptive requests for ETFs under the Investment Company Act of 1940 (the "**Investment Company Act**") that seek "to permit ETFs that would make significant investments in derivatives." For more information on this announcement by the SEC, please see the ***April 6, 2010 Investment Management Regulatory Update***.

Counterparty Risk

According to the reports, synthetic ETFs replicate index returns at lower costs, but expose the ETF and its investors to the risk of default by the counterparties. The IMF report notes that European restrictions on derivative contracts mitigate counterparty risk by requiring a synthetic ETF to maintain minimum amounts of cash and security holdings to pay investors in the event of a counterparty default, but questions, given the significant presence of synthetic ETFs in the European markets, whether these requirements could avoid systemic risk under stressed market conditions. The FSB report raises the additional concern of the conflicts of interest that could arise from the dual role of banks acting as the ETF provider and derivative counterparty. The Investment Company Act generally prohibits a bank from serving as both the sponsor of and a derivative counterparty to an ETF.

Both reports caution that physical ETFs can also create counterparty risk due to the extensive securities lending that is generally undertaken by physical ETF providers. For example, the reports note that if a securities borrower were to default, the ETF provider may be left scrambling to replace the securities it lent to the borrower. While the IMF report acknowledges that there are regulations concerning securities lending activities, requiring, among other things, adequate collateralization and the ability to recall loaned securities on short notice, the report indicates that market participants have found such processes to lack transparency and that cash reinvestment guidelines have not been clearly laid out by regulators.

Liquidity Risk and Other Risks

Both reports find that ETFs can be subject to liquidity risks. In the United States, the SEC generally requires that ETFs registered under the Investment Company Act limit illiquid assets to not more than 15% of an ETF's net asset value. Nevertheless, according to the IMF report, "illiquid assets, reduced market access, and a dearth of derivatives in some emerging markets, combined with the sudden exit of market makers" can make ETFs susceptible to volatility under market stress, citing the May 2010 "flash crash" as an example.

Other risks noted in the reports include legal and policy risks from bankruptcy laws in connection with counterparty default and tax arbitrage risks.

Forecast and Policy Implications

The reports forecast strong growth and increasing complexity for ETFs, as well as increased notice from national and international regulators. Both reports discuss the need for increased transparency, such as ETF providers making publicly available information on product composition and risk characteristics. The FSB also suggests that ETF providers and investors review and assess the risk management strategies of ETFs, especially in areas such as counterparty risk, collateral management, and exposure to market and funding liquidity risks.

- See a copy of the FSB report
- See a copy of the IMF report

Litigation

Fifth Circuit Affirms Dismissal of Hedge Fund Investor Suit in Connection with its Withdrawal Rights Following the Departure of a Key Person

The U.S. Court of Appeals for the Fifth Circuit affirmed a decision by the U.S. District Court for the Southern District of Texas granting summary judgment in favor of defendants Tuckerbrook/SB Global Special Situations Fund, L.P. ("**GSS**"), a Delaware limited partnership specializing in distressed assets, its general partner, Tuckerbrook/SB Global Special Situations Fund GP, L.L.C. ("**GSS GP**") and Tuckerbrook Alternative Investments, L.P. ("**Tuckerbrook**"), a managing member of GSS GP. *Alkek & Williams Ltd. v. Tuckerbrook Alternative Invs., L.P.*, No. 10-20395, 2011 WL 990305 (5th Cir. Mar. 22, 2011). The court found that termination of GSS's portfolio manager, Sumanta Banerjee, did not trigger withdrawal rights under the fund's "key-person" provision.

The dispute centered around former portfolio manager Sumanta Banerjee's departure from GSS. Plaintiffs, Alkek & Williams Ltd. and the Albert and Margaret Alkek Foundation (collectively, "**Alkek**") were limited partners in GSS. Banerjee not only served as the portfolio manager of GSS, responsible for the investment and management of GSS's capital, but was also a managing member of GSS GP with a fifty percent ownership interest in GSS GP. The remaining fifty percent stake was held by Tuckerbrook, which also served as the investment manager and management company of GSS GP. Under the limited partnership agreement of GSS, GSS GP was solely responsible for management of GSS.

Alkek based its claim on the alleged trigger of the key-person provision in the GSS limited partnership agreement which allowed any limited partner to withdraw from GSS in the event that Banerjee "cease[d] to be directly or indirectly involved in the activities of the General Partner." Following Banerjee's termination, Alkek notified GSS that it was withdrawing from the partnership, stating that Banerjee's lack of involvement in the activities of GSS GP had triggered its withdrawal rights under the partnership agreement. The Defendants did not act on the withdrawal notice and Alkek brought suit to recover its capital accounts in GSS in addition to management fees paid after May 31, 2008, the day Alkek contended the withdrawal became effective.

The Fifth Circuit affirmed the District Court's grant of summary judgment, finding that Alkek's withdrawal rights were not triggered because Banerjee remained active in the management of GSS GP. The Fifth Circuit noted that although he was terminated from his position as portfolio manager, Banerjee retained authority as a managing member and fifty-percent owner of GSS GP. In support of this, the Fifth Circuit noted that in its letter advising the limited partners of Banerjee's termination, Tuckerbrook indicated that Banerjee would continue to be a managing member of GSS GP. In addition, the Fifth Circuit pointed to various correspondence between Banerjee and GSS's limited partners, counsel, administrator and bank, in which Banerjee explicitly stated that since he retained his position as managing member and fifty-percent owner of GSS GP, GSS GP would not be able to act without his approval. As evidence of Banerjee's continued participation, the Fifth Circuit focused on Banerjee having access to GSS GP's books and records and on Tuckerbrook's inability to collect management fees, release financial statements on behalf of GSS GP or write off one of GSS's investments without Banerjee's approval. Accordingly, the opinion stated that although Tuckerbrook attempted to exclude Banerjee from participation, "these efforts…were nugatory."

Alkek also made arguments under the doctrine of quasi-estoppel, arguing that the defendants could not challenge whether the "key-person" provision was triggered because Tuckerbrook, as manager of another limited partner in GSS, the Tuckerbrook/SB Global Distressed Fund I, L.P. ("**GDF**"), submitted a withdrawal notice following Banerjee's termination. The Fifth Circuit rejected Alkek's argument that it assumed GDF's withdrawal notice was valid and therefore detrimentally relied on it, because Alkek was not aware of GDF's withdrawal until after it filed its suit. The Fifth Circuit noted, however, that assuming Alkek was entitled to rely on the validity of GDF's withdrawal notice, Alkek did not show how this reliance was detrimental to it and thus defendants could not be estopped from challenging the validity of Alkek's withdrawal notice.

- See a copy of the Fifth Circuit's opinion

Court Rules an Investment Manager for a Fund Lacks Standing to Pursue Claims on the Fund's Behalf

The United States District Court for the Eastern District of California ruled on April 14, 2011 that MVP Asset Management (USA) LLC ("**MVPAM**"), the investment manager for MVP Fund of Funds Ltd. ("**MVP**"), lacked standing to pursue claims on MVP's behalf over an investment that was part of a scam. *MVP Asset Management (USA) LLC v. Vestbirk*, No. 2:10-cv-02483, 2011 WL 1457424 (E.D. Cal. Apr. 14, 2011).

MVPAM asserted securities fraud and other claims against Ark Royal Asset Management Ltd. and several associated entities and individuals, in connection with MVP's $2 million investment in Ark Discovery Fund (Offshore Ltd.). The defendants, which included Ark Royal Asset Management Ltd and various affiliated entities, allegedly represented to MVPAM that the Ark Discovery Fund would generate returns by financing the purchase of "white goods" (i.e., household appliances and consumer electronics) by "big box" retailers (such as Costco and Wal-Mart). MVPAM asserted that it was told by the defendants that investments in the Ark Discovery Fund were safe, had a low risk of fraud, were insured and were subject to the defendants' stringent safeguards. MVPAM asserted that, in fact, these representations were false.

According to the complaint, the Ark Discovery Fund made loans to a special purpose entity affiliated with companies owned by an individual named Tom Petters, the loan proceeds of which were to be used for the purchase of "white goods" by retailers. The complaint alleged that the loans made by the Ark Discovery Fund were allegedly secured by the white goods purchased. While the existence and value of the collateral of Ark Discovery Fund's loans purportedly were verified by the defendants, the counterparties to the underlying transactions and certain insurers, the complaint alleged that the underlying transactions financed by Ark Discovery Fund were fictitious and the "collateral" for these transactions did not exist. The complaint also alleged that in September 2008, federal authorities said that Petters had been engaged in a massive Ponzi scheme and that shortly thereafter the Ark Discovery Fund was in liquidation and MVP's $2 million investment in the Ark Discovery Fund was lost. Petters was later convicted of wire fraud, mail fraud, conspiracy and money laundering and sentenced to 50 years in prison.

In MVPAM's action to recover the $2 million investment, the defendants argued that MVPAM lacked standing under Article III of the United States Constitution because MVPAM was merely an investment adviser and attorney-in-fact and it had not suffered an injury-in-fact. MVPAM countered that it had Article III standing because MVP had assigned its claims arising out of the Ark Discovery Fund to MVPAM; however, MVPAM's complaint did not make this specific allegation. The court granted the defendant's motion to dismiss and stated that MVPAM's complaint did not "allege MVP assigned its claims arising out of the investments in Ark Discovery to MVPAM." The court noted that MVPAM's status as both attorney-in-fact for litigation purposes and an investment manager for MVP with unfettered discretion did not confer on MVPAM Article III standing to sue in a representative capacity on its client's behalf. The court concluded that MVPAM had not established Article III standing and granted MVPAM leave to file an amended complaint.

- See a copy of the court's decision

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