Investment Management Regulatory Update

SEC Rules and Regulations

Federal Agencies Propose Interagency Rule Impacting Incentive-Based Compensation Arrangements of Investment Advisers

Recently, the SEC released its version of a proposed rule (which is being promulgated jointly with six other federal agencies under Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act) that would subject financial institutions with $1 billion of assets to substantive and procedural requirements relating to incentive-based compensation. Financial institutions with $50 billion of assets would be subject to additional substantive requirements, including mandatory deferral of incentive-based compensation paid to certain executive officers. These requirements would apply to a wide array of financial institutions, including banks, broker-dealers and investment advisers.

The versions of the proposed rule issued to date indicate that the test that will be used to measure an investment adviser's assets is a balance-sheet test, rather than an assets-under-management test. An interpretative question arises in the not-uncommon situation in which an investment adviser is required to consolidate its assets with those of affiliated entities (*e.g.*, general partners or funds) for accounting purposes.

Once the seven agencies agree on the final text of the proposed joint rule, they will publish it in the Federal Register, which will trigger a 45-day comment period. A summary of the proposed rule is detailed in the Davis Polk Client Memorandum ***Federal Agencies Propose Interagency Rule on Incentive-Based Compensation for Financial Institutions***.

- See a copy of the SEC's proposed rule
- See the SEC's press release and fact sheet

Industry Update

CFTC Proposes Amendments to Regulations for CPOs and CTAs

On February 1, 2011, the Commodity Futures Trading Commission (the "**CFTC**") released proposed amendments to certain regulations concerning Commodity Pool Operators ("**CPOs**") and Commodity Trade Advisors ("**CTAs**") (the "**Proposal**"). The stated purpose of these amendments is to enhance the level of regulation of CPOs and CTAs, ensure consistent regulation of similarly situated entities across financial regulatory agencies and provide assistance to the Financial Stability Oversight Council ("**FSOC**") for assessment of systemic risk.

Removal of CPO Registration Exemptions

The Proposal would rescind certain exemptions from CPO registration contained in Rule 4.13(a)(3) and (a)(4) under the Commodity Exchange Act. Under Rule 4.13(a)(3), a fund manager is exempt from registration as a CPO if the interests in its fund are exempt from registration under the Securities Act of 1933 (the "**Securities Act**") and offered only to qualified eligible persons ("**QEPs**"), accredited investors, or knowledgeable employees, and the pool's aggregate initial margin and premiums attributable to commodity interests generally do not exceed 5% of the liquidation value of the pool's portfolio. Rule 4.13(a)(4) provides an exemption when the interests in the fund are exempt from registration under the Securities Act and the manager reasonably believes that the participants are all QEPs (or accredited investors in the case of non-natural persons). The CFTC reasoned that the operators of these pools are similarly situated to private fund advisers and, in light of the general requirement under the Dodd-Frank Act that investment advisers to private funds register under the Investment Advisers Act of 1940 (the "**Advisers Act**"), the exemptions should be eliminated to allow for CFTC registration and oversight. These exemptions are currently relied on by many private fund advisers who trade in commodity futures and, if these exemptions are repealed, these advisers would be required to register as CPOs unless an alternative exemption applied.

Reinstatement of Conditions to Rule 4.5 Exclusion

Rule 4.5 provides an exclusion from the definition of CPO for certain "otherwise regulated persons," including registered investment companies ("**RICs**"). Under the Proposal, the CFTC would reinstate certain conditions on RICs claiming the Rule 4.5 exclusion. These conditions include filing a notice of eligibility representing that (i) the use of commodity futures for non bona fide hedging purposes will generally be limited to 5% of the liquidation value of the RIC's portfolio and (ii) the RIC will not be marketed to the public as a commodity pool or a vehicle for trading in commodity futures or commodity options markets.

Annual Filing of Notices of Claiming Exemptions

The Proposal would require all persons claiming exemptive or exclusionary relief from registration as a CPO or CTA to file a notice on an annual basis confirming their claim of exemption or exclusion. A person would be required to file a registration application with the NFA within 30 days of the anniversary date of the person's initial claim for exemptive relief, if the person could not continue to rely on such relief and would be required to register.

Forms CPO-PQR & CTA-PR: Data Collection for CPOs and CTAs

The Proposal would require registered CPOs and CTAs to report a substantial amount of information to the CFTC on Forms CPO-PQR and CTA-PR, respectively. According to the Proposal, the information requested would be generally identical to that sought in the SEC's Form PF. For a more comprehensive discussion and analysis of the SEC and CFTC's joint proposal for Form PF reporting, see the ***February***

14, 2011, Investment Management Regulatory Update. Similar to the reporting requirements under proposed Form PF, the amount of information that a CPO or CTA would be required to disclose on each form would vary depending on both the size of the operator and the size of the advised pools.

General Purpose. According to the Proposal, the primary purpose of Forms CPO-PQR and CTA-PR is for CPOs and CTAs to provide information to the CFTC, other financial regulators or the FSOC to identify systemic risk.

Persons Required to Report. Any CPO or CTA that is registered or required to be registered with the CFTC would be required to file Forms CPO-PQR and CTA-PR, respectively, with the National Futures Association (the "**NFA**") as the CFTC's delegatee.

Form CPO-PQR adopts a tiered approach to the reporting obligations of CPOs according to the size of the relevant CPO. All CPOs would be required to file Schedule A, which according to the Proposal would request essentially the same information that the NFA currently solicits through Form PQR. CPOs with assets under management of at least $150 million would also be required to file Schedule B, which requests basic information on the commodity pools operated. A CPO with assets under management of at least $1 billion would be required to complete Schedule C, which solicits aggregate information about the CPO's commodity pools and even more detailed information about each of the CPO's commodity pools with a net asset value exceeding $500 million.

Form CTA-PR has two schedules. Schedule A is required of all CTAs, and consists of limited questions regarding self-identification, general operations of the CTA and whether the CTA manages assets for commodity pools equal to or exceeding $150 million. Only CTAs with commodity pool assets under management of at least $150 million would be required to complete Schedule B of Form CTA-PR, which solicits basic information regarding the CTA's trading program, client pool(s) and the position data of each commodity pool advised by the CTA. According to the Proposal, the CFTC anticipates that most CPOs and CTAs would only have to complete Schedule A.

Dual Registrants. According to the Form PF proposal jointly issued by the SEC and CFTC, a CPO registered with the CFTC that is dually registered as an investment adviser with the SEC will be deemed to have satisfied its filing requirements for Schedules B and C of Form CPO-PQR by completing and filing the applicable portions of Form PF for each of its commodity pools that is a "private fund" under the Advisers Act (i.e., 3(c)(1) or 3(c)(7) funds), and it appears under the Proposal that the same would apply to CTAs with respect to Schedule B. All registered CPOs and CTAs, however, would still be required to file Schedule A of proposed Form CPO-PQR (for CPOs) or Schedule A of proposed Form CTA-PR (for CTAs) irrespective of the filing of Form PF. Furthermore, Forms CPO-PQR and CTA-PR would remain applicable to dual registrants with respect to any advised commodity pools that are not private funds under the Advisers Act.

Frequency of Reporting. The Proposal would generally require that CPOs and CTAs file Forms CPO-PQR and CTA-PR on a quarterly basis, except that "mid-sized CPOs" (i.e., those with between $150 million and $1 billion in aggregate pool assets under management) would be required to file Schedule B of Form CPO-PQR on an annual basis.

Implementation of Reporting Obligation. According to the Proposal, the CFTC anticipates that the proposed rules would become effective six months after adoption of the proposed Forms CPO-PQR and CTA-PR. The NFA would remain the official custodian for the filings and reports under the Proposal.

Information Required on Form CPO-PQR. According to the Proposal, the information required under Form CPO-PQR would be largely identical to that required under Form PF for private fund advisers.

- ***Schedule A (all CPOs registered or required to be registered).*** Part 1 of Schedule A seeks basic identifying information about the CPO, including its (i) name, (ii) NFA identification number and (iii) assets under management. Part 2 of Schedule A would require information about each of the CPO's commodity pools, including (i) names and NFA identification numbers; (ii) position information for any positions representing 5% or more of a pool's net asset value; (iii) key relationships with brokers, other advisers and administrators; (iv) identifying information about each pool's carrying brokers, administrators, trading managers, custodians, auditors and marketers; (v) quarterly and monthly performance information of each pool and (vi) information and restrictions on a pool's subscriptions and redemptions.

- ***Schedule B (CPOs with assets under management equal to or exceeding $150 million).*** Under the Proposal, CPOs meeting this threshold would be required to report detailed information for all operated pools, including each pool's: (i) investment strategy; (ii) borrowings by geographic area and the identities of significant creditors; (iii) credit counterparty exposure and (iv) entities through which the pool trades and clears its positions.
- ***Schedule C (CPOs with assets under management equal to or exceeding $1 billion).*** Under the Proposal, CPOs would be required to complete a Schedule C detailing additional information about their commodity pools. Part 1 of Schedule C would require certain aggregate information including: (i) the breakdown of the market value of assets along different types of securities and derivatives; (ii) turnover in these instruments and (iii) the duration of various fixed income portfolio holdings, including asset-backed securities. Part 2 would require certain information about any advised commodity pool with a net asset value of at least $500 million as of the end of any business day during the reporting period. In addition to requiring substantially similar information on the individual pool level as that requested in Part 1 on an aggregate level, Part 2 would also require for each individual pool: (i) a geographic breakdown of the reportable pool's assets; (ii) information regarding asset liquidity, concentration of positions, material investment positions, collateral practices with significant counterparties and clearing relationships; (iii) risk metrics, financial information, investor information, and the monthly value at risk ("**VaR**") if calculated; (iv) the impact of market stressors on the pool's portfolio; (v) whether the CPO regularly performed stress tests involving such market stressors; (vi) certain financing information for its reportable pool and (vii) the pool's investor composition and liquidity.

Information Required on Form CTA-PR

- ***Schedule A (all CTAs registered or required to be registered).*** Proposed Schedule A would require reporting of general information about the CTA, including: (i) name; (ii) NFA identification number; (iii) number of offered trading programs; (4) total assets managed by the CTA and (5) total pool assets managed by the CTA.
- ***Schedule B (CTAs that manage pool assets equal to or exceeding $150 million).*** Schedule B would require the reporting of certain information, including: (i) position, performance, and trading strategy for each trading program; (ii) identification of the pools advised under each program and the percentage of the pool's assets managed by the CTA and (3) whether the CTA uses an administrator.

Confidential Treatment of Data Collected on Forms CPA-PQ and CTA-PQ. The Proposal notes that certain information submitted on Forms CPO-PQR and CTA-PQ would contain proprietary information. However, the Proposal indicates the CFTC would take the position that certain exemptions from Freedom of Information Act disclosure, in conjunction with certain disclosure limitations set forth in Section 8(a)(1) of the Commodity Exchange Act, would protect such information from public disclosure.

Removal of Exemptive Relief from Annual Audit Requirement for Rule 4.7 Exempt Pools

Noting that the vast number of CPOs and CTAs that operate pools under Rule 4.7 audit their annual reports, the CFTC proposed to eliminate, for commodity pools whose participants are QEPs, the exemption under Rule 4.7(b)(3) from the requirement to provide audited financial statements in commodity pool annual reports.

New Accredited Investor Definition

In accordance with the newly proposed definition of "accredited investor" by the SEC, as required by the Dodd-Frank Act, the CFTC proposed to amend certain provisions related to accredited investors to conform to the new definition of accredited investor. The SEC's proposed definition of accredited investor is discussed in more detail in the ***February 14, 2011 Investment Management Regulatory Update***.

New Risk Disclosure Statement for CPOs and CTAs

The proposal would also amend the mandatory Risk Disclosure Statement for CPOs and CTAs to include a description of certain risks specific to swap transactions.

The CFTC is soliciting comments on the Proposal. Comments to the Proposal are due on April 12, 2011.

- See a copy of the Proposal
- See a copy of the fact sheet
- See a copy of the Q&A

Federal Reserve Issues Final Regulations Implementing Volcker Rule Conformance Period

On February 9, 2011, the Federal Reserve issued final regulations implementing the conformance period during which banking entities must bring their activities, investments and relationships into compliance with the prohibitions and restrictions in the Volcker Rule. The November 17, 2010 proposal of these implementing regulations was described in the ***December 17, 2010 Investment Management Regulatory Update***.

The final regulations, which become effective on April 1, 2011, apply to both proprietary trading and hedge fund or private equity fund activities; however, most of the provisions relate to hedge funds and private equity funds, and especially to illiquid funds.

A summary of the final regulations are detailed in the Davis Polk Client Memorandum ***Summary of the Federal Reserve's Final Regulations on the Conformance Period for the Volcker Rule***.

- See a copy of the final regulations

Litigation

SEC and U.S. Attorney Bring Charges in Expert-Network Insider Trading Case

On February 8, 2011, the SEC and the United States Attorney for the Southern District of New York, Preet Bharara, announced a number of charges in connection with an alleged insider trading scheme involving the expert-network firm Primary Global Research LLC ("**PGR**"). According to the SEC and the U.S. Attorney, a New York-based hedge fund and four hedge fund portfolio managers and analysts illegally traded securities based on material nonpublic information obtained from technology company employees who were also working as expert-network consultants. According to the SEC's complaint, the scheme garnered over $30 million for hedge funds and other traders.

The SEC filed a complaint against ten individuals and one investment adviser entity, Barai Capital Management ("**Barai Capital**"), all of them consultants, employees or clients of PGR. Expert-network firms provide services to hedge funds seeking information about companies by connecting consultants, including current and former employees of publicly traded companies, with fund managers in order to facilitate the exchange of such information. For more information on expert-network firms and charges relating to PGR, please see the ***December 17, 2010 Investment Management Regulatory Update***.

The SEC alleges that four technology company employees who doubled as PGR consultants, Mark Anthony Longoria, Daniel L. DeVore, Winifred Jiau and Walter Shimoon, used their access to technology companies to obtain material nonpublic information about the sales, earnings and performance data of such companies. These defendants then shared their inside information, in exchange for cash compensation, with PGR clients who traded on the information, according to SEC allegations. Two PGR employees, defendants James Fleishman and Bob Nguyen, allegedly facilitated the transfer of inside information between PGR consultants and PGR clients, and at times allegedly passed the information directly between them. This material nonpublic information, according to the complaint, was received by personnel of hedge fund managers, including the defendants Samir Barai, the founder and portfolio manager of Barai Capital, Jason Pflaum, a former technology analyst at Barai Capital, Noah Freeman, a former managing director at a Boston-based hedge fund and Donald Longueuil, a former managing director at a Connecticut-based hedge fund. According to the SEC, these defendants either traded on the information they received or caused their hedge funds to trade on it.

The SEC's charges represent the first charges brought against traders in the SEC's ongoing investigation into insider trading through the use of expert-network firms. The SEC's expert network insider trading case is currently pending in the United States District Court for the Southern District of New York. The SEC is charging the defendants with violating Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and seeking disgorgement of profits received illegally and the payment of financial penalties. The SEC has also brought civil charges against Longoria, DeVore, Jiau, Shimoon, Fleishman and Nguyen. In connection with these charges, the SEC is seeking to permanently enjoin defendants from future violations of federal securities laws, disgorgement of approximately $500,000 and the payment of penalties.

The United States Attorney for the Southern District of New York has brought criminal charges for the same fraud against Barai, Pflaum, Freeman and Longueuil for their roles in the scheme. Pflaum and Freeman have already pled guilty to securities fraud and conspiracy to commit securities fraud. Barai and Longueuil have both been charged with one count of conspiracy to commit securities fraud and wire fraud, and Barai has been charged with three counts of securities fraud. Obstruction of justice charges have also been brought against Longueuil and Barai, who, according to the U.S. Attorney, attempted to destroy evidence of their involvement in the scheme upon learning about the insider trading investigation from news reports.

- See a copy of the SEC complaint
- See a copy of the SEC press release
- See a copy of the United States Attorney for the Southern District of New York press release

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SEC Settles with Investment Adviser over IPO Allocations

On February 7, 2011, the SEC settled with New York-based investment adviser Alpine Woods Capital Investors ("**Alpine**") and its CEO, Samuel Lieber, over violations regarding Alpine's trading activities in connection with initial public offerings ("**IPOs**"). According to the SEC, Alpine and Lieber failed to implement the company's policies and procedures regarding IPO allocations for its funds and failed properly to disclose material information about those IPO allocations to its investors.

According to the SEC, Alpine's assets under management grew significantly between 2003 and 2007 after the company launched several new funds, leading to greater opportunities for Alpine to obtain shares in IPOs. As the investment manager for several funds, Alpine determined how IPOs would be allocated among its various funds. According to Alpine's compliance policies and procedures, allocations were to be made "fairly and equitably" across funds managed by Alpine. In practice, however, Alpine's two smallest and newest funds, which were investment companies registered under the Investment Company Act of 1940, Alpine Dynamic Financial Services Fund and Alpine Dynamic Innovators Fund (the "**Funds**"), received a disproportionate number of allocations. According to the SEC, between February 1, 2006 and January 31, 2008, Alpine made a total of 399 IPO allocations, of which approximately 135 were allocated to the Financial Services Fund and approximately 69 were allocated to the Innovators Fund. IPO allocations, the SEC alleged, materially affected the performance of the funds—during the fiscal year 2007, the Financial Services Fund had a 21.6% return with IPO trading whereas without IPO trading, the fund's return would have been -14.7%. Similarly, the Innovators Fund had a 39.5% return with IPO trading and would have had a 25.3% return without such trading. According to the SEC, Lieber was required under the Alpine compliance manual to ensure compliance with Alpine's IPO allocation policies and to direct someone within Alpine to oversee the allocation process, both of which he failed to do. Underlying the compliance policy failures, the SEC says, was a lack of adequate resources available to support them.

Additionally, the SEC says, Alpine and Lieber failed to disclose to investors the material positive impact of IPO trading on the performance of the funds. Disclosure of this information, according to the settlement, would have been relevant to investors' decisions regarding whether to invest in or redeem from the funds.

The SEC held that Alpine willfully violated (i) Section 17(a)(3) of the Securities Act of 1933, (ii) anti-fraud provisions under Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder and (iii) Section 34(b) of the Investment Company Act of 1940 and Rule 31a-1(b)(5) thereunder. Pursuant to the settlement order, both Alpine and Lieber have agreed to cease-and-desist orders and civil penalties of $650,000 and $65,000, respectively. In addition, Alpine has agreed to a censure.

- See a copy of the SEC order

SEC Charges AXA Rosenberg with Securities Fraud for Concealing Quantitative Investment Modeling Error

On February 3, 2011, the SEC charged three AXA Rosenberg entities with securities fraud for concealing a significant coding error in a quantitative investment model used to manage certain client portfolios. According to the SEC, AXA Rosenberg Group LLC ("**ARG**") is the holding company of Barr Rosenberg Research Center LLC ("**BRRC**") and AXA Rosenberg Investment Management LLC ("**ARIM**"), which are investment advisers registered with the SEC. The SEC's settlement order indicated that BRRC developed the computer code for the model and ARIM uses the model to manage client assets.

According to the SEC, a material error in the quantitative investment model's code had disabled a key component for managing risk. Instead of disclosing and correcting the error immediately upon discovery in June 2009, according to the SEC, a senior ARG and BRRC official directed others to conceal the error and did not take steps to have the model's computer code fixed. As a result, the SEC alleged, ARG, BRRC and ARIM provided investors inaccurate information about the performance and risk management capabilities of the model, which ultimately caused $217 million in investor losses. Although the error was eventually corrected for certain of their U.S. managed portfolios in September 2009 and for other portfolios soon thereafter, knowledge of the error was not disclosed to ARG's CEO until November 2009, according to the SEC's order. After conducting an internal investigation, ARG allegedly disclosed the error to SEC examination staff in late March 2010 after being informed by the SEC staff that an SEC examination of ARIM and BRRC was impending.

The SEC's order instituting cease-and-desist proceedings indicated that ARG, BRRC and ARIM made material misrepresentations and omissions about the quantitative investment model to ARIM's clients. According to the SEC, the firms "failed to disclose the error and its impact on client performance, attributed the model's underperformance to market volatility rather than to the error and misrepresented the model's ability to control risks." The SEC also found that BRRC "did not have reasonable compliance procedures in place to ensure that the model would assess certain risk factors as intended." In particular, the coding process for the model "represented a serious compliance risk for BRRC and its clients," according to the SEC, "because accurate coding is required for the model to function properly and in the manner represented to clients."

The SEC found that ARG had willfully violated anti-fraud provisions of Sections 17(a)(2) and (3) of the Securities Act of 1933 (the "**Securities Act**"). The SEC also concluded that ARIM had willfully violated an anti-fraud provision of Section 206(2) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). Lastly, the SEC found that BRRC had willfully violated anti-fraud and compliance provisions of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

ARG, ARIM and BRRC, in settlement of the SEC's charges, have agreed to the entry of a cease-and-desist order enjoining them from committing or causing any violations of the above provisions and requiring them to pay $217 million to harmed clients and a $25 million penalty. Furthermore, the firms must undergo a reorganization of their compliance functions, hire an independent compliance consultant with expertise in quantitative investment techniques to review compliance policies and procedures related to the quantitative investment model, and generally enhance the role of compliance personnel.

- See a copy of the SEC Order

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

John G. Crowley	212 450 4550	john.crowley@davispolk.com
Nora M. Jordan	212 450 4684	nora.jordan@davispolk.com
Yukako Kawata	212 450 4896	yukako.kawata@davispolk.com
Leor Landa	212 450 6160	leor.landa@davispolk.com
Gregory S. Rowland	212 450 4930	gregory.rowland@davispolk.com
Danforth Townley	212 450 4240	danforth.townley@davispolk.com
John A.B. O'Callaghan	212 450 4897	john.ocallaghan@davispolk.com