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Investment Management Regulatory Update

Industry Update

President Obama Proposes Significant Limits for Financial Institutions

On January 21, 2010, President Barack Obama announced that his Administration, as part of its ongoing efforts to reform the financial system, would seek to limit both the activities and size of U.S. banks (the "**Obama Proposal**"). Among other restrictions, the Obama Proposal includes a proposal, commonly referred to as the "**Volcker Rule**," that would prohibit banks from owning, investing in or sponsoring hedge funds, private equity funds or proprietary trading operations "for their own profit, unrelated to serving their customers." In his address, the President urged Congress to "get this done" and, while welcoming constructive criticism, warned industry players against attempts to derail the Administration's reform efforts.

Industry participants and other commentators have since voiced numerous concerns about the Obama Proposal and, particularly, the Volcker Rule. Specifically, many have noted that defining "proprietary trading" will not be easy and have suggested that any definition that is adopted for the term should take care to exclude from its coverage, among other things, market making activities.

Subsequently, on February 2, 2010, the Senate Committee on Banking, Housing, and Urban Affairs held a hearing on the Volcker Rule. Both Paul Volcker, Chairman of the President's Economic Recovery Advisory Board, and Neal S. Wolin, Deputy Secretary of the Treasury, testified at the hearing.

In a prepared statement, Wolin responded to industry concerns by clarifying that the intent of the Volcker Rule is to target only the use of a firm's capital in trading activities that are "unrelated to client business." Wolin suggested that a bank's speculation "on the price of oil and gas" is an activity that the Volcker Rule seeks to prohibit. On the other hand, according to Wolin, it is not the intent of the Volcker Rule to disrupt a bank's ability to "make markets for customers in financial assets" or "hedge risks in connection with client-driven transactions."

Volcker expressed his belief that the safety net provided to depository institutions is justified by the essential nature of commercial banking activities and noted that no similar rationale exists for continuing to allow that safety net to cover banks' proprietary trading activities.

Notably, Senator Christopher J. Dodd (D-CT), whose own reform proposal is under consideration in the Senate, voiced strong support for the Volcker Rule. See the ***December 4, 2009 Investment Management Regulatory Update*** for an overview of the proposal. Dodd, however, expressed frustration with the timing and content of the proposal and commented that it was presented very late in the regulatory reform process with precious few details on exactly how it would work.

- See the Davis Polk Client Memorandum entitled ***President Obama Proposes Size and Activities Limits for Financial Institutions***
- See the full text of President Obama's speech
- See a copy of Wolin's statement
- View the testimony of Wolin and Volcker

Developments Regarding the Directive on Alternative Investment Fund Managers

Since the European Commission (the "**Commission**") published the controversial Directive on Alternative Investment Fund Managers (the "**Directive**"), there have been several significant developments. See the *May 8, 2009 Investment Management Regulatory Update* for an overview of the Directive. Certain notable aspects of these developments are summarized below.

First, the Swedish Presidency of the European Council issued a revision of the Directive (the "**Swedish Draft**"), styled as a "compromise proposal" and aimed at reconciling the concerns expressed by national governments, regulatory authorities and the alternative investment fund industry both within and outside of the European Community (the "**EC**") regarding the Directive.

- Perhaps most controversially, the Swedish Draft includes proposed amendments that would directly impact the remuneration paid to alternative investment fund managers ("**AIF Managers**"), an area left unregulated by the Directive. The ostensible purpose of these provisions is to "promote effective risk management," and they apply to an AIF Manager's "staff, including senior management, whose professional activities have a material impact on their risk profile or the risk profiles of alternative investment funds ("**AIF**") they manage." Among other substantive provisions related to remuneration, the Swedish Draft would require the deferral of "a substantial portion . . . of the variable remuneration" paid to staff of AIF Managers. Additionally, any performance measurement used to calculate variable remuneration would need to be adjusted to account for "all types of current and future risk."
- The Swedish Draft also sets forth proposed amendments to the scope of the Directive. Like the Directive, the scope of the Swedish Draft extends to all AIF Managers "established in the European Community." However, while the Swedish Draft retains the Directive's assets under management thresholds (*i.e.*, AIF Managers that manage less than certain amounts of assets are not subject to the Directive), it also adds several more exemptions, including those intended to remove AIF Managers that manage endowments, sovereign wealth funds and certain structured finance vehicles from its provisions. Also exempt under the Swedish Draft are AIF Managers that manage AIF whose only investors are related parties of the AIF Manager (provided that such investors are not themselves AIF).

- Another amendment proposed by the Swedish Draft muddies the waters regarding the ability of AIF Managers established outside of the EC to market AIF to investors within the EC. Specifically, the Swedish Draft deletes a provision in the Directive allowing member states to authorize non-EC AIF Managers to take advantage of the Directive's "passporting" feature to market AIF to "professional investors" throughout the EC. Without the ability to take advantage of this feature, non-EC AIF Managers would need to rely on each member state's private placement regime to market AIF, and these regimes would remain subject to change by each individual member state.

Second, following the release of the Swedish Draft, the Directive's "rapporteur," Jean-Paul Gauzès, who is also a Member of the European Parliament ("**MEP**"), issued his draft report (the "**Gauzès Report**") setting forth additional proposed changes to the Directive.

- Like the Swedish Draft, the Gauzès Report addresses the sensitive topic of remuneration; it calls for the Directive to impose on AIF Managers remuneration restrictions modeled on those contained in the G-20 Leader's Statement issued in connection with the 2009 G-20 Summit in Pittsburgh, Pennsylvania (the "**Leaders' Statement**"). The Leaders' Statement recommends that compensation in the financial services sector be restructured so that excessive risk taking is discouraged, and, as a means to accomplishing this end, it suggests that, among other things, firms require a large portion of employees' variable compensation to be "deferred, tied to performance and subject to appropriate clawback."
- Among other things, the Gauzès Report, unlike the Swedish Draft, recommends carrying forward provisions in the Directive that serve to prohibit AIF Managers from delegating their portfolio management responsibilities to third parties, unless that third party has been "authorized" as an AIF Manager pursuant to the Directive. As a practical matter, were this approach to be adopted, AIF Managers would not be able to hire non-EC portfolio managers for the AIF that they manage because non-EC portfolio managers cannot be "authorized" under the Directive.

It is also noteworthy that Spain has assumed the Presidency of the European Council. Thus far, the Spanish Presidency's primary contribution to the ongoing debate has been its January 11, 2010 publication of a document cataloguing various differences between the Swedish Draft and the Gauzès Report and flagging issues for further discussion—without a clear indication as to whether it favors a particular approach.

Lastly, recent news reports indicate that a substantial number of MEPs have put forward for consideration over 1,000 further amendments to the Directive. The text of these amendments is not currently available.

As the foregoing discussion indicates, the shape of the Directive is still very much in flux and whether any of these proposals will be incorporated into the final form of the Directive remains unclear.

We will continue to monitor developments in this area.

- See a copy of the Directive
- See a copy of the Swedish Draft
- See a copy of the Gauzès Report
- See a copy of the G-20 Leaders' Statement
- See a copy of the document released by the Spanish Presidency

Joint Forum Study Identifies Areas of Concern with Respect to Hedge Funds

At the request of the G-20, the Joint Forum—a group of experts from the banking, insurance and securities industries working under the auspices of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors—has prepared and released a report analyzing key issues related to, and identifying regulatory gaps arising from, the differentiated nature and scope of financial regulation in the international banking, insurance and securities sectors (the "**Report**").

Among other things, the Report identifies hedge funds as a "key issue area" and cautions that, despite the potential for hedge funds to impact global financial stability, there is not a consistent prudential regime for monitoring and assessing the risks that they pose. Indeed, the Report observes that there is not a uniform understanding of how hedge funds are organized or how their managers measure and manage the risks posed by these funds. The Report further suggests that this failure may be attributed, in part, to the fact that, typically, any reporting requirements to which hedge funds are subject are very limited and have not been implemented consistently across jurisdictions.

Other areas of concern raised by the Joint Forum relate to the ability of hedge funds to absorb financial shocks and to the potential for hedge funds to transmit systemic risk to other markets. With respect to the former concern, the Report notes that minimum capital requirements are not uniformly imposed on hedge funds by all regulators, even where such funds are likely to be of systemic importance. Further, the Report posits that hedge funds may amplify negative market trends through the use of substantial amounts of leverage, often in a manner that is not sufficiently transparent.

To address these and other issues, the Report sets forth three formal recommendations pertaining to hedge funds and their managers, which the Report describes as having a "functional tenor." The Report notes that the recommendations should be viewed as applying to "all pools of capital and to managers/advisers who engage in activities posing risks substantially similar to hedge funds, regardless of how they are denominated or qualified domestically."

The Report's first recommendation is for regulators to introduce or, if applicable, strengthen minimum risk management standards for hedge fund managers. According to the Report, these standards ought to be scaled to the size and complexity of the funds managed by these managers and should require each such manager, at a minimum, to:

- develop and maintain a risk management policy consistent with each managed fund's "intended risk profile" and designed to ensure appropriate upward reporting;
- establish a risk management function that is, among other things, "hierarchically and functionally independent from the hedge fund management functions";
- manage liquidity risk and conduct stress testing to ensure that the liquidity profile of each managed fund's investments is appropriate in light of the fund's obligations and redemption policy;
- retain full responsibility for any risk management function delegated to a third party; and
- adopt effective qualitative and quantitative risk measurement methods and techniques to ensure that the funds that they manage remain within their intended risk profile.

Another of the Report's recommendations suggests that regulators impose reporting requirements on hedge fund operators to enable appropriate supervisory and regulatory entities to identify sources of systemic risk. However, the Report notes that collecting relevant data is only a first step; it must also be shared among domestic and international regulators for there to be effective "[m]acroprudential oversight" of hedge funds.

In its final formal recommendation, the Report indicates that, with respect to systemically significant hedge funds, regulators should impose minimum initial and ongoing capital requirements on their operators. The Report suggests that such requirements should be imposed as a condition for registration and ongoing supervision, but also acknowledges the cost associated with such capital requirements and notes that they "may not be necessary for all fund operators in all circumstances." For systemically significant hedge funds, however, the Joint Forum's consensus is that regulators should consider risk-based capital requirements designed to allow hedge fund operators to absorb losses arising out of operational failures and to allow for the orderly winding down of a failing fund operator, if necessary.

In addition to these formal recommendations, the Report also puts forth additional, informal regulatory proposals supported by some, but not all, of the Joint Forum's members. The Report includes these additional proposals as options that regulators may consider in their efforts to mitigate risks posed by hedge funds. Generally, these policy options focus on leverage-related risks posed by hedge funds and the ability of hedge funds to maintain adequate capital buffers on which to rely during market downturns. The proposals suggest that regulators consider requiring hedge funds to:

- post collateral in excess of the amount of any borrowed funds in order to balance counterparty risks and establish a sufficient buffer against capital calls;
- take a closed-end form or establish gating structures if they invest significantly in illiquid assets;
- comply with risk-independent leverage limits or leverage limits that fluctuate based on the riskiness of a hedge fund's assets (*i.e.*, less leverage may be employed with respect to riskier assets); and
- timely deliver all financial instruments sold short.

  ▸ See a copy of the Joint Forum Report

SEC Chairman Discusses Views on Pending Private Fund Adviser Registration Proposals and Collaboration with the FSA

On January 20, 2010, SEC Chairman Mary L. Schapiro delivered a speech at Northwestern University School of Law's Annual Securities Regulation Institute addressing the SEC's response to the changing financial markets landscape. Among other things, Schapiro reiterated the SEC's support of legislation that would require most advisers to hedge funds and other private funds to register with the agency. She cautioned lawmakers, however, to draft such legislation in a manner that avoids "broad new carve-outs" that could allow "unscrupulous" advisers to escape SEC registration and thwart the agency's data collection efforts. Additionally, because it is currently estimated that approximately 80 percent of hedge fund assets are managed by advisers based in the United States or the United Kingdom, Schapiro indicated that the SEC will work with the U.K. Financial Services Authority (the "**FSA**") to gather and share data pertaining to hedge funds. It is the SEC's view, according to Schapiro, that such cooperation would lead to a more complete understanding of the effects hedge funds have on global securities markets.

Subsequently, Schapiro met with the Chairman of the FSA, Adair Turner, and its Chief Executive, Hector Sants, as part of the agencies' Strategic Dialogue, a program started in 2006 and intended to encourage cross-border regulatory collaboration between the agencies. According to the SEC's press release regarding the meeting, the agency heads discussed, among other things, the regulation of hedge funds and investment advisers. The two agencies expect that their cooperative efforts will continue to increase on this and other fronts, and, to this end, they plan to review their existing Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to the Supervision of Financial Services Firms and Market Oversight.

- See the full text of Schapiro's speech
- See a copy of the SEC press release discussing its meeting with the FSA

SEC Revamps Enforcement Division, Establishing Specialized Asset Management Unit

The SEC has established several new specialized units within its Division of Enforcement, including a specialized asset management unit (the "**Asset Management Unit**") and units devoted to structured and new products and municipal securities and public pensions. According to the SEC, these changes to the Division of Enforcement "mark its most significant reorganization since its establishment in 1972." The specific details of the Asset Management Unit's mandate have not been released yet; however, the SEC has indicated that the broad purpose of the Asset Management Unit will be to investigate investment advisers, investment companies, hedge funds and private equity funds. According to Robert Khuzami, the Director of the Division of Enforcement, the Asset Management Unit, like the other newly established specialized units, will address "[t]wo great challenges fac[ing] every enforcement authority policing our securities markets—the complexity and high-velocity pace of innovation in financial products, transactions, and markets, and the willingness of violators to use every trick to cover their tracks."

The Asset Management Unit will be co-headed by Bruce Karpati, the founder and head of the SEC's Hedge Fund Working Group, and Robert Kaplan, who previously served as Assistant Director of the Division of Enforcement.

Speaking at the news conference announcing the creation of the specialized units, Karpati acknowledged the SEC's responsibility to protect investors and expressed his belief that the newly created Asset Management Unit will be a key means of fulfilling that responsibility. Karpati also addressed the recent trend of consolidation within the asset management industry. According to Karpati, consolidation brings "new risks" and a heightened potential for advisers to face conflicts of interest. The Asset Management Unit will focus on this "period of consolidation," and other issues, noted Karpati, including those related to "valuation and performance and due diligence and diversification."

Kaplan, for his part, pledged to "aggressively pursue" investigations currently underway and, going forward, to "utilize proactive investigative approaches that incorporate risk analytics and technology."

- See a copy of the SEC press release announcing the creation of the specialized units
- See a copy of the remarks by Karpati and Kaplan

CalPERS Discloses Placement Agent Fees

As reported in the ***November 11, 2009 Investment Management Regulatory Update***, the California Public Employees' Retirement System ("**CalPERS**"), the nation's largest public pension fund, announced on October 14, 2009 that it would conduct a "special review of the fees paid by its external managers to placement agents and their related activities." Pursuant to this review, on January 14, 2010, CalPERS released over 600 placement agent fee disclosures that it received between May 2009 and January 2010 from its external investment managers. These disclosures were made pursuant to CalPERS' new policy mandating disclosure regarding the use of placement agents and fees and were made on a voluntary basis. Indeed, over 90 percent of the managers asked to provide disclosures voluntarily did so. CalPERS has subsequently submitted this information to the law firm that is assisting the pension fund with its ongoing special review.

In comments accompanying the release of the fee disclosures, Anne Stausboll, CalPERS Chief Executive Officer, noted that the pension fund remains committed to "working aggressively to take measures to provide transparency, adopt thoughtful reforms, and restore trust in [the pension plan] system."

- See a copy of the CalPERS press release

Litigation

Investment Advisory Firms Charged with Unlawful Short Selling Practices

On January 26, 2010, the SEC separately charged two investment advisory firms, Palmyra Capital Advisors LLC ("**Palmyra**") and AGB Partners LLC ("**AGB**"), along with AGB's principals, Gregory A. Bied and Andrew J. Goldberger, with engaging in unlawful short selling of securities. According to the SEC, the two cases are the first to be brought under Rule 105 of Regulation M since the rule was amended in October 2007. In both cases, the charges were settled without any admission or denial of the SEC's findings.

Prior to its amendment, Rule 105—a rule designed to prevent market manipulation—generally made it unlawful to use securities purchased in a public offering to *cover* a short sale of such securities effected within the five days preceding the offering's pricing date. As amended, Rule 105 generally makes it unlawful merely to *purchase* a security in a public offering after having sold the same security short within the five days preceding the offering's pricing date.

The charges against Palmyra were brought under the amended Rule 105. According to the SEC's order, three funds advised by Palmyra sold short shares of Capital One at $53.51 per share; four business days later, Capital One priced a secondary offering of its common stock at $49 per share. The three funds purchased shares in the offering, resulting in combined profits of $225,000. Palmyra agreed to the disgorgement of such profits, interest in the amount of approximately $10,000 and a penalty of $105,000.

In the matter of AGB, according to the SEC's order, the unlawful short selling practices occurred in two funds managed by AGB, one of which was funded solely by the two principals of the firm (the "**Partners' Fund**"). The second fund (the "**Client Fund**") consisted primarily of outside investors' assets but also contained assets of the principals.

During the five business days before Boots and Coots International Well Control, Inc. ("**Boots and Coots**") priced its follow-on offering at $2.10 per share, the Partners' Fund sold short shares of Boots and Coots at an average price of $2.57 per share. The Client Fund subsequently purchased shares in the offering, some of which were used to cover the short position in the Partners' Fund. The short sales in the Partners' Fund occurred in April 2007, before the amendment of Rule 105, and, according to the SEC's order, violated the version of the rule then in effect.

AGB was also charged with violating the amended rule as a result of unlawful short selling activity occurring in June 2008. According to the SEC's order, during the five business days before BGC Partners Inc. priced a secondary offering of its common stock, the Partners' Fund sold short shares of BGC Partners at an average price of $8.45 per share. After the offering price was announced, the Client Fund purchased shares in the offering, thereby causing a violation of the amended rule.

AGB and its principals have agreed to be jointly and severally liable for disgorgement of approximately $38,000 in profits, interest of approximately $3,000 and a penalty of $20,000.

- See a copy of the SEC press release announcing the charges
- See a copy of the SEC's order against Palmyra Capital Advisors LLC
- See a copy of the SEC's order against AGB Partners et al.

Reserve Primary Fund Distributes $3.4 Billion to Investors

On January 29, 2010, the Reserve Primary Fund (the "**Fund**") completed a court-ordered distribution of $3.4 billion in assets to investors who held shares of the Fund when its net asset value ("**NAV**") fell below $1 per share, or "broke the buck," in September 2008.

As reported in the ***May 8, 2009 Investment Management Regulatory Update***, the SEC filed fraud charges against entities and individuals involved in the operation of the Fund. The SEC's complaint alleged that these parties affirmatively misled the Fund's investors and trustees and failed to provide them with key material facts regarding the impact of the bankruptcy of Lehman Brothers Holdings, Inc. on the Fund. The complaint also requested that the court issue an order, pursuant to the Investment Company Act of 1940 and the Securities Exchange Act of 1934, requiring the Fund to distribute its remaining assets on a pro rata basis, and, in November 2009, the court approved the SEC's distribution plan.

According to the SEC, the January 29th distribution will bring the Fund's investors' recovery to over 98 cents on the dollar. Despite this recovery, SEC Chairman Mary L. Schapiro promised that the SEC will "continue to seek the return of even more assets for investors in the coming months."

- See a copy of the SEC press release announcing the distribution

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
Danforth Townley	212 450 4240	danforth.townley@davispolk.com
Joseph J. Cipolla	212 450 4911	joseph.cipolla@davispolk.com