Investment Management Regulatory Update

SEC Rules and Regulations

SEC Opens Public Comment Period Prior to Issuing JOBS Act Rule Proposals

On April 11, 2012, prior to proposing rules that are required to implement certain aspects of the Jumpstart Our Business Startups Act (the "**JOBS Act**"), the Securities and Exchange Commission (the "**SEC**") announced that it will begin accepting public comments on the JOBS Act, which was enacted on April 5, 2012. According to the SEC's press release, although generally required by law to establish a public comment period when new rules (or rule amendments) are proposed, the SEC has decided to allow public comment before JOBS Act rules are proposed, a process that the SEC first utilized with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"). The comments will be publicly available, as will information about JOBS Act meetings with interested persons, according to the SEC.

Among other things, the JOBS Act relaxes certain regulatory restrictions applicable to private fund offerings. For instance, the JOBS Act increases the record-holder threshold, from 500 to 2,000 (or 500 persons that are not "accredited investors"), which issuers were previously required to abide by pursuant to Section 12(g) of the Securities Exchange Act of 1934 (the "**Exchange Act**") in order to avoid public company reporting. In addition, the JOBS Act directs the SEC, within 90 days of its enactment, to revise Rule 506 of Regulation D under the Securities Act of 1933 (the "**Securities Act**") to remove the prohibition on general solicitation and general advertising in private offerings made pursuant to Rule 506, as long as the only purchasers are accredited investors.

In addition to the revisions to Rule 506, the SEC is required to implement several aspects of the JOBS Act through rulemaking. For example, the JOBS Act amends Section 12(g)(5) of the Exchange Act to provide that the definition of "held of record" for purposes of Section 12(g)(1) does not include securities held by persons who received such securities under employee compensation plans in transactions that were exempt from the registration requirements of Section 5 of the Securities Act, but directs the SEC to adopt a safe harbor for issuers in determining whether a security holder satisfies such exclusion. In addition, the JOBS Act requires the SEC to promulgate rules exempting from the restrictions of Section 12(g) securities acquired in so-called "crowdfunding" transactions. Further, the SEC's new rules must require that an issuer offering securities pursuant to Rule 506 "take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the [SEC]."

For further discussion of the impact of the JOBS Act on private funds, see the March 23, 2012 Davis Polk Client Memorandum, ***Senate Passes Legislation To Raise the 500 Shareholder Threshold for SEC Registration and To Relax General Solicitation Prohibition in Reg D Offerings***.

- See a copy of the SEC's press release

SEC Staff Denies No-Action Relief to a Single Individual Serving as Key Employee to Multiple Family Offices and Updates Family Office Rule FAQs

On April 3, 2012, the staff of the SEC's Division of Investment Management issued a no-action letter denying relief to Peter Adamson III who proposed to serve as a "key employee," director, partner, manager, or trustee of up to ten family offices each serving a separate family and to qualify for the exclusion from the definition of "investment adviser" for family offices under the Investment Advisers Act of 1940 (the "**Advisers Act**"). Section 202(a)(11)(G) of the Advisers Act, which was added to the Advisers Act by the Dodd-Frank Act effective July 21, 2011, excludes any "family office" from the definition of "investment adviser." Rule 202(a)(11)(G)-1 under the Advisers Act, the so-called "family office rule," defines a family office as a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their employment) that (i) has no clients other than "family clients," (ii) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more "family members" and/or "family entities" (*i.e.*, any family trust or estate, non-profit or charitable organization or other family entity qualifying as a family client under the rule, other than key employees and their trusts), and (iii) does not hold itself out to the public as an investment adviser. In addition, according to the SEC's June 23, 2011 release adopting the rule (the "**Adopting Release**"), the rule does not include a family office that provides advisory services to multiple families (a so-called "multifamily office"). For additional discussion of the family office rule, see the June 29, 2011 Davis Polk Client Memorandum, **SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940**.

In its letter, the SEC staff denied no-action relief on the grounds that it was unclear how the proposed arrangement would not create a multifamily office, which falls outside of the purview of the family office exclusion. In doing so, the staff pointed to the discussion in its Adopting Release stating that separate family offices established by unrelated families, but staffed with the same or substantially the same employees, would create a *de facto* multifamily office. Because Adamson would be serving as a key employee (or director, partner, manager, or trustee) of multiple family offices, he could be deemed to be managing a multifamily office and thus would be unable to rely on the family office exclusion.

Citing both the April 3 no-action letter and the Adopting Release, on April 27, 2012, the SEC staff updated its responses to frequently asked questions ("**FAQs**") about the family office rule to provide that, "[i]f two or more families staff their family offices with the same or substantially the same employees that provide investment advice to the families, such employees would be managing a *de facto* multifamily office" and thus would not qualify for the family office exclusion, which is available only to single-family offices. For a discussion of responses to other family office rule FAQs, see the ***February 21, 2012 Investment Management Regulatory Update***.

- See a copy of the no-action letter
- See a copy of the Adopting Release
- See a copy of the staff's responses to the FAQs

Industry Update

Legislation Imposing Investment Adviser Oversight by SROs Is Introduced in the House

On April 25, 2012, House Financial Services Committee Chairman Spencer Bachus (R-Ala.) and Representative Carolyn McCarthy (D-N.Y.) introduced in the U.S. House of Representatives a bill—the Investment Adviser Oversight Act of 2012 (the "**Oversight Act**")—that would amend the Advisers Act to require that investment advisers registered with the SEC or with a State (subject to certain exemptions discussed below) become members of a "registered national investment adviser association" ("**NIAA**"). According to a House Financial Services Committee press release, the bill is designed to "create more efficient and effective oversight of the retail investment advisory industry" and is meant to capture "[i]nvestment advisers that conduct business with retail customers." As such, the Oversight Act would exempt certain investment advisers from the requirement to register with an NIAA, including the following: (i) any investment adviser one or more of whose clients is an investment company registered under the Investment Company Act of 1940 (the "**Investment Company Act**" and such company, a "**RIC**"); and (ii) any investment adviser with "total assets under management 90% or more of which are attributable individually or in the aggregate" to certain clients with which the adviser has a written advisory contract—including: a non-U.S. client; a "qualified purchaser"; an issuer that would be an "investment company" but for Section 3(c)(10), 3(c)(5)(C) or 3(c)(11) of the Investment Company Act or Rule 3a-7 thereunder; a private fund; an SEC- or State-registered adviser. An investment adviser that is controlling, controlled by, or under common control with, one or more advisers described in clause (i) or (ii) above would also be exempt if 90% or more of the combined assets under management of such advisers are attributable to RICs and/or the types of clients described in clause (ii) above, unless the SEC determines, by order, that the compliance programs, operations, and business of such advisers are sufficiently independent from those of the other advisers that membership of an NIAA is "necessary in the public interest for the protection of investors or in furtherance of the purposes" of the Oversight Act.

Under the Oversight Act, an NIAA would become registered by filing an application with the SEC "in such form, and containing the rules of the association and such other information and documents, as the [SEC], by rule, may prescribe." Prior to approving the registration of any NIAA, the SEC would have to determine that the association is capable of carrying out the purposes of the Oversight Act and enforcing compliance by its members, and that its rules of association "are designed to prevent fraudulent and manipulative acts and practices, to protect investors and the public interest, and to promote business conduct standards for its members consistent with their obligations to investors under [the Oversight Act] and the rules thereunder . . . ." In addition to meeting various other specified criteria, the rules of an NIAA would have to provide for periodic examinations of its members and persons associated with its members, other than advisers that are registered in the State in which they maintain their principal office and place of business if the State has a "plan to conduct an on-site examination of all such advisers on average at least once every four years" (although the NIAA would be able to conduct for-cause examinations of such advisers). The Oversight Act also details various aspects of SEC oversight, including procedures for approving or denying registration of, and proposed rules or rule changes for, an NIAA, annual SEC inspection of NIAAs, and SEC enforcement power over NIAAs.

According to the House press release, the Oversight Act was introduced in response to a 2011 SEC study, mandated by the Dodd-Frank Act, that "revealed the [SEC] lacks resources to adequately examine the nation's nearly 12,000 registered advisers." The study, which is discussed in further detail in the ***February 14, 2011 Investment Management Regulatory Update***, considers various options for increased investment adviser oversight, including the use of one or more self-regulatory organizations to supplement the SEC's oversight authority.

We will continue to monitor developments.

- See a copy of the Oversight Act

- See the House Financial Services Committee press release

Federal Reserve Issues Guidelines on Volcker Rule Conformance Period

On April 19, 2012, the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") issued guidelines confirming that banking entities will have until "the end of the conformance period," *i.e.*, July 21, 2014, or such later date as specified by the Federal Reserve, to conform their activities, investments, relationships and transactions to the provisions of the Dodd-Frank Act that are commonly referred to as the "Volcker Rule." The Volcker Rule, which is technically an amendment to the Bank Holding Company Act (the "**BHCA**"), will restrict the ability of banking entities to sponsor and invest in, and have certain other relationships with, private funds. The Federal Reserve's guidelines clarify previous guidance that was discussed in the ***October 14, 2011 Investment Management Regulatory Update***, according to which banking entities would have had to conform their activities "as soon as practicable" after July 21, 2012.

According to the guidelines, during the conformance period, a banking entity should use "good-faith efforts . . . that will result in the conformance of all of its activities and investments" by the end of such period. The guidelines also provide that "good-faith efforts" include the evaluation of a banking entity's activities and investments covered by Section 13 of the BHCA and establishing and implementing a conformance plan that is "as specific as possible."

For additional discussion of the guidelines, please see the April 20, 2012 Davis Polk Client Memorandum, ***Volcker Rule Conformance Period Guidelines***.

- See a copy of the guidelines

SEC Approves Proposed FINRA Communications Rules

In a March 29, 2012 release (the "**Release**"), the SEC approved, on an accelerated basis, new rules proposed by the Financial Industry Regulatory Authority ("**FINRA**") that govern communications by FINRA members with customers and the public, including fund offering materials that are published or distributed by a FINRA member. The new rules will reorganize and simplify the existing communications rules and will also introduce some noteworthy changes.

New FINRA Rule 2210 ("Communications with the Public") will incorporate NASD Rules 2210 and 2211, related NASD Interpretive Materials, as well as portions of Incorporated NYSE Rule 472, and new FINRA Rules 2212 through 2216 will incorporate certain Interpretive Materials that currently follow NASD Rule 2210. In addition to codifying certain existing interpretations, FINRA Rule 2210 will generally continue to impose the content standards of the existing rules that must be satisfied for all communications with the public, including materials used or distributed by placement agents to solicit investors in registered and unregistered funds. For example, new FINRA Rule 2210(d) will now specifically require communications to be "clear and not misleading within the context in which they are made" and to "provide balanced treatment of risks and potential benefits," and members will have to "consider the nature of the audience to which the communication will be directed and . . . provide details and explanations appropriate to the audience." In addition, new FINRA Rule 2210(c) will require that all retail communications (not just advertising and sales materials as currently required) concerning a registered investment company be filed with FINRA ten days prior to first use, to the extent that such communications include "performance rankings or comparisons of the investment company with other investment companies when the ranking or comparison is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate."

According to the Release, FINRA has indicated that it will publish a Regulatory Notice by June 27, 2012 announcing the implementation date for the new rules (which will be no later than 365 days following SEC approval—*i.e.*, by March 29, 2013) and, in setting the implementation schedule, will take into account that FINRA members may need time to alter their internal policies and procedures in response to the new rules.

For further information on the new rules, see the April 18, 2012 Davis Polk Client Memorandum, ***SEC Approves Amendments to FINRA Communications Rules***.

- See a copy of the Release
- See a copy of the new rules

CFTC and SEC Adopt Final Rules Defining Swap Dealer, Major Swap Participant and Eligible Contract Participant

On April 18, 2012, in accordance with the Dodd-Frank Act, the Commodity Futures Trading Commission (the "**CFTC**") and the SEC adopted final rules further defining the terms "swap dealer," "security-based swap dealer," "major swap participant," "major-security-based swap participant," and "eligible contract participant." The rules set the initial threshold for the *de minimis* exclusion from the requirement to register as a swap dealer or security-based swap dealer at (i) $8 billion for swaps connected with dealing activity effected during a 12-month period for CFTC-regulated swaps and all credit default swaps and (ii) $400 million for other security-based swaps, although these thresholds are subject to certain exceptions and will be reduced in the future. The final rules also include several exclusions from the definitions of swap dealer and security-based swap dealer for certain types of activities, such as hedging of price risk associated with physical positions. Further, among other things, the rules confirm that, absent a limited purpose designation, the registration of a swap dealer or security-based swap dealer applies to the entire legal entity and to all such person's swaps or security-based swaps. The definitions will be effective 60 days after they are published in the Federal Register. For more information on the final rules, see the May 2, 2012 Davis Polk Client Memorandum, ***CFTC and SEC Adopt Final Swap Dealer, Major Swap Participant and Eligible Contract Participant Definitions***.

- See a copy of the final rule release

2011 Annual Survey of U.S. Direct Investment Abroad Deadline Nears

The Bureau of Economic Analysis (the "**BEA**"), an agency of the U.S. Department of Commerce, conducts surveys that collect information on the financial and operating data of foreign affiliates of U.S. business enterprises. According to the BEA, the information gathered in the BEA reports is used for securing current economic data and is not used for taxation, investigation, regulation or in a manner that identifies individual reporters. One such report is the BE-11 report which applies to certain private equity funds, hedge funds and their advisers.

Who Must File. A U.S. business enterprise that owns or controls at least 10% of the voting securities issued by a foreign business enterprise (a "**Foreign Affiliate**") at the end of its most recent fiscal year must file a BE-11 report for itself and for each of its Foreign Affiliates, unless, as described below, an exemption applies. For purposes of the BE-11 report, the BEA generally considers general partner interests to be "voting securities." Entities related to a U.S. investment adviser that might be considered Foreign Affiliates include, among others, foreign subsidiaries, offshore funds of which the investment adviser or its U.S. affiliate is the general partner and fund portfolio companies that are foreign business enterprises. The entity that is required to file the report (the "**U.S. Reporter**") is the top tier U.S. domestic business enterprise (*e.g.*, the U.S. business enterprise not majority owned by any other U.S. business enterprise, excluding individuals, estates, trusts and non-profit organizations). For purposes of the BE-11, a U.S. Reporter must fully consolidate all of its majority-owned U.S. business enterprises.

Exemption from Reporting. An exemption from reporting is provided with regard to (i) any Foreign Affiliate that was acquired or established in the most recent fiscal year if it has no more than $25 million of each of the following three items for the most recent fiscal year ("**Exemption Level Items**"): (a) total assets, (b) sales or gross operating revenues excluding sales taxes and (c) net income after provision for U.S. income taxes and (ii) any other Foreign Affiliate, if none of its Exemption Level Items exceed $60 million (each, an "**Exempt Affiliate**"). A U.S. Reporter whose Foreign Affiliates are all Exempt Affiliates is not required to file any BE-11 reports at all.

Filing Information. BE-11 reports are mandatory for entities that meet the required thresholds, regardless of whether they have been notified by the BEA of their filing obligation. According to the BE-11 report, failure to report can result in a civil penalty of up to $25,000 and willful failure to report may result in criminal penalties of up to $10,000 and one year of imprisonment. Criminal penalties can also be imposed, according to the BE-11 report, upon an officer, director, employee, or agent of an entity who knowingly participates in the willful failure to report. The BE-11 reports have been required for several years, and the BEA has stated to us informally that going forward it intends more rigorously to enforce filing obligations. The deadline for filing BE-11 reports with the BEA is May 31, 2012. This deadline may be extended by request and the length of such extension will vary depending upon the number of forms expected to be filed. The BE-11 report can be filed electronically via the BEA's website or by mailing the printed form.

Litigation

Federal Appeals Courts Rule in Excessive Fee Cases Under the Investment Company Act

Eighth Circuit Upholds Dismissal of Claims by Mutual Fund Shareholders

On March 30, 2012, the U.S. Court of Appeals for the Eighth Circuit upheld a grant of summary judgment in favor of the advisers to nine mutual funds, dismissing claims brought by fund shareholders alleging excessive advisory fees in violation of Section 36(b) of the Investment Company Act. *Gallus v. Ameriprise*, 2012 U.S. App. LEXIS 6424 (8th Cir. Mar. 30, 2012). Under Section 36(b), an investment adviser to a registered investment company owes "a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser" or any affiliate thereof. Although the Eighth Circuit initially vacated the district court's grant of summary judgment finding that the district court had erred in concluding that there was no Section 36(b) violation merely because the fees were not patently excessive and that the proper analysis under Section 36(b) should consider "both the adviser's conduct during the negotiation and the end [fee] result," G*allus v. Ameriprise Financial, Inc.,* 561 F.3d 816 (8th Cir. 2009), the U.S. Supreme Court decided *Jones v. Harris Associates* following the Eighth Circuit's decision and then vacated the Eighth Circuit's initial holding and remanded the case for further consideration in light of *Jones*. The Eighth Circuit, in turn, remanded to the district court which, in applying *Jones,* again granted summary judgment in favor of the defendants.

In reviewing the decision of the district court *de novo*, the Eighth Circuit considered whether the plaintiffs raised a genuine issue of material fact as to whether defendants charged "a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining," in accordance with the *Jones* standard. As articulated by the Eighth Circuit, "after *Jones*, a process-based failure"—*e.g.*, a deficiency in the funds' board deliberations or in the fee information provided to the board—"alone does not constitute an independent violation of Section 36(b)," but rather Section 36(b) "is sharply focused on the question of whether the fees themselves were excessive." In other words, according to the Eighth Circuit, *Jones* does not "allow a deficient process to be additional evidence required to survive summary judgment . . . because [*Jones*] focuses on evidence that the fee is outside the arm's length range." Nonetheless, "[t]he fee negotiation process remains critically important, as it allows the court to determine the amount of deference to give the board's decision to approve the fee"—in other words, if the board's approval process is robust, the court should give it deference, but if it is deficient or significant information is withheld from the board, then the court must conduct a more rigorous review.

Finding that the board's process could "fairly be described as robust," the Eighth Circuit gave deference to the board's decision. However, the court noted that more deference would have been given "had the [b]oard not focused primarily on tethering the fees to the industry median" since *Jones* had "cautioned courts that [] comparisons [of fees charged by other advisers] are problematic because the comparison fees, like those challenged, may not be the product of negotiations conducted at arm's length." In addition, although the Eighth Circuit found that the disparity in the fees charged by the adviser to different clients informs the issue of whether fees are excessive, the court concluded that the plaintiffs had failed to present additional evidence that the fees were outside of arm's length range, as required by *Jones.*

The Supreme Court's decision in *Jones* is discussed in additional detail in the ***April 6, 2010 Investment Management Regulatory Update***.

- See a copy of the Eighth Circuit's opinion
- See a copy of *Jones v. Harris*

Third Circuit Upholds Dismissal of Claims by Retirement Plan Participants

On April 16, 2012, the U.S. Court of Appeals for the Third Circuit upheld a district court's dismissal of excessive fee claims brought by three individuals against John Hancock Life Insurance Company (U.S.A.) and its affiliates ("**John Hancock**") alleging that John Hancock had charged plaintiffs' retirement plans excessive fees on annuity contracts offered to plan participants in violation of Section 36(b) of the Investment Company Act. *Santomenno v. John Hancock Life Insurance Company (U.S.A.), et al.,* No. 11-2520 (3d Cir. Apr. 16, 2012). The Third Circuit affirmed the district court's decision to grant John Hancock's motion to dismiss on the grounds that plaintiffs lacked standing to bring the Section 36(b) claims because they did not own the securities in question during the course of the entire litigation. Under Section 36(b), "[a]n action may be brought . . . by the [SEC], or by a security holder of [a] registered investment company on behalf of such company . . . ." According to the Third Circuit, "Section 36(b) plainly requires that a party claiming a breach of the fiduciary duty imposed by that legislative provision be a security holder of the investment company at the time the action is initiated." The Third Circuit further reasoned that "[i]mposing a *continuous* ownership requirement throughout the pendency of the litigation assures that the plaintiff will adequately represent the interests of the security holders in obtaining a recovery for the benefit of the company."

The Third Circuit also rejected plaintiffs' argument that the district court erred in dismissing their claims under Section 26(f) of the Investment Company Act, which requires that fees charged be "reasonable in relation to the services rendered," and Section 47(b), pursuant to which a contract made in violation of (or whose performance involves a violation of) the Investment Company Act is unenforceable. Finding that Section 36(b) is the "exclusive" private right of action under the Investment Company Act and that Section 47(b) does not create such a right, the Third Circuit concluded that the plaintiffs could not bring an action under Section 47(b) to enforce the standards of Section 26(f). Nor was the court persuaded by the argument that Section 47(b) should be viewed as creating a private right of action given that the U.S. Supreme Court had found such a right in Section 215 of the Advisers Act, noting instead the significant "differences in text and structure" between the two provisions.

- See a copy of the Third Circuit's opinion

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