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Industry Update

Regulators Release Proposed Regulations Implementing the Volcker Rule

On October 11, 2011, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency released proposed regulations implementing the Volcker Rule. (On October 12, 2011, the Securities and Exchange Commission released its own version of the same proposed regulations, which were substantively identical to the ones released by the other three regulators.) For prior Davis Polk discussions of the Volcker Rule please see the Davis Polk Client Memoranda ***Senate-House Conference Agrees on Final Volcker Rule***, ***Summary of the Federal Reserve's Final Regulations on the Conformance Period of the Volcker Rule*** and the ***December 17, 2010*** and ***March 15, 2011 Investment Management Regulatory Updates***.

The Dodd-Frank Act requires these four regulators and the Commodities Futures Trading Commission to consult and adopt rules restricting the ability of banking entities (i) to engage in proprietary trading and (ii) to invest, sponsor or enter into certain transactions with hedge funds or private equity funds.

Slides that map the key restrictions on proprietary trading and on relationships with hedge funds or private equity funds are available in the Davis Polk Client Memorandum ***Volcker Rule – Proposed Regulations***.

Comments on the proposed regulations are due by January 13, 2012. The statutory Volcker Rule prohibitions will become effective on July 21, 2012, whether or not regulations are finalized by that date.

- See a copy of the proposed regulations

SEC Grants No Action Relief from Pay-to-Play Recordkeeping Requirements

The Securities and Exchange Commission (the "**SEC**") issued a no-action letter on September 12, 2011 to the Investment Company Institute (the "**ICI**") that provides conditional relief from the recordkeeping requirements of Rule 206(4)-5 (the "**Pay-to-Play Rule**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), to registered investment advisers who advise registered investment companies that are investment options of a plan or program of a government entity ("**Registered**

Covered Investment Pools"). See the ***July 14, 2010***, ***April 15, 2011*** and ***May 17, 2011 Investment Management Regulatory Updates*** for an overview of and recent developments regarding the Pay-to-Play Rule.

Under the Pay-to-Play Rule, among other things, an investment adviser is required to comply with Rule 204-2(a)(18)(i)(B) under the Advisers Act (the "**Government Plan Recordkeeping Rule**"), which requires a registered investment adviser to make and maintain a list of all government entities that are or were an investor in a Registered Covered Investment Pool to which the investment adviser provides or has provided investment advisory services in the past five years (but not before September 13, 2010). The no-action letter indicated that, because many of these government accounts are held in omnibus positions on a registered fund's books and records, and because such a fund and its adviser may not have information on the shareholders in these accounts, there are difficulties in complying with the Government Plan Recordkeeping Rule with respect to these accounts. To address the concern with respect to the lack of transparency in omnibus accounts and the potential for widespread non-compliance, the SEC has issued no-action relief that permits advisers to satisfy the recordkeeping requirement of the Government Plan Recordkeeping Rule relating to Registered Covered Investment Pools through alternative means that do not require investment advisers to pierce their omnibus accounts or seek information from their omnibus accountholders in order to comply with the Government Plan Recordkeeping Rule.

The SEC no-action relief allows an adviser to satisfy its recordkeeping requirements under the Government Plan Recordkeeping Rule if it makes and keeps a list or other record that includes:

- Each government entity that invests in a Registered Covered Investment Pool whose account can reasonably be identified as being held in the name of or for the benefit of such government entity on the records of the Registered Covered Investment Pool or its transfer agent;
- Each government entity whose account was identified as that of a government entity, at or around the time of the initial investment, to the adviser or one of its client servicing employees, regulated persons or covered associates;
- Each government entity that sponsors or establishes a 529 Plan and has selected a specific Registered Covered Investment Pool as an option to be offered by such 529 Plan; and
- Each government entity that has been solicited to invest in a Registered Covered Investment Pool either (i) by a covered associate or regulated person of the adviser; or (ii) by an intermediary or affiliate of the Registered Covered Investment Pool if a covered associate, regulated person, or client servicing employee of the adviser participated in or was involved in such solicitation, regardless of whether such government entity invested in the Registered Covered Investment Pool.
  - See a copy of the SEC No-Action Letter
  - See a copy of the ICI No-Action Request

SEC Plans to Consider Raising the 500 Shareholder Threshold for SEC Registration

At a congressional hearing on September 15, 2011, SEC Chairman Mary Schapiro told the House Financial Services Committee (the "**House Committee**") that changing the requirement for companies with more than 500 shareholders to register with the SEC would be the first item on the SEC's agenda for its newly created Business Advisory Committee on Small and Emerging Companies (the "**Advisory Committee**"). Generally, under Section 12(g)(1) of the Securities and Exchange Act of 1934 (the "**Exchange Act**") and Rule 12g-1 thereunder, any company with total assets exceeding $10,000,000 and at least 500 shareholders is required to register under the Exchange Act (the "**500 Shareholder Rule**").

Several new pieces of legislation have recently been proposed to loosen the 500 shareholder threshold. In June 2011, the Private Company Flexibility and Growth Act proposed doubling the threshold to 1,000 shareholders and excluding accredited investors and certain employees from the calculations. Another piece of legislation, the Community Banks Serving Their Communities First Act, has proposed, among other things, raising the threshold to 2,000 shareholders in some circumstances.

In commenting on the SEC's plans to address raising the shareholder registration threshold, Chairman Schapiro emphasized the care with which such an increase should be considered. She explained that the SEC is "moving very deliberately" in considering an increased threshold and explained that "when the 500 limit was put in place there had been years of study." Chairman Schapiro stressed that the 500 shareholder cap was "carefully calibrated and we don't want to just toss it out the window." Nonetheless, she suggested that in addition to raising the threshold, the Advisory Committee is considering excluding accredited investors and/or certain employees when calculating the threshold.

- Listen to SEC Chairman Mary Schapiro's Testimony
- See a copy of the Community Banks Serving Their Communities First Act bill
- See a copy of the Private Company Flexibility and Growth Act bill

Litigation

SEC Charges Co-Founder of AXA Rosenberg Group, LLC with Securities Fraud for Concealing Quantitative Investment Modeling Error

On September 22, 2011, the SEC charged Barr M. Rosenberg, co-founder of the money manager AXA Rosenberg Group, LLC ("**AXA Rosenberg**"), with securities fraud. The charges arose out of SEC allegations that Rosenberg concealed a significant material error in the computer code of the quantitative investment model developed by him and used by AXA Rosenberg to manage client portfolios, causing client losses of $217 million. Previously in February 2011 the SEC charged three AXA Rosenberg entities, AXA Rosenberg, Barr Rosenberg Research Center LLC ("**BRRC**") and AXA Rosenberg Investment Management LLC ("**ARIM**"), with securities fraud in connection with the same incidents. In settling these charges, the three entities agreed to pay $217 million to harmed clients as well as a $25 million penalty. For more information concerning this enforcement action, please see the ***March 15, 2011 Investment Management Regulatory Update***.

According to the SEC, Rosenberg was the original developer of the quantitative investment model, oversaw important research projects associated with the model, and exercised significant authority over the AXA Rosenberg entities. According to the SEC, it was brought to Rosenberg's attention in June 2009 that a material error disabling a key component for managing risk had been introduced into the quantitative investment model's code in 2007. Instead of disclosing and correcting the error immediately upon discovery, Rosenberg allegedly directed others to conceal the error, did not take steps to have the model's computer code fixed, and also concealed the error from the AXA Rosenberg Board in the October 2009 board meeting. As a result, the SEC alleged, AXA Rosenberg, 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. AXA Rosenberg 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. On April 15, 2010, AXA Rosenberg disclosed the error to its clients. The SEC indicated that AXA Rosenberg clients expressed dissatisfaction with their portfolios' performance both before and after the error was discovered and Rosenberg and others at BRCC were aware of these concerns. The SEC further alleges that Rosenberg's instructions to delay fixing the error resulted in additional client losses.

The SEC alleges that Rosenberg's actions constitute a willful violation of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, both of which are anti-fraud provisions.

In settlement of the SEC's charges, Rosenberg agreed to the entry of an SEC cease-and-desist order, a $2.5 million penalty and a lifetime ban from the securities industry.

- See a copy of the SEC order
- See a copy of the SEC press release

SEC Charges Former Goldman Employee and His Father in First Ever ETF Insider Trading Enforcement Action

On September 21, 2011, the SEC charged a former employee of Goldman, Sachs & Co. ("**Goldman**"), Spencer Mindlin, and his father, Alfred Mindlin, with insider trading. The SEC alleges that the pair illegally traded four different underlying securities of the SPDR S&P Retail ETF (the "**XRT**") while using material nonpublic information regarding Goldman's hedging intentions regarding the XRT. The charges mark the SEC's first insider trading enforcement action involving exchange-traded funds ("**ETFs**").

The XRT is an equal-weighted ETF made up of a mixture of apparel, automotive and bargain retailers based in the U.S. According to the SEC, in December 2007 and March 2008, when the alleged insider trading took place, Goldman was the largest institutional holder of XRT. In order to hedge its long position in the XRT, Goldman shorted the individual securities underlying the XRT. The SEC alleges that, as a result of his position on the ETF desk, and more specifically through emails he received in the course of his business, Spencer Mindlin knew of Goldman's nonpublic position in the XRT and its nonpublic plans to hedge its position in the XRT by trading large amounts of its underlying securities.

In December 2007 and March 2008, the SEC contends, Spencer and Alfred Mindlin traded in four different underlying securities of the XRT in anticipation of Goldman's large, market-moving trades in these securities, reaping over $57,000 in profits. According to the SEC, the Mindlins used a non-Goldman brokerage account in a family member's name for most of these trades, which Spencer Mindlin failed to disclose to Goldman, against firm policy.

Pursuant to these allegations, the SEC has instituted public administrative and cease-and-desist proceedings, charging the Mindlins with a willful violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

- See a copy of the SEC complaint
- See a copy of the SEC press release

Hedge Fund Directors Under Scrutiny by Cayman Court

On August 26, 2011, the Grand Court of the Cayman Islands (the "**Court**") ordered Stefan Peterson and Hans Ekstrom, the former directors of the hedge fund Weavering Macro Fixed Income Fund Limited (the "**Macro Fund**"), to pay $111 million in damages to the Macro Fund for losses caused by the "willful neglect or default" of their duties. *Weavering Macro Fixed Income Fund Ltd. (In Liquidation) v. Peterson* (unreported) Grand Ct. (Fin. Serv. Div.) No. FSD 113 26th Aug. 2011. According to the Court, Peterson and Ekstrom (together, the "**Directors**") "consciously chose not to perform their duties to the Macro Fund, or at least not in any meaningful way," and "did nothing" with respect to their duties as directors over a sustained period of time.

In assessing the actions of the Directors, the Court provided guidance on what is expected of directors of an open ended investment company incorporated in the Cayman Islands throughout the life of the fund:

Duties in connection with fund establishment

The Court rejected the Directors' argument that they were entitled to delegate their task of reviewing the Macro Fund's articles of association and service providers' contracts to their professional advisors, stating that it was the duty of the Directors themselves to review the Macro Fund establishment documents and verify that each one met industry standards and created an appropriate and satisfactory management structure. Additionally, the court asserted that the Directors had a duty to ensure that the offering documents of the fund complied with the disclosure requirements outlined in the Cayman Islands Mutual Funds Law and that relying on legal counsel to make this assurance did not satisfy fiduciary duties.

Duties in connection with ongoing fund operations

The Court determined that the Directors had very little involvement with the operations of the Macro Fund. According to the Court, the board meetings held by the Directors, which according to the court were the crux of their defense that they had performed their duties as directors, did not satisfy their fiduciary duties. The Directors never requested quarterly reports to be given at these meetings or asked any of the employees whom they supervised to give written or oral reports at any meeting, according to the Court. Among other things, the Court found that (i) each board meeting consisted solely of a discussion between Mangus Peterson, the principal investment adviser to the Macro Fund and Stefan Peterson's older brother, and the Directors, (ii) no agendas were created or records kept of the discussions carried out at these meetings and (iii) in place of minutes, pro forma documents were used that were produced by amending templates in advance of meetings and that did not contain a record of what was discussed. According to the Court, two of the quarterly meetings never took place at all, and minutes were fabricated to make it appear as though they did. In short, the Court contended that "there is no evidence that any real business was ever in fact conducted at these meetings."

Duties during a crisis and liquidation

The Court found that "the way in which [the Directors] behaved during this most serious financial crisis is … the most compelling evidence that they never intended to perform their duties as directors." The Court emphasized that additional supervision and diligence was required of the Directors during the financial crisis, which they failed to provide. In particular, the Court indicated that the Directors failed to review critical sections of the Q3 and Q4 2008 quarterly reports of the Macro Fund, despite there having been significant redemption requests. In addition, the Court concluded that the Directors failed to hold appropriate board meetings to discuss (i) the solvency risk of the Macro Fund's principal counterparty, (ii) the massive redemption requests of investors in the Macro Fund and (iii) generally, the financial condition of the Macro Fund.

The Court held that the Directors were guilty of willful neglect or default, and were liable for the Macro Fund's losses in the amount of $111 million. According to news reports, the defendants are appealing the Court's decision.

- See a copy of the judgment of the Court

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

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