Investment Management Regulatory Update

SEC Rules and Regulations

SEC Proposes Rule Defining "Family Offices" under the Dodd-Frank Act

On October 12, 2010, the SEC proposed rule 202(a)(11)(G)-1 (the "**Proposed Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**") to define "family offices" as required by Title IV of the Dodd-Frank Act. Pursuant to Section 409 of the Dodd-Frank Act, a company that is a family office is excluded from the definition of an investment adviser under the Advisers Act and thus would generally not be subject to any provisions of the Advisers Act. For a summary of the entirety of the Dodd-Frank Act, including Title IV, please see the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010***.

"Family offices" are generally entities established by wealthy families to manage the assets of, and provide other services to, its family members. The SEC estimates that there are 2,500 to 3,000 single family offices, generally servicing families with at least $100 million of investable assets. Services provided by family offices typically include portfolio management, financial, tax, accounting and estate planning advice for family members.

Family offices generally meet the definition of an "investment adviser" under Section 202(a) of the Advisers Act because family offices are in the business of providing advice about securities for compensation. Although some family offices have been excepted from the definition of investment adviser by exemptive order, many family offices are currently exempt from registration under Section 203(b)(3) of the Advisers Act, which is the "private investment adviser" exemption from registration for an adviser that had fewer than 15 clients during the course of the preceding 12 months and does not hold itself out to the public as an investment adviser. The Dodd-Frank Act will repeal the "private investment adviser" exemption, effective July 21, 2011.

Section 409 of the Dodd-Frank Act, however, creates an exclusion from the definition of an investment adviser for any family office (as defined by the SEC), thus placing such entities generally outside the scope of the Advisers Act. Section 409 of the Dodd-Frank Act directs the SEC to define the term "family office" consistently with previous exemptive policy of the SEC and in a manner that recognizes "the range of organizational, management, and employment structures and arrangements employed by family offices." The Proposed Rule is designed to codify exemptive orders that were previously issued by the SEC to family offices and reflects the SEC's current exemptive policy regarding family offices. The main policy behind the previously-issued SEC exemptive orders is that the Advisers Act was not designed to regulate families in the management of their own assets.

The Proposed Rule would define a family office as any firm that (i) has no clients other than family clients, (ii) is wholly owned and controlled (directly or indirectly) by family members and (iii) does not hold itself out to the public as an investment adviser.

Family Clients

The Proposed Rule provides that excluded family offices would not be permitted to have any investment advisory clients other than "family clients." Family clients include (i) family members, (ii) key employees of the family office, (iii) charities (foundations, organizations or trusts) established and funded exclusively by family members and former family members, (iv) trusts or estates that exist for the sole benefit of family clients, (v) entities wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, family clients (with certain exceptions) and, under certain circumstances, (vi) former family members and former key employees.

Family Member. The proposed definition of the term "family member" includes (i) founders, their lineal descendants (including adopted children and stepchildren) and such lineal descendants' spouses or spousal equivalents, (ii) parents of the founders and (iii) the siblings of the founders, including such siblings' spouses or spousal equivalents and their lineal descendants (including adopted children and stepchildren) and such lineal descendants' spouses or spousal equivalents.

The Proposed Rule would not extend to family offices that serve multiple families. The SEC notes in the proposing release that it has never granted a family office exemptive order to a multifamily office.

Involuntary Transfers. In cases where assets under the management of a family office are transferred involuntarily to a person or entity that does not qualify as a family client, the Proposed Rule would allow the family office to continue to advise such a client without violating the terms of the exclusion for four months following the transfer resulting from the involuntary event. Within that four-month period, the family office would have to transfer the assets, obtain an exemptive ruling, or otherwise restructure to comply with the Advisers Act.

Former Family Members. The Proposed Rule would allow former family members (e.g., former spouses, spousal equivalents and stepchildren) to retain investments that were held through the family office at the time they became a former family member, but would prohibit such former family members from making new investments through the family office.

Family Trusts, Charitable Organizations and Other Family Entities. Under the Proposed Rule, (i) any charitable foundation, organization or trust established and funded exclusively by one or more family members, (ii) any trust existing for the sole benefit of one or more family client and (iii) any company, including a pooled investment vehicle, that is wholly owned and controlled, directly or indirectly, by one or more family members and operated for the sole benefit of family clients, would be treated as a family client.

Key Employees. Key employees would be able to participate in the investment opportunities provided by the family office and receive investment advice from the family office. A key employee is defined as any natural person who is (i) an executive officer, director, trustee, general partner, or a person who serves in a similar capacity of the family office or (ii) a family office employee who participates in the investment activities of the family office in connection with that employee's regular duties (other than performing solely clerical or similar duties), and has been performing such duties for the family office (or substantially similar duties for another company) for at least 12 months. The SEC believes this definition would limit the proposed class of employees to those who have a sufficient knowledge in financial matters to be able to evaluate the risks and take steps necessary to protect themselves and would not need the protections of the Advisers Act. Subject to conditions relating to control and ownership that apply equally to family members, key employees would be able to structure their investments through various entities, such as trusts. Consistent with its treatment of former family members, the Proposed Rule would not require former key employees to transfer or liquidate the investments that such key employees held through the family office at the time their employment ends.

Ownership and Control

Under the Proposed Rule, the family office would need to be wholly owned and controlled by family members. The rationale for this requirement, according to the SEC is (i) that the family is in a position to protect its own interest and is less likely to need the protection of the federal securities laws, (ii) that the requirement distinguishes family offices from family-run offices that function as a more typical commercial investment adviser and (iii) to alleviate any concerns about the profit structure of the family office, though the Proposed Rule does not contain a condition regarding whether or not the family office generates a profit.

The Proposed Rule also contains a grandfathering provision that includes in the definition of a family office persons not registered or required to be registered under the Advisers Act on January 1, 2010 that would meet all of the required conditions under the Proposed Rule but for the provision of investment advice to certain clients, including, for example, (i) natural persons who, at the time of their investment, are officers, directors or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors or (ii) any company owned exclusively and controlled by one or more family members.

The SEC is not proposing to rescind exemptive orders previously issued to family offices, which, according to the SEC, may be slightly broader in some areas than the Proposed Rule, while narrower in other areas. Family offices currently operating under the exemptive orders could continue to rely on such orders, or, if they meet the conditions of the Proposed Rule, they could rely on the Proposed Rule.

- See a copy of the Proposed Rule
- See a copy of the SEC's press release

SEC Requests Comment on President's Working Group Study of Money Market Fund Reforms

On November 3, 2010, the SEC published a request for comment on the recently released President's Working Group ("**PWG**") report that examines potential money market fund reforms. The PWG is composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board of Governors, the Chairman of the SEC and the Chairman of the CFTC. The PWG report proposes a number of possible measures to address the systemic risk of money market funds and their susceptibility to runs. The report notes that while some of their proposed measures could be implemented by the SEC under current statutory authorities, other broader proposed changes would likely require new legislation, inter-governmental agency coordination and the creation of new private entities. In addition, the PWG report requests that the Financial Stability Oversight Council (the "**FSOC**"), which is undertaking an analysis of the systemic risk posed by certain nonbank financial entities, consider the proposals in the report "to identify those most likely to materially reduce [money market funds'] susceptibility to runs and to pursue their implementation."

In light of the substantial run on prime money market funds that occurred after the Reserve Primary Fund "broke the buck" in September 2008, the PWG is of the opinion that the primary objective of money market fund reforms should be to mitigate systemic risk and suppress any contagious effect that the strain of any particular money market fund can create on other money market funds and the financial system as a whole. The report does not prescribe any specific plan, but presents a discussion of reform options and the potential benefits and risks of each option. In particular, the report proposes the following as potential strategies for money market fund reform:

- *Floating net asset values ("**NAVs**")*. Perhaps the most dramatic change proposed is for money market funds to move to a floating NAV. According to the PWG, this shift would help dispel expectations of money market funds being risk-free and reduce investors' incentives to redeem shares from funds at risk of a capital loss. Some of the possible negative consequences of the floating NAV include a general reduction in investor demand for money market funds, a shift of assets to other stable NAV vehicles that are less regulated and the uncertainty of investor responses to unstable NAVs.
- *Private emergency liquidity facilities*. The PWG suggests that external liquidity facilities to augment the SEC's new money market fund liquidity requirements could help mitigate liquidity risks associated with money market funds, thus lowering their vulnerability to runs.
- *Mandatory redemptions in kind*. Large redemptions by investors in money market funds impose liquidity costs on other investors by forcing money market funds to sell assets in an untimely manner. Requiring money market funds to distribute large redemptions in kind would force redeeming investors to bear their own liquidity costs, reducing the incentive to make large redemptions.
- *Money market fund insurance*. Insurance for money market fund investors could help mitigate systemic risks associated with money market funds, substantially reducing shareholder losses when the money market fund suffers a capital loss and therefore reducing the risk of runs. Determining the scope, pricing and source of such insurance would present significant challenges.
- *Two-tier system of money market funds with enhanced protection for stable NAV funds*. Allowing investors to select between stable and floating value money market funds, with the former being subject to enhanced protections, could mitigate the risks and disadvantages associated with each type of fund, provided that investors understand those risks.
- *Two-tier system of money market funds with stable NAV funds reserved for retail investors*. Similarly, a two-tiered system could be established in which institutional investors would be limited to floating NAV funds, while stable NAV money market funds would only be available to retail investors. The PWG report noted that the September 2008 run on money market funds was primarily due to redemptions from prime money market funds by institutional investors. The PWG proposes that such a two-tiered system would preserve money market funds' original purpose of providing retail investors with "cost-effective access to diversified investments in money market instruments" and reduce the chances that a run in institutional money market funds would spread to retail funds.
- *Regulating stable NAV money market funds as special purpose banks ("**SPBs**")*. Recognizing functional similarities between money market fund shares and bank deposits, the PWG suggests the possibility of requiring stable NAV money market funds to reorganize as SPBs. According to the report, this would allow the SPBs' well-established regulatory framework for mitigating systemic risk to be applied to money market funds; however, the report also recognizes the substantial challenges associated with implementing such a reorganization.

- *Enhanced constraints on unregulated money market fund substitutes*. According to the report, unregulated money market fund substitutes include offshore money market funds, enhanced cash funds, and other stable value vehicles. The growth of such funds, which are less transparent and less constrained than money market funds, would likely pose systemic risks, the report notes. Because measures designed to mitigate risks in money market funds would also likely reduce the appeal of money market funds to some investors, additional reforms may be needed "to address risks posed by funds that compete with [money market funds] and to combat regulatory arbitrage that might offset intended reductions in [money market fund] risks."

As discussed in the ***March 9, 2010*** and ***July 14, 2010 Investment Management Regulatory Updates***, earlier this year, the SEC adopted new rules designed to make money market funds more resilient, reduce the likelihood and impact of runs on money market funds and mitigate systemic risks associated with money market funds. While finding the SEC rules to be effective, the PWG considers them to be the beginning of a regulatory framework that will need to be augmented to more fully address systemic risks and the vulnerability of money market funds to runs.

The SEC hopes that comments will help it, and the FSOC, evaluate the probable effectiveness and consequences of the options discussed the PWG report. Comments must be received no later than January 10, 2011.

- ► See a copy of the SEC's request for comment (PWG report is attached as Appendix)

SEC Proposes Rules Implementing Say-on-Pay and Proxy Vote Reporting Requirements under the Dodd-Frank Act

On October 18, 2010, the SEC proposed rules to implement provisions of the Dodd-Frank Act that require U.S. public companies subject to the SEC's proxy rules to conduct shareholder advisory votes on (i) executive pay ("**Say-on-Pay**"), (ii) the frequency of the Say-on-Pay vote (the "**Frequency Vote**") and (iii) executive payments in connection with M&A transactions that are presented for shareholder approval ("**Say-on-Golden Parachutes**"). Under the Dodd-Frank Act, the Say-on-Pay vote must be held at least once every three years and, at least once every six years, shareholders must be provided a frequency vote on whether the Say-on-Pay vote should occur every one, two or three years. Both the Say-on-Pay vote and the Frequency Vote must be included in any proxy statement for an annual meeting taking place on or after January 21, 2011, regardless of whether the SEC's final rules have become effective.

In a companion release issued the same day, the SEC also proposed rule and form amendments implementing the Dodd-Frank Act provision requiring institutional investment managers subject to reporting requirements under Section 13(f) of the Exchange Act to disclose annually on Form N-PX how they voted on Say-on-Pay, the Frequency Vote and Say-on-Golden Parachutes. Form N-PX is currently used by registered management investment companies ("**RICs**") to file their proxy voting records. The use of Form N-PX would be expanded to include institutional investment managers, but only with respect to say-on-pay, frequency and say-on-golden parachutes votes. The proposed rule would also expand the information required to be reported on Form N-PX, including requiring filers to disclose the number of shares they were entitled to vote (for RICs) or had or shared "voting power" (for institutional investment managers) and the number of shares that were actually voted by the manager. Because RICs disclose their entire proxy voting record on Form N-PX, the proposed rule would extend these requirements to all matters voted on by RICs.

Both releases are discussed in greater detail in the Davis Polk Client Memorandum, ***SEC Proposes Say-on-Pay Rules for Companies and Proxy Vote Reporting Rules for Investment Managers***.

- ► See the SEC release containing the proposed say-on-pay vote, frequency vote and say-on-golden parachute rules

- See the SEC release containing the proposed proxy vote reporting rules

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SEC and CFTC Adopt Interim Final Rules Regarding Reporting and Recordkeeping Requirements for Pre-Dodd-Frank Swaps

The SEC and the CFTC have separately adopted substantially similar interim final rules concerning the reporting of swaps and security-based swaps (collectively, "**Swaps**") that were entered into prior to the enactment of the Dodd-Frank Act but whose terms had not expired as of July 21, 2010. These interim final rules, which are now effective, have been adopted to satisfy the Dodd-Frank Act's requirement for interim rules related to reporting of pre-enactment unexpired swaps within 90 days of enactment of the Dodd-Frank Act, which was enacted on July 21, 2010. Permanent reporting rules, including reporting rules for post-enactment swaps, are required to be adopted by July 16, 2011. While actual reporting will not be required until one or more Swap repositories are registered, the new interim rules impose new recordkeeping obligations on persons who may be required to report pre-enactment Swaps (which will include Swap dealers, and in some cases, other Swap counterparties).

The SEC and CFTC releases and public statements accompanying the interim final rules note that no repositories have registered and that neither the SEC nor the CFTC is prepared to receive Swap data. As a result, the interim final rules defer reporting by counterparties until the earlier of (i) compliance dates established by the SEC and the CFTC in future rulemaking or (ii) 60 days after a repository registers and becomes operational. At such time, counterparties will be required to provide to the repository or the CFTC or the SEC (as appropriate):

- a copy of the transaction confirmation, in electronic form if available, or in written form if there is no electronic copy; and
- the time, if available, that the transaction was executed.

In addition, counterparties are required to provide any additional information regarding pre-enactment unexpired Swaps requested by the relevant regulator, including both transaction-specific and summary data.

For more information, please see the Davis Polk Client Newsflash, ***SEC and CFTC Adopt Interim Final Rules on Reporting and Recordkeeping for Pre-Dodd-Frank Swaps***, which discusses the interim final rules in greater detail.

- See a copy of the SEC's interim final rule
- See a copy of the CFTC's interim final rule

Industry Update

California Enacts Law To Limit "Pay-to-Play" Practices

On September 30, 2010, Governor Schwarzenegger signed into law California Assembly Bill No. 1743 ("**AB 1743**"), which requires "placement agents" to register as lobbyists under California's Political Reform Act of 1974 (the "**Political Reform Act**" or the "**Act**"). A placement agent is an individual retained by an "external manager" to act as a marketer, broker or other intermediary in connection with the sale of securities, assets, or services of an external manager to a California state public retirement system. An external manager is an individual or entity that seeks to be retained by a California state public retirement system to manage a portfolio of securities or other assets for compensation, or is engaged in the business of investing, holding, or trading securities or other assets, and offers or sells securities to a state public retirement system in California.

AB 1743 intends to curb "pay-to-play" practices by placement agents that attempt to raise money or investment from California state pension funds. Pay-to-play practices generally refer to situations when an investment adviser seeking to provide services to a government client makes a political contribution to an elected official in a position to influence the selection of the investment adviser, or to a candidate for such a position, to gain an improper advantage in the hiring process of the investment adviser. See the ***March 9, 2010*** and ***May 10, 2010 Investment Management Regulatory Updates*** for more background on AB 1743. For information regarding the SEC's recently adopted rule to curb pay-to-play practices, see the ***July 14, 2010 Investment Management Regulatory Update***.

In addition to prohibiting individuals from acting as placement agents in connection with a California state retirement system unless such individuals are registered in the state as lobbyists, AB 1743 compels placement agents to comply with the requirements of local governmental agencies in connection with an investment made by a local public retirement system. The Political Reform Act exposes lobbyists and their employing firms to various regulations, including additional filing and reporting requirements and other disclosures. The Act excludes from the definition of placement agent certain individuals including employees, officers and directors of an external manager, provided that such individuals spend at least one-third of their time in a given calendar year managing the assets controlled by an external manager. The Act also excludes certain employees, officers and directors of an external manager (or of an affiliate of an external manager) from the definition of placement agent provided that the external manager (i) is registered with the SEC as an investment adviser or broker-dealer, (ii) was selected through a competitive bidding process in accordance with applicable California state law and (iii) agrees to be subject to a special state-level fiduciary standard of care pursuant to applicable state law.

Knowing or willful violation of the Political Reform Act is considered a misdemeanor and carries a fine of up to the greater of $10,000 or three times the amount failed to be reported or unlawfully contributed for each violation. Furthermore, persons convicted of a misdemeanor under the Act are precluded from acting as lobbyists for a period of four years following the date of conviction, unless a court determines otherwise.

- See a copy of AB 1743 as enacted

SEC Issues No-Action Letter Regarding Compliance with the Annual Audit Provision of the Custody Rule

On October 12, 2010, the staff of the SEC's Division of Investment Management (the "**Staff**") issued a no action letter (the "**Letter**") concerning compliance by certain investment advisers with Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**").

Rule 206(4)-2(b)(4) provides that an adviser will be excepted from compliance with certain provisions of the Custody Rule, if the adviser satisfies certain requirements. Most advisers to private funds satisfy rule 206(4)-2(b)(4) by obtaining annual audits of their private funds (the "**Annual Audit Provision**"). The Annual Audit Provision requires that such annual audits be conducted by an independent public accountant that is registered with the Public Company Accounting Oversight Board ("**PCAOB**") and subject to regular inspection by the PCAOB as of the commencement of the professional engagement period and as of each calendar year-end.

Currently, only auditors to public companies are subject to such regular inspection by the PCAOB. Section 982 of the Dodd-Frank Act, however, which was enacted on July 21, 2010, provides the PCAOB with authority to develop rules to establish a regular inspection program for auditors of brokers and dealers. Because PCAOB rules regarding inspections of broker-dealer auditors are not effective until the SEC gives its prior approval under Sarbanes-Oxley Act Section 107(b), with an opportunity for public notice and comment, such PCAOB rules would not become effective in 2010, given the required notice and comment periods.

The request letter stated that several private fund managers have engaged firms that serve as auditors to brokers or dealers but not to public companies. The audits by such auditors will not technically comply with the Custody Rule's Annual Audit Provision until the PCAOB inspection rules take effect. Additionally, depending on when such rules become effective, some audit firms may not be able to represent that they were subject to regular inspection as of the commencement of their professional engagement periods. The applicant noted the possible burden that this aspect of the Custody Rule may cause to certain advisers who would be required to replace the auditors they have engaged temporarily until those auditors become subject to the regular inspection by the PCAOB.

The Letter provides that the Staff would not recommend enforcement action to the SEC against an investment adviser that, for the purposes of the Annual Audit Provision, engages an auditor that also audits a broker or dealer, subject to the following conditions:

- the auditor was engaged to audit the financial statements of one or more of the adviser's private funds for the most recently completed fiscal year;
- the auditor was registered with the PCAOB and engaged to audit the financial statements of a broker or dealer (i) on July 21, 2010 and (ii) as of the issuance of the audited financial statements used to satisfy the Annual Audit Provision; and
- prior to distributing financial statements, the adviser provides to each investor in each of the adviser's private funds written notification that the private fund's auditor is not subject to regular inspection by the PCAOB.

The Letter specifies that the relief applies only to financial statements issued before (i) the adoption of rules regarding PCAOB inspection of auditors of brokers and dealers or (ii) July 21, 2011, whichever date is earlier.

► See a copy of the Letter

OCIE Director Discusses Examination Reform

On October 21, 2010 at an ALI-ABA conference, Carlo di Florio, Director of the SEC's Office of Compliance Inspections and Examinations ("**OCIE**"), announced that senior management and boards of directors of registered entities (such as investment advisers and broker-dealers) would be expected to be more heavily involved in the OCIE's examination process. The plan is part of a larger effort by the OCIE to reform its examination process in light of recent frauds involving investment advisers, and the OCIE plans to implement this new strategy over the next year. This strategy is related to an announcement by di Florio earlier this year of a new risk-based examination process whereby OCIE examiners would conduct extensive due diligence on advisers prior to conducting onsite examinations.

Di Florio highlighted five areas OCIE staff will pay particular attention to as an initial matter when inspecting firms: (i) the independence of the legal and compliance departments and their officers, (ii) whether compliance and risk functions, processes and controls are operating adequately and effectively, (iii) the level of engagement of senior management in compliance and risk programs, (iv) whether the board is adequately engaged in risk management and (v) the adequacy and independence of internal audits.

Di Florio said registrants should consider the sufficiency of their risk management programs as a whole and pay attention to the checks and balances in those systems. OCIE examiners, he said, would continue to focus on valuation, conflicts of interest, portfolio management and the consistency of the investment strategies firms advertise with those actually executed. The OCIE is also working with the Division of Investment Management, di Florio said, to create an extensive examination program for hedge fund and private equity fund advisers that will be required to register under the new registration requirements created by the Dodd-Frank Act.

Litigation

Recent New York “Pay-to-Play” Enforcement Actions

Former State Comptroller Pleads Guilty in Pay-to-Play Probe

On October 7, 2010, former New York State Comptroller Alan Hevesi pled guilty in New York Supreme Court to receiving awards for official misconduct, a violation of Section 200.25 of the New York Penal Law and a Class E felony. Hevesi admitted to accepting over $1 million dollars in gifts and campaign contributions in exchange for an improper approval of a $250 million investment by the New York State Common Retirement Fund (“**CRF**”), which the comptroller’s office is responsible for managing and of which Hevesi was the sole trustee. The CRF is the third-largest state public pension fund in the country with an estimated value of $124.8 billion as of June 30, 2010. Hevesi has agreed to cooperate fully with the investigation into charges against him. His sentencing is scheduled for December 16, 2010, when he will face a possible sentence of up to four years in jail as well as monetary sanctions.

Hevesi admitted to giving preferential treatment to Elliott Broidy, a principal of Markstone Capital Partners, L.P. (the “**Markstone Fund**”) and personal friend and political adviser to Hevesi, when deciding how to invest CRF money. Hevesi approved $250 million of CRF investments in the Markstone Fund, resulting in the payment of approximately $18 million in management fees to the Markstone Fund. In exchange, Broidy paid at least $75,000 in travel expenses for Hevesi, his family and colleagues, $380,000 in sham consulting fees for an unnamed lobbyist friend and more than $500,000 in campaign contributions directed by Hevesi, totaling nearly $1 million. In December 2009, Broidy pled guilty to a felony charge of rewarding official misconduct in connection with gifts made to Hevesi and other senior officials at the comptroller’s office for the purpose of securing pension fund investments. For more information on the Broidy plea, please see the ***January 7, 2010 Investment Management Regulatory Update***.

Hevesi also admitted to knowing that Henry “Hank” Morris, his former senior political adviser and chief fundraiser, solicited Hevesi campaign contributions from entities doing business with CRF. Additionally, Hevesi admitted to knowing during his tenure as State Comptroller that Morris was also working as a paid placement agent in connection with CRF investments and was steering CRF investments to his friends and political allies. An indictment against Morris is pending.

Hevesi’s indictment is the latest action in a comprehensive investigation into pay-to-play arrangements by New York Attorney General Andrew Cuomo. The investigation looks into what Attorney General Cuomo alleges is a complex network of fraudulent behavior connected to the CRF pension fund. Thus far, Cuomo’s investigation has resulted in seven guilty pleas, including Hevesi’s, and has resulted in fines and penalties totaling $138 million from fifteen firms and two individuals. Additionally, investment firms have agreed to voluntarily return over $100 million to the CRF.

- See a copy of the Attorney General’s press release
- See a copy of the Hevesi complaint
- See a copy of the Hevesi allocution

Attorney General Reaches Settlement with Manatt Phelps & Phillips, LLP

On October 12, 2010, New York Attorney General Andrew Cuomo announced that a settlement had been reached with the law firm Manatt Phelps & Phillips, LLP (“**Manatt**”) over Manatt’s involvement with financial firms seeking investments from public pension funds. Manatt agreed to a five-year ban from appearing before all public pension funds in New York and to a fine of $550,000. Manatt has also agreed to cooperate with Attorney General Cuomo’s investigation and to comply with his Public Pension Fund Reform Code of Conduct, which prohibits placement agents from soliciting investments from public pension funds and bars investments with an investment firm within two years of any campaign contribution from such firm to the Comptroller or other elected trustees.

In May 2009, the Attorney General's office issued subpoenas to investment firms and their agents after determining that nearly half of the agents acting to secure investments from city and state pension funds were unlicensed. According to Attorney General Cuomo's investigation, Manatt made introductions and arranged meetings on behalf of firms seeking investments from public pension funds. However, neither Manatt nor any of the partners at the firm engaged in this conduct were licensed as placement agents or securities brokers under state and federal law, as required by law, according to the New York Attorney General.

In announcing the settlement, Attorney General Cuomo said "unlicensed agents are untrained, unsupervised, and typically traffic in political and personal connections to get access to public money…[w]e will continue to protect the integrity of public pension funds, which are supported by New York taxpayers."

- See the Attorney General's press release
- See a copy of the settlement agreement

SEC Charges Hedge Fund Managers with Defrauding Investors in the Valuation of Side Pocket Investments

On October 19, 2010, the SEC charged two Georgia-based hedge fund portfolio managers, Paul T. Mannion, Jr. and Andrew S. Reckles, and their investment advisory business with defrauding investors in their Palisades Master Fund, L.P. (the "**Fund**") by allegedly overvaluing illiquid fund assets held in a side pocket, misappropriating investor funds for their personal use and making material misrepresentations related to a private securities transaction. The SEC filed suit against the defendants in U.S. District Court for the Northern District of Georgia. The SEC is seeking injunctive relief, disgorgement of profits and civil monetary penalties.

According to the SEC's complaint, the decision to use side pockets grew out of the Fund's involvement with World Health Alternatives, Inc. ("**World Health**"), a medical staffing company from Pittsburg, Pennsylvania that is now bankrupt. World Health was the Fund's largest single position in July 2005, constituting at least 20% of the Fund's net asset value. When World Health began to experience the financial trouble that eventually led to its bankruptcy, according to the SEC's complaint, the company turned to Mannion and Reckles for loans to cover the company's operating expenses. Public disclosures about World Health's financial troubles led to a dramatic decrease in the price of the company's common stock, according to the SEC's complaint, causing concern among Mannion and Reckles about the value of the Fund's World Health assets and the possibility that many investors would seek redemptions from the Fund. Large-scale redemptions would have been problematic, according to the SEC's complaint, as the Fund was primarily invested in illiquid securities and did not have the cash to satisfy redemptions from a large number of investors. This concern ultimately led the portfolio managers to place the World Health assets into a side pocket, according to the SEC's complaint.

In general, a side pocket is a type of account used by hedge funds to separate particular investments, which are usually illiquid, from the remainder of the investments in the fund. In a hedge fund with a side pocket, investors are typically not allowed to redeem the portion of their investment in the fund that has been allocated to the side pocket until the assets are either liquidated or released from the side pocket by the fund managers. As such, according to the SEC's complaint, Mannion and Reckles prevented investors from redeeming the portion of their investment attributable to the troubled Word Health assets. Ultimately, according to the SEC's complaint, following the bankruptcy of World Health, Mannion and Reckles valued the Fund's World Health holdings as worthless.

According to the SEC, Mannion and Reckles fraudulently valued three categories of World Health assets placed into the side pocket: (i) a convertible debenture, (ii) bridge loans and (iii) restricted stock. These valuations contradicted Mannion and Reckles' internal undisclosed valuations of these investments. Mannion and Reckles' fraudulent valuations inflated the Fund's net asset value, in turn enabling them to take excessive management fees from the Fund, the SEC alleges. At the same time, the SEC alleges, the managers sold hundreds of thousands of shares of the same issuer of the troubled securities from their personal accounts. In addition, the SEC charged Mannion and Reckles with stealing over $1.6 million in warrants from the Fund. The Commission also alleges that Mannion and Reckles took a $2 million short-term loan from the Fund, without disclosure, to finance personal investments.

Robert P. Kaplan, Co-Chief of the SEC's Asset Management Unit, which has been investigating instances of side pocket-related fraud, commented that "side pockets are not supposed to be a dumping ground for hedge fund managers to conceal overvalued assets."

- See a copy of the SEC's press release
- See a copy of the SEC's litigation release
- See a copy of the SEC's complaint

Federal District Court Rules that Fund Manager Committed Fraud in SEC Enforcement Action Relating to PIPE Deals

Recently, in *SEC v. Berlacher*, No. 07-CV-3800 (E.D. Pa. Sept. 13, 2010), Judge Michael S. Goldberg of the U.S. District Court for the Eastern District of Pennsylvania ruled that Robert A. Berlacher ("**Berlacher**") and several investment funds he oversaw (together with Berlacher, the "**Defendants**") were liable on two Rule 10b-5 fraud claims brought by the SEC but not guilty of insider trading. In connection with the fraud claims, the court ordered disgorgement of over $350,000 but did not grant other relief requested by the SEC.

Private Investment in Public Equity ("**PIPE**") transactions allow publicly traded companies that are seeking an immediate infusion of capital to raise capital in the private markets by selling restricted stock in the company at a price that is typically below the public market price. Though the PIPE shares are initially restricted, typically a registration statement covering such shares will become effective approximately three to four months after the PIPE transaction. Once the registration statement is effective, the holder of PIPE shares may sell the shares on the public market. The general public is typically not aware of a PIPE offering until after the transaction has closed, because PIPE shares dilute the value of existing shares and public knowledge of such an offering would impede the PIPE transaction by potentially reducing the public share price.

The SEC's claims arose from certain PIPE transactions involving four companies, Radyne ComStream, Hollywood Media, International Display Works ("**IDWK**") and SmithMicro. Pursuant to these transactions, Berlacher executed stock purchase agreements ("**SPAs**") to purchase company stock at a fixed price. The insider trading claim was based solely on the Radyne PIPE transaction. The SEC alleged that the Defendants were guilty of fraud with respect to all four PIPE transactions.

Insider Trading Claim

The court, citing *United States v. Chestman*, 947 F. 2d 551, 566 (2d Cir. 1990), stated that "[a] person is liable for insider trading 'when he misappropriates material nonpublic information in a breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction.'" The court found that shortly after Berlacher received non-public information about the Radyne PIPE from Brian Sognefest ("**Sognefest**"), a placement agent for PIPE transactions, he traded on the basis of such non-public information through his barrier options account.

The court held that even though Berlacher traded on non-public information, he was not guilty of insider trading because the information he traded on was not material. The court relied on the testimony of Berlacher's expert witness, who testified that the information Berlacher possessed could not be considered material because there was no statistically significant movement in the price of Radyne stock when the information was made publicly available. In support of this conclusion, Berlacher's expert conducted an event study, a financial methodology used to measure the effect on market prices of new information relevant to a company's stock valuation. The SEC also presented an expert witness of its own regarding the materiality of the non-public information, but the court found Berlacher's expert more persuasive, in part because the SEC's expert did not conduct an event study and instead chose to rely on his general familiarity with how securities markets operate.

Fraud Claims

Among other arguments, the SEC argued that Berlacher had committed fraud in executing the SPAs by making certain representations in the SPAs regarding the types of transactions he had engaged in after learning of the PIPEs, representations Berlacher knew to be false based on his trading activity.

The court noted that in order to establish a claim in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the SEC would have to prove that the Defendants (i) made a material misrepresentation or a material omission as to which they had a duty to speak, or used a fraudulent device, (ii) with scienter, (iii) in connection with the purchase or sale of securities.

The court found that Berlacher was guilty of fraud based on the material misrepresentations he made by signing the SPAs with knowledge that he had engaged in certain trading activities that were contrary to the representations contained in the SPAs.

This holding is of particular interest because the court did not rely on the traditional analysis of materiality in the context of Section 10(b)/Rule 10b-5 claims. The court noted that in such cases, "materiality typically involved factual scenarios that differ from the facts before the court and revolve around 'corporate insiders' such as directors or officers of corporations." Since Berlacher was not an insider and only gained "insider" status when he received information about the PIPE offerings from the placement agent, and because it would have been difficult to analyze the effect of Berlacher's misrepresentation on the company's stock price under the Third Circuit's existing materiality jurisprudence, the court utilized an alternative test for materiality.

Instead, the court relied on what it deemed to be an analogous case in the Seventh Circuit, *Jakubowski v. SEC*, 150 F.3d 675 (7th Cir. 1998), which ruled that materiality "covers whatever is important enough to reasonable participants in an investment decision to alter their behavior." Applying this standard, the court found that Berlacher's misrepresentations were material because they influenced the decision of the sellers to sell PIPE shares to him. The court reasoned that if the sellers of the PIPEs had known of Berlacher's trading activities, they would not have entered into the SPAs and sold the shares, thus, the misrepresentations were material. Therefore, the court found that all the elements of the fraud claim against Berlacher were met with respect to the IDWK and Radyne PIPE transactions.

The SEC sought (i) a permanent injunction enjoining the Defendants from committing future violations of the federal securities laws, (ii) disgorgement, (iii) pre-judgment interest and (iv) a civil monetary penalty. The court granted disgorgement of net profits related to the fraudulent activity in an amount over $365,000. The court did not grant an injunction, noting how unlikely it is that Berlacher would engage in the same type of activity, nor did the court impose additional civil monetary penalties, finding that the disgorgement of profits was a sufficient deterrent against future behavior.

- See a copy of the court's opinion
- See a copy of the SEC's complaint

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