Davis Polk
CLIENT NEWSLETTER

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Investment Management Regulatory Update

SEC Rules and Regulations

SEC Proposes Rule on Disqualification of "Bad Actors" from Rule 506 Offerings

On May 25, 2011, the SEC proposed rules and form amendments to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Proposal**"), which requires the SEC to adopt rules that disqualify securities offerings involving certain felons and other "bad actors" from the safe harbor exemption from registration under Rule 506 of Regulation D under the Securities Act of 1933 (the "**Securities Act**"). Rule 506 of Regulation D allows the unregistered offering of an unlimited dollar amount of securities to an unlimited number of "accredited investors" and up to 35 other purchasers, so long as certain restrictions in the Rule are met, including the restriction against a general solicitation. According to the Proposal, the proposed rules would be "substantially similar" to Rule 262 under the Securities Act, which sets forth the bad actor disqualification provisions of Regulation A. (Regulation A provides a limited offering exemption that allows companies which are not required to file periodic reports to make public offerings of securities that do not exceed $5 million in any 12-month period.)

Covered Persons

Under the proposed rules and amendments, the disqualification provisions of Rule 506 would be triggered if any of the following persons were subject to a disqualifying event:

- the issuer, the predecessor of the issuer, or any affiliated issuer;
- any director, officer, general partner or managing member of the issuer;
- any beneficial owner of 10% or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with sales of securities in the offering; and

- any director, officer, general partner, or managing member of any such compensated solicitor.

Importantly, under the Proposal, officers of issuers and compensated solicitors of investors would be covered. As is currently the case in Rule 262 of Regulation A, “officer” would be defined as in Rule 405 under the Securities Act, which includes “a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization.” The Proposal notes, however, that this broad definition of officer “may present significant challenges, particularly as applied to financial intermediaries” and, as such, requests comment on whether disqualification should be limited only to executive officers or officers who are actually involved in the offering.

Affiliated Issuers; Investment Advisers Not Covered

As proposed, a disqualification event relating to an affiliated issuer that occurred before the affiliation would not be a disqualifying event for the issuer if the affiliated issuer is not (i) in control of the issuer or (ii) under common control with the issuer by a third party that controlled the affiliated entity at the time of such disqualifying event.

The Proposal also specifically notes that investment advisers of issuers, or the directors, officers, general partners, or managing members of such investment advisers are not covered by the proposed rule and amendments (because, according to the Proposal, such persons are not covered in Rule 262 of Regulation A), but it requests comment on expanding coverage to include them. The Proposal does not discuss the fact that many advisers also serve as general partner for their funds and that, as proposed, general partners of issuers would be covered by the disqualification rules.

Disqualifying Events

The proposed rule would include the following disqualifying events:

- Criminal convictions of any felony or misdemeanor *within 10 years* before the date of the sale for which exemption is sought (“**such sale**”) (or *five years*, in the case of issuers, their predecessors and affiliated issuers);
  - The Proposal notes that, for purposes of determining the look-back period for ongoing offerings, the rule would refer to the date of the relevant sale, rather than the date of first sale in such offering.
- Court injunctions and restraining orders entered *within five years* before such sale;
  - Under the Proposal, in order for such criminal convictions, court injunctions or restraining orders to constitute disqualifying events, they must (i) be in connection with the purchase or sale of securities; (ii) involve the making of any false filing with the SEC; or (iii) arise out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities.
- Final orders of certain state regulators (such as state securities, banking and insurance regulators) and certain federal regulators (not including the SEC or CFTC) constituting a bar in effect *at the time of such sale* from engaging in certain activities or a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered *within 10 years before such sale*;
  - The Proposal specifically notes that orders issued in stand-alone SEC cease-and-desist proceedings would not be disqualifying but seeks comment on whether such orders should be disqualifying.
  - The Proposal specifically seeks comment on whether orders of the SEC and CFTC should be included for purposes of this disqualifying provision.

- Certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers and investment advisers and their associated persons that are effective (i.e., that prohibit some act or require some act to be performed) at the time of such sale;
    - The Proposal notes that censures would not be disqualifying and a disqualification based on a suspension or limitation of activities would expire upon the termination of such suspension or limitation. In addition, the Proposal also suggests that orders to pay civil penalties would not be disqualifying.
- Suspension or expulsion from membership in, or suspension or bar from associating with a member of, a registered national securities exchange or a registered national or affiliated securities association for "conduct inconsistent with just and equitable principles of trade";
- The filing, as registrant or issuer, of any registration statement or Regulation A offering statement, or being named as an underwriter therein, that was the subject of a refusal order, stop order, or order suspending the Regulation A exemption within *five years* before such sale, or is the subject of a proceeding for such determination at the time of such sale; and
- U.S. Postal Service false representation orders entered within *five years* before such sale, or being subject to a temporary restraining order or preliminary injunction regarding conduct alleged to constitute a scheme or device for obtaining money or property through the mail by means of false representation at the time of such sale.

Reasonable Care Exception and Waivers

Under the proposed rule, disqualification would not apply when the issuer can demonstrate that it did not know, and in the exercise of reasonable care, could not have known, of the disqualification. According to the Proposal, the exercise of reasonable care entails factual inquiry, the extent of which would depend on the particular circumstances. In addition, issuers may also seek waivers from disqualification from the SEC if the issuer shows good cause.

Transition

Under the Proposal, disqualifying events that have occurred within the relevant look-back periods would trigger the disqualification provisions, regardless of whether such events occurred before or after the enactment of the Dodd-Frank Act. For ongoing offerings, application of the disqualification provisions would depend on the timing of the sale, as opposed to the timing of the initial sale of the offering under which the sale takes place, even if the offering was intended to continue after the effective date of the rule amendments. Only sales made after the effective date of the proposed rule or the occurrence of the disqualification event would be covered.

Form D Amendment

Under the Proposal, the certification on Form D would be broadened to require issuers claiming a Rule 506 exemption to confirm that the offering is not disqualified.

The SEC is seeking comments on the Proposal, which are due by July 14, 2011.

► See a copy of the Proposal

Industry Update

FINRA Delays Implementation of Rule 5131(b) Prohibition on Spinning, Giving Fund Managers More Time to Collect Necessary Investor Information

On May 17, 2011, the Securities and Exchange Commission (the "**SEC**") approved an amendment to Financial Industry Regulatory Authority ("**FINRA**") Rule 5131 to delay the effectiveness of the rule's anti-spinning prohibitions until September 26, 2011. "Spinning" refers to the practice of securities firms' allocating valuable initial public offering ("**IPO**") shares to directors or executives of their investment banking clients in exchange for receipt of investment banking business. Rule 5131(b) is designed to prevent such abuse by prohibiting certain allocations of new issues. A "new issue" is defined in Rule 5131(e) as an initial public offering of an equity security (excluding, among other things, private placements, offerings of direct participation programs, offerings of securities that have a pre-existing market outside the U.S. and offerings of preferred stock).

Specifically, the rule prohibits a FINRA member from allocating new issues to executive officers or directors (or materially supported persons thereof) of a public company or a covered non-public company, if (i) the FINRA member currently provides investment banking services to the company, (ii) the FINRA member has in the past 12 months received compensation from the company for investment banking services, (iii) the person making the allocation decision knows or has reason to know that the company intends to provide the FINRA member with investment banking business within the next three months or (iv) the allocation is conditioned on performance of future investment banking services. A "covered non-public company" is defined in Rule 5131(e) as any non-public company with "(i) income of at least $1 million in the last fiscal year or in two of the last three fiscal years and shareholders' equity of at least $15 million; (ii) shareholders' equity of at least $30 million and a two-year operating history; or (iii) total assets and total revenue of at least $75 million in the latest fiscal year or in two of the last three fiscal years."

The *de minimis* exception to the spinning prohibition excludes those accounts (including funds) where the beneficial interests of all the executive officers and directors associated with a particular public or covered non-public company (and persons materially supported by such executive officers and directors) do not exceed, in the aggregate, 25% of the account. In addition, the anti-spinning prohibitions do not apply to allocations of shares of a new issue to any account described in Rule 5130(c)(1) through (c)(3) and (c)(5) through (c)(10). Generally, this excludes registered investment companies, certain common trust funds, certain insurance company accounts, certain non-U.S. public investment companies, certain publicly traded entities that are either listed on a national securities exchange or are foreign issuers whose securities meet the quantitative designation criteria for listing on a national securities exchange, state or municipal government benefit plans, certain ERISA benefits plans, 501(c)(3) tax-exempt charitable organizations and church plans.

In order to facilitate compliance with the spinning provisions, Rule 5131 provides that FINRA members may rely on written representations obtained within the prior 12 months from the beneficial owners of the account, or a person authorized to represent the beneficial owners, as to whether any such beneficial owner is an executive officer or director of any public company or covered non-public company (or is a person materially supported by such an executive officer or director). The initial representation received by a member firm from an account must be an affirmative representation as to the account's restricted status but may thereafter be updated by means of a negative consent letter. Records relating to whether an account is eligible to receive an allocation of a new issue must be maintained for at least three years following the allocation.

In addition to delaying the effective date, FINRA removed the requirement of original Rule 5131(b)(1) that FINRA members must establish, maintain and enforce policies and procedures designed to ensure that investment banking personnel are not involved with, and in no way influence, new issue allocations.

- See a copy of Rule 5131, as amended

- See a copy of the FINRA amended Rule 5131 filing
- See a copy of the SEC Order approving the amended rule

Treasury Extends First Reporting Date for Proposed Form SLT to September 30, 2011

The U.S. Department of the Treasury ("**Treasury**") has extended the initial reporting date for its proposed Form SLT to September 30, 2011, three months beyond its original initial reporting date of June 30, 2011. Thus, quarterly reports would be required as of September 30, 2011 and December 30, 2011, after which monthly reporting for covered entities would commence on January 31, 2012. According to Treasury, there are no other changes to Treasury's revised proposed new Form SLT.

Proposed Form SLT was released by Treasury in connection with its Treasury International Capital reporting system, which tracks international capital movements. The proposed form is to be completed by all U.S. persons who are either (i) U.S.-resident custodians, (ii) U.S.-resident issuers of U.S. securities or (iii) U.S.-resident end-investors in foreign securities, whose consolidated total of all reportable securities exceeds the $1 billion reporting threshold. For more information regarding Treasury's proposed Form SLT, please see the ***April 15, 2011 Investment Management Regulatory Update***.

- See a copy of the TIC Form SLT and instructions

SEC Holds Roundtable on Money Market Funds and Systemic Risk

On May 10, 2011, the SEC hosted a roundtable discussion on the systemic risks potentially posed by money market funds (the "**Roundtable**"). The Roundtable was intended to provide a forum for discussing options for mitigating the systemic risks associated with money market funds, including but not limited to the options raised in the President's Working Group Report on potential money market fund reforms that was issued in October 2010 (the "**PWG Report**"). For more information on the PWG Report, please see the ***November 12, 2010 Investment Management Regulatory Update***. The Roundtable sought to include a variety of perspectives on how best to mitigate the risks associated with money market funds. Among those in attendance were representatives from the SEC and the Financial Stability Oversight Council (the "**FSOC**"), academics, sponsors of money market funds, former regulators (including Paul Volcker) and a non-U.S. regulator, Bank of England Deputy Governor Paul Tucker. The Roundtable was moderated by Eileen Rominger and Robert Plaze, Director and Associate Director, respectively, of the SEC's Division of Investment Management.

The Roundtable began with a speech by SEC Chairman Mary Schapiro. Chairman Schapiro discussed the recent history of money market funds, beginning with the run on institutional prime money market funds that occurred in September 2008 after the Reserve Primary Fund "broke the buck." Chairman Schapiro discussed the government programs put into place in response to the events of September 2008 and the subsequent SEC regulations intended to mitigate the systemic risks associated with money market funds. The most significant of these reforms, Chairman Schapiro said, were rules and rule amendments with respect to money market funds adopted by the SEC in February 2010 (the "**Money Market Fund Amendments**"). Among other things, the Money Market Fund Amendments tightened a number of conditions imposed on money market funds to limit their exposure to credit, currency and interest rate risks. The Money Market Fund Amendments generally require money market funds to increase the credit quality of their portfolios, to reduce the maximum weighted average maturity of their portfolios, and to maintain liquidity buffers to enable the funds to withstand sudden redemption demands. In addition, the Money Market Fund Amendments also introduced procedural requirements for money market funds, including the requirements that money market fund managers stress test their portfolios and provide investors with portfolio information. The Money Market Fund Amendments also provide a means for a liquidating money market fund to be wound down in an orderly manner in cases where the fund has broken the buck. More information about the Money Market Fund Amendments can be found in the ***March 9, 2010 Investment Management Regulatory Update***.

Despite the steps taken by the SEC and the President's Working Group, Chairman Schapiro stated that "more needs to be done to better protect money markets—and the broader financial system—from the destabilizing risk that can result from a broad money market fund run."

- See a copy of Chairman Schapiro's Speech
- See a copy of the list of participants and moderators of the Roundtable
- See a copy of the PWG Report
- See a copy of the SEC press release announcing the Roundtable

Litigation

SEC Enters Into First-Ever Deferred Prosecution Agreement with Tenaris S.A. to Settle FCPA Violations

On May 17, 2011, the Securities and Exchange Commission (the "**SEC**") entered into a Deferred Prosecution Agreement ("**DPA**") with Tenaris S.A. ("**Tenaris**"), a Luxembourg-based manufacturer and supplier of steel pipe products for the oil and gas industry. The DPA arose out of SEC allegations that Tenaris bribed Uzbekistan government officials to win bids to supply oil and natural gas pipelines to the country. The agreement marks the first SEC use of a deferred prosecution agreement, a strategy it announced last year to encourage individuals and companies to provide information about misconduct and to facilitate and reward cooperation with SEC investigations.

According to the DPA, between 2006 and 2007 Tenaris bid on a series of contracts offered by an Uzbekistani government agency to provide pipelines for the oil and gas industry in Uzbekistan. Around December 2006, Tenaris obtained an agent to assist in the bidding process. According to the SEC, the agent facilitated bribes between Tenaris's regional sales personnel and the Uzbekistani government agency. According to the DPA, this bribery led the Uzbekistan government to award contracts to Tenaris, generating a total of nearly $5 million in profits.

Tenaris discovered the bribery while conducting an internal review of its operations and controls in 2009. After discovering the misconduct, Tenaris reported it to the SEC. Speaking on the DPA, Robert Khuzami, Director of the SEC's Division of Enforcement, said that "effective enforcement of the securities laws includes acknowledging and providing credit to those who fully and completely support our investigations and who display an exemplary commitment to compliance, cooperation, and remediation."

The SEC alleges that Tenaris's conduct violated the Foreign Corrupt Practices Act (the "**FCPA**") and Sections 13(b)(2)(A), 13(b)(2)(B) and 30A of the Securities Exchange Act of 1934. Under the DPA, the SEC agrees to refrain from prosecuting Tenaris in a civil action, provided that Tenaris complies with certain undertakings. Among other things, Tenaris has agreed to strengthen its compliance with the FCPA and anti-corruption practices, implement due diligence requirements relating to the payment and retention of agents, provide FCPA and other anti-corruption law training, require certification of compliance with anti-corruption policies and notify the SEC if any complaints, charges or convictions arise against Tenaris or its employees relating to violations of anti-bribery or securities laws. Tenaris has also agreed to pay the SEC $5.4 million in disgorgement and prejudgment interest. In addition, Tenaris has entered into a Non-Prosecution Agreement with the U.S. Justice Department arising out of the same allegations. Under this agreement, Tenaris has agreed to pay a $3.5 million criminal penalty.

- See a copy of the Deferred Prosecution Agreement
- See a copy of the SEC press release

FINRA Fines Wells Fargo Advisors $1 Million for Delays in Delivering Prospectuses and Reporting Required Information Regarding its Brokers

In a release dated May 5, 2011, the Financial Industry Regulatory Authority ("**FINRA**") announced that it has fined Wells Fargo Advisors, LLC ("**Wells Fargo**") $1 million for failure timely to deliver prospectuses to customers who purchased mutual funds in 2009, and for delays in the reporting of material information regarding its current and former representatives.

According to the release, in 2009, Wells Fargo failed to deliver prospectuses within three business days, as required by federal securities laws, to approximately 934,000 customers who had purchased mutual funds. While the settlement between FINRA and Wells Fargo notes the failure of certain mutual fund companies to keep an adequate supply of paper copies of prospectuses on hand as a primary cause of the late deliveries, the release faults Wells Fargo for its failure to take corrective measures after timely notice of late deliveries to customers from a third-party service provider with which it had contracted to mail the prospectuses.

The release further states that Wells Fargo failed timely to file certain amendments to its FINRA Forms U4 (which provide information on a representative's registration with FINRA) and FINRA Forms U5 (which provide information on a representative's termination notice). According to the release, FINRA found that, from July 1, 2008 to June 30, 2009, Wells Fargo failed to update 8.1% of their Forms U4 and 7.6% of their Forms U5 on time, with a total of nearly 190 late amendments.

In the settlement, Wells Fargo accepted and consented to the entry of FINRA's findings, without admitting or denying the findings.

- See a copy of the settlement
- See a copy of FINRA's press release

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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