Investment Management Regulatory Update

May 16, 2013

SEC Rules and Regulations

SEC Staff Responds to Questions About Form PF

On April 25, 2013, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued additional responses (the "**Responses**") to frequently asked questions regarding Form PF. For details on previously posted SEC responses to frequently asked questions regarding Form PF, please see the ***July 16, 2012 Investment Management Regulatory Update***, the ***August 22, 2012 Investment Management Regulatory Update***, the ***December 20, 2012 Investment Management Regulatory Update*** and the ***March 25, 2013 Investment Management Regulatory Update***.

Investment advisers registered or required to register with the SEC under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") that advise one or more private funds (*i.e.*, 3(c)(1) or 3(c)(7) funds) and that have at least $150 million in private fund assets under management ("**private fund advisers**") are required to file Form PF with the SEC for the purpose of reporting systemic risk information to the SEC. Additionally, private fund advisers that are also registered with the Commodity Futures Trading Commission (the "**CFTC**") as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**") and that are required to file Form PF under the Advisers Act must file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are private funds. Such CPOs and CTAs may file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are not private funds. Please see the ***November 18, 2011 Investment Management Regulatory Update*** for a discussion of the final Form PF rules and the ***June 19, 2012 Investment Management Regulatory Update*** for a discussion of the initial Form PF deadlines.

The Responses provided guidance on a number of Form PF topics including, among other things:

General Filing Information. The Responses clarified that a private fund adviser is not required to report on its Form PF information on private funds for which the adviser does not provide "continuous and regular supervisory or management services" in accordance with Instruction 5.b.(3) of Form ADV (*e.g.*, because the private fund adviser does not have discretionary authority over the fund and is not responsible for arranging or effecting the purchase or sale of securities for the fund, including those recommended by the adviser). According to the Responses, an adviser that does not provide continuous and regular supervisory or management services to certain private funds must nonetheless report such funds under section 7.B.1 of Form ADV (unless such funds are being reported by another adviser).

Categorizing Fair Valued Assets. The Responses explained that when responding to Question 14, a reporting adviser need only use the hierarchy described in Question 14 to categorize assets and liabilities that are required to be shown at fair value in the fund's financial statements. According to the Responses, this is the appropriate approach regardless of whether a fund is subject to an audit.

NAICS Codes. The Responses explained that if a North American Industry Classification System ("**NAICS**") code entered by a reporting adviser into Form PF with respect to a portfolio company is rejected, the adviser should instead use the "parent" or general NAICS code (*e.g.*, according to the Responses, a reporting adviser could use 221100 instead of 221113 if the latter were rejected). In addition, the Responses noted that, in responding to Question 77, which asks for a breakdown of a reporting fund's investments in portfolio companies based on such companies' NAICS codes, the breakdown should be based on the "percentage of the total gross value of the reporting fund's investments in portfolio companies attributable to specific NAICS codes."

- See a copy of the Responses

SEC Requests Information to Inform Consideration of Uniform Fiduciary Standard for Broker-Dealers and Investment Advisers

On March 1, 2013, the SEC issued a request for information (the "**Request**") seeking quantitative and qualitative data and other information and economic analysis regarding the costs and benefits of adopting a uniform fiduciary standard for broker-dealers and investment advisers that provide personalized investment advice to retail investors. In addition, the Request seeks comment on the costs and benefits of seeking to more broadly harmonize the existing regulatory regimes applicable to broker-dealers and investment advisers.

According to the Request, in order to establish a "baseline" to assess potential regime changes, the SEC is also generally targeting data and information related to the current regulatory regimes for broker-dealers and investment advisers and in particular, according to the Request, the SEC is seeking comments related to "retail customer demographics and accounts; broker-dealer or investment adviser services offered to retail customers; security selections by or for retail customers; and the claims of retail customers in dispute resolution."

In discussing potential alternative approaches to establishing a uniform fiduciary standard of conduct for broker-dealers and investment advisers, the SEC stated that respondents to the Request should assume, among other things, that any uniform fiduciary standard would (1) "accommodate different business models and fee structures" (and allow broker-dealers to continue to receive commissions), (2) generally not require a broker-dealer or investment adviser to have a continuing duty of care or loyalty to a retail customer after personalized investment advice has been provided, (3) allow broker-dealers to make principal trades, (4) not prohibit the offering or recommending of only proprietary products (or a limited range of products) to retail customers, (5) require certain disclosure in a "general relationship guide" similar to Form ADV Part 2, (6) include a duty of care designed to impose suitability obligations (including product specific suitability, due diligence and disclosure requirements), best execution obligations and fair and reasonable compensation obligations on broker-dealers and investment advisers when providing personalized advice to a retail customer about securities and (7) include a duty of loyalty that would require broker-dealers and investment advisers to act in accordance with prior guidance and precedent as it relates to the allocation of investment opportunities among customers and the aggregation of orders on behalf of customers.

In addition to the request for comments on the existing regulatory regimes and on a potential uniform standard of conduct, according to the Request, the SEC is seeking comment on whether harmonization of the respective regulatory regimes of broker-dealers and investment advisers (outside of a potential uniform fiduciary standard) is needed, including with respect to (1) the rules for advertising and other communications (*e.g.*, as it relates to content restrictions), (2) the use of finders and solicitors, (3) supervisory systems and control procedures, (4) the licensing and registration of firms and individuals, (5) continuing education requirements for firms' associated persons and (6) books and record requirements.

The Request follows the release of a 2011 SEC study, mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), on the effectiveness of the existing standards of care required of broker-dealers and investment advisers. In that study, the SEC staff recommended that the SEC establish a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. The SEC staff recommended that any such uniform fiduciary standard be no less stringent than that which is applied under Sections 206(1) and (2) of the Advisers Act. For further information regarding the SEC staff's recommendations, please see the January 24, 2011 Davis Polk Client Memorandum, ***SEC Study on the Fiduciary Duty of Investment Advisers and Broker-Dealers*** and the ***February 14, 2011 Investment Management Regulatory Update***.

According to the Request, while the Dodd-Frank Act permits the SEC to adopt a uniform fiduciary standard or to harmonize the regulatory regimes applicable to broker-dealers and investment advisers, the SEC is not mandated to do so. According to the Request, respondents must submit comments to the SEC by July 5, 2013.

- See a copy of the Request

Industry Update

SEC Official Discusses Broker-Dealer Registration Issues for Private Fund Advisers

On April 5, 2013, in a speech at a meeting of the American Bar Association's Trading and Markets Subcommittee, David Blass, Chief Counsel of the SEC's Division of Trading and Markets, discussed, among other things, his views on broker-dealer registration considerations affecting private fund advisers. According to Blass, SEC staff is putting more examination focus on private fund advisers due, in part, to the SEC staff's observations of the practices of newly registered private fund advisers. Blass added that while it is appropriate for private fund advisers to be attentive to the requirements of the Advisers Act, they should also not ignore activities that could require registration as a broker-dealer under the Securities Exchange Act of 1934 (the "**Exchange Act**").

Absent an available exemption or other relief, a person engaged in "the business of effecting transactions in securities for the account of others" must generally register as a broker under Section 15(a) of the Exchange Act. According to Blass, the SEC staff has generally observed two categories of activity that could require broker-dealer registration of private fund advisers or their personnel: (1) private fund advisers that "[pay their] personnel transaction-based compensation for selling interests in a fund" or that employ personnel whose "only or primary functions are to sell interest[s] in the fund" and (2) the receipt of transaction-based compensation by private fund advisers (or their affiliates or their personnel) for so-called "investment banking" or other broker activities in connection with services provided to a fund's portfolio companies.

Common to both of these activities is the payment of transaction-based compensation (*i.e.*, compensation that is dependent upon the occurrence or size of a securities transaction). According to Blass, the SEC considers the receipt of transaction-based compensation a "hallmark of being a broker."

According to Blass, while noting that the question of broker-dealer registration is a fact-specific inquiry, private fund advisers should consider (i) the manner in which they solicit new investors and retain existing ones (including consideration of whether the adviser has a "dedicated sales force" working in a “marketing” or similar department, which, according to Blass, may be a strong indication of “effecting transactions” in fund interests) and (ii) whether a private fund adviser has employees whose primary responsibility is to solicit investors (and whether such employees receive transaction-based compensation).

In addition, Blass also discussed the potential broker-dealer registration implications for fund advisers that receive fees for investment banking activity, including for activities such as the negotiation or structuring of transactions for portfolio companies and the identification and solicitation of buyers or sellers of portfolio companies’ securities. In Blass’ view, it is the apparent transaction-based nature of such fees that could cause an adviser to fall within the meaning of broker. According to Blass, in analyzing broker-dealer status, cases in which such fees offset the amount of the advisory fee received by the adviser (or an affiliate of the adviser) should not raise broker-dealer registration issues (but Blass stated that, in his view, if such fees are paid to a fund’s general partner (or an affiliate of the general partner), the general partner would not be considered the same person as the fund to support an argument that there are no transactions “for the account of others”).

In discussing the SEC staff’s increased focus on broker-dealer registration issues, Blass cautioned that there are significant consequences that could result from acting as an unregistered broker-dealer, including a potential right of rescission. Blass also raised the idea of and invited dialogue on the need for a broker-dealer registration exemption (similar to that provided by Rule 3a4-1 under the Exchange Act—the so-called “issuer exemption”) that is specifically tailored for private fund advisers.

- See a copy of Blass’ speech

NFA Amends Rules to Simplify Reporting Requirements for CPO and CTA Members

On April 24, 2013, the National Futures Association (the “**NFA**”) notified its members that it has amended NFA Rule 2-46, which requires periodic reporting by (a) registered commodity pool operators (“**CPOs**”) on NFA Form PQR with respect to performance and certain other information for each pool operated by a CPO and (b) registered commodity trading advisors (“**CTAs**”) on NFA Form PR. According to the NFA, the amended NFA Rule 2-46 aims to (i) simplify the reporting requirements for CPOs and CTAs and (ii) minimize duplicate information from being reported on Form PF and CFTC Form PQR (for CPOs).

Under the amended NFA Rule 2-46, a CPO is required to report on the schedule of investments contained in NFA Form PQR any investment that exceeds 5% of a pool’s net asset value at the end of the reporting period. Prior to the amendments, a CPO was only required to report an investment that exceeded 10% of a pool’s net asset value.

In addition, while CPOs are generally required to file NFA Form PQR quarterly, the amended NFA Rule 2-46 permits CPOs to satisfy certain of their quarterly filing obligations with their CFTC Form CPO-PQR filings. In particular, under the amended NFA Rule 2-46, (i) “large CPOs” (*i.e.*, CPOs with assets under management (“**AUM**”) equal to or exceeding $1.5 billion), in lieu of quarterly NFA Form PQR filings, must file Schedules A, B and C of CFTC Form CPO-PQR on a quarterly basis within 60 days of the end of each quarter; (ii) “mid-size” CPOs (*i.e.*, CPOs with AUM equal to or exceeding $150 million but less than $1.5 billion) must file NFA Form PQR within 60 days of the quarters ending March, June and September and must file Schedules A and B of CFTC Form CPO-PQR within 90 days of the calendar year end; and (iii) “small CPOs” (*i.e.*, CPOs with AUM of less than $150 million) must file NFA Form PQR within 60 days of the quarters ending March, June and September and must file Schedule A of CFTC Form CPO-PQR plus a schedule of investments within 90 days of the calendar year end. According to the NFA, CPOs that file Form PF with the SEC must file NFA Form PQR within 60 days of the quarters ending March, June and September and must file Schedule A of CFTC Form CPO-PQR and a schedule of investments within 60 or 90 days (depending on the size of the CPO) after the quarter ending December 31 of each year.

The amended NFA Rule 2-46 also requires CTAs to file NFA Form PR on a quarterly basis within 45 days of the quarters ending March, June and September and on an annual basis within 45 days of the calendar year end (in addition, CFTC Rule 4.27 requires CTAs to file CFTC Form CTA-PR annually within 45 days of the calendar year end). According to the NFA, it has not finalized the compliance date of the CTA reporting requirements under NFA Rule 2-46 and no report will be due for the quarters ended March 31, 2013 or June 30, 2013.

- See a copy of the NFA's notice

Litigation

SEC Charges Former Public Company Employee in Expert-Network Insider Trading Case

On April 8, 2013, the SEC charged ThanhHa Bao ("**Bao**"), a former employee of the finance department of Abaxis, Inc. ("**Abaxis**"), a medical device manufacturer based in California whose securities are listed on the NASDAQ, with regularly providing material nonpublic information ("**MNPI**") to her brother, Tai Nguyen ("**Nguyen**"). Nguyen, who according to the SEC owned Insight Research, an equity research firm, was charged by the SEC in 2012 for trading in Abaxis securities for his own account in advance of Abaxis's quarterly earnings announcements and for providing the MNPI to clients of Insight Research, including two hedge funds (whose portfolio managers, analysts or other personnel were also charged in connection with this matter, as discussed in the ***March 15, 2011 Investment Management Regulatory Update***). According to the SEC, the charges stem from the SEC's ongoing investigations into expert networks, which have resulted in 40 enforcement actions against entities or individuals totaling $430 million in alleged illicit gains.

The SEC alleged that Bao provided Nguyen with MNPI, including information on Abaxis's quarterly revenues, gross profit margins and earnings per share, in violation of Abaxis's stated policy on the sharing of such information. According to the SEC, Nguyen obtained nearly $150,000 (and the hedge fund clients of Insight Research obtained at least $7.2 million) in illicit profits through the trading of Abaxis securities based on the MNPI.

Based on this conduct, the SEC charged Bao with violating Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. According to the SEC's press release, Bao has agreed to a settlement, subject to court approval, requiring her to pay $144,910 in penalties and barring her from serving as an officer or director of a public company for a period of five years.

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

SEC Charges Mutual Fund Directors and Service Providers for Deficiencies Relating to Investment Advisory Contract Approvals

On May 2, 2013, the SEC settled charges against five trustees of two registered investment companies ("**RICs**") for securities laws violations for their role in approving or renewing the RICs' investment advisory contracts. The RICs' CCO-service provider and the RICs' administrator were also charged in connection with this matter. For a further discussion of the SEC's charges against the trustees, the CCO-service provider and the administrator and the implications for registered fund directors, please see the May 13, 2013 Davis Polk Client Memorandum, ***The SEC's Northern Light's Enforcement Action: Implications for Fund Directors***. The SEC noted in its press release announcing the charges that procedures related to the renewal of investment advisory contracts—the so-called "15(c) process"—have been a focus of the SEC Enforcement Division's Asset Management Unit.

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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