Investment Management Regulatory Update

SEC Rules and Regulations

- SEC Extends Expiration Date for Temporary Rule on Principal Trades with Certain Advisory Clients

Industry Update

- President Obama Signs Into Law the Regulated Investment Company Modernization Act of 2010
- NASAA Proposes Model Rule for the Exemption of Private Fund Advisers from State Registration
- SEC Extends No-Action Relief for an FCM that Custodies Assets for Registered Funds for Cleared CDS Transactions

Litigation

- Recent New York "Pay-to-Play" Enforcement Actions

SEC Rules and Regulations

SEC Extends Expiration Date for Temporary Rule on Principal Trades with Certain Advisory Clients

On December 28, 2010, the SEC amended temporary rule 206(3)-3T (the "**Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**"), extending its expiration date by two years to December 31, 2012 but otherwise leaving the substantive content of the rule the same as adopted on an interim final basis in 2007. This action by the SEC marks the second extension of the sunset date of the Rule, which was previously extended by one year on December 23, 2009, as previously reported in the ***January 7, 2010 Investment Management Regulatory Update***.

As described in more detail in the ***October 2007 Investment Management Regulatory Update***, the Rule was adopted in September 2007 to provide an alternative means for investment advisers who are registered with the SEC as broker-dealers to satisfy the requirements under Section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain nondiscretionary advisory accounts. Absent further action by the SEC, the Rule will now expire on December 31, 2012 instead of December 31, 2010.

The SEC's action resulted at least in part from the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). Under Section 913 of the Dodd-Frank Act, the SEC is required to conduct a study and provide a report to Congress concerning the obligations of broker-dealers and investment advisers by January 2011. Section 913 also authorizes the SEC to issue rules regarding the legal standards of care for broker-dealers and investment advisers for providing personalized investment advice about securities to retail customers, taking into account any conclusions or recommendations from the study. In light of these developments, the SEC indicated that it would extend the Rule for an additional two years in order to allow firms to continue to rely on the Rule while the SEC conducted its study and considered more broadly the regulatory requirements applicable to investment advisers and broker-dealers. The SEC indicated that, as part of its comprehensive review, it would consider principal trading by advisers and whether the Rule should be modified, made permanent or allowed to expire.

In the SEC's proposing release regarding the extension of the Rule, it noted that the SEC staff had observed certain compliance issues associated with firms' use of the Rule, including most significantly instances where firms:

- did not comply with section 206(3) of the Advisers Act or the Rule for transactions executed on a principal basis;
- demonstrated technological weaknesses in compliance monitoring of principal trades executed in reliance on the Rule;
- failed to test periodically the adequacy of compliance programs;
- had inadequate policies and procedures relating to the Rule;
- failed to provide adequate disclosures to clients;
- failed to obtain transaction-by-transaction consent required by the Rule;
- provided clients with incomplete or potentially confusing written confirmations; and
- maintained inadequate books and records relating to the Rule.

The SEC reiterated these concerns in the adopting release, and indicated that it would pursue matters where appropriate, including through referrals to the SEC's Division of Enforcement.

The extension of the Rule is a reversal of the SEC's previous announcement that the Rule's expiration date would likely not be extended and would expire on December 31, 2010, which was previously reported in the ***September 13, 2010 Investment Management Regulatory Update***.

- See a copy of the SEC's adopting release with the amendment to the Rule
- See a copy of the SEC's proposing release

Industry Update

President Obama Signs Into Law the Regulated Investment Company Modernization Act of 2010

On December 22, 2010, President Obama signed into law the Regulated Investment Company Modernization Act of 2010 (the "**Act**"). This legislation updates and liberalizes in various respects the U.S. federal tax rules applicable to regulated investment companies ("**RICs**"). The Act includes, with certain minor changes, most of the provisions from the House bill that was introduced on December 16, 2009, which is described in our ***January 7, 2010 Investment Management Regulatory Update***, as well as a few new provisions. The Act does not, however, include the provision that would have expanded the definition of RIC "qualifying income" to include income from investments in commodities other than foreign currencies.

Among the enacted changes are the following:

- ***Savings Provisions for Failures to Satisfy Asset Diversification or Income Test***. A corporation will qualify as a RIC for any taxable year only if (i) it meets an asset diversification test at the close of each quarter of the taxable year and (ii) at least 90% of its gross income for the taxable year consists of certain types of income ("qualifying income"). The Act introduces new "savings" provisions to mitigate the consequences of a RIC's failure to satisfy either of these tests. There is a special cure provision for *de minimis* asset test failures, as well as a mechanism under which a RIC can cure other asset test and "qualifying income" test failures through reporting and the payment of penalty taxes. These provisions apply to any taxable year for which the due date of the RIC's tax return (taking into account extensions) is after the date of enactment.
- ***Repeal of Preferential Dividend Rule for Publicly Offered RICs***. For "publicly offered" RICs, the Act repeals the rule that "preferential" (*i.e.,* non-*pro rata*) dividends do not give rise to a dividends-paid deduction. A RIC will be treated as "publicly offered" for this purpose if its shares

are (i) continuously offered pursuant to a public offering, (2) regularly traded on an established securities market or (3) held by no fewer than 500 persons at all times during the taxable year. This provision applies to distributions in taxable years beginning after the date of enactment.

- ***Redemptions of RIC Stock**.* In general, a redemption of stock by a corporation is treated as a sale or exchange if the redemption meets certain criteria, and otherwise is treated as a distribution. Under the Act, any distribution in redemption of stock of an open-end RIC will be treated as a sale or exchange, rather than as a dividend, provided that the RIC is "publicly offered," as defined above. In addition, except to the extent provided in regulations, the generally applicable rule deferring the recognition of loss from the sale or exchange of property between members of a controlled group of corporations until the property is transferred outside the group will not apply to a RIC's redemption of stock in a lower-tier open-end RIC. These provisions apply to distributions made after the date of enactment.

- ***Pass-Through of Items by Funds of Funds**.* Under the Act, a "qualified fund of funds" will be permitted to pass underlying funds' foreign tax credits and exempt-interest dividends through to the shareholders in the fund of funds. Prior to the enactment of this new provision, a RIC could distribute exempt-interest dividends only if at least 50% of the value of its assets consisted of tax-exempt obligations, and could pass through foreign tax credits to its shareholders only if more than 50% of the value of its assets consisted of stock or securities of foreign corporations. A RIC that invested principally in other RICs did not meet these tests. For purposes of the new provision, a RIC will be a "qualified fund of funds" (and thus will be entitled to pass through tax-exempt interest and foreign tax credits) if, at the close of each quarter of its taxable year, at least 50% of the value of its assets consists of interests in other RICs. This provision applies to taxable years beginning after the date of enactment.

- ***Repeal of 60-Day Dividend Designation Requirements**.* The Act simplifies the manner in which a RIC is required to notify its shareholders of dividends that pass through certain types of underlying RIC income and credits (*e.g.,* capital gain dividends and exempt-interest dividends). Under prior law, a RIC was required to provide a written designation notice not later than 60 days after the close of its taxable year. The Act eliminates the requirement of a separate designation notice, providing only that this information be reported to the RIC shareholders in a written statement, which could be an IRS Form 1099. These provisions apply to taxable years beginning after the date of enactment.

- ***Capital Loss Carryovers**.* The capital loss carryover rules for RICs have been revised to be similar to the rules applicable to individuals. Under prior law, a RIC that had a net capital loss for any taxable year could carry that loss over to each of the eight subsequent taxable years, and the carryover was treated entirely as a short-term capital loss. The Act permits RICs to carry forward net capital losses indefinitely. The excess of a RIC's net short-term capital loss over its net long-term capital gain, if any, will be treated as short-term capital loss, and the excess of a RIC's net long-term capital loss over its net short-term capital gain, if any, will be treated as a long-term capital loss. The new treatment of a portion of the carryover as a long-term capital loss in subsequent years will tend to reduce the amount of the RIC's net long-term capital gain, and therefore the amount of capital gain dividends that the RIC distributes, in those years. The new provisions generally apply to net capital losses for taxable years beginning after the date of enactment.

- ***Revisions to Excise Tax Rules**.* The Act increases from 98% to 98.2% the percentage of capital gain net income that a RIC must distribute in respect of each calendar year in order to avoid the imposition of an excise tax. This increase in the calendar-year distribution requirement was not included in the 2009 proposed legislation. In addition, the Act contains several other technical revisions to the rules governing this excise tax. These provisions apply to calendar years beginning after the date of enactment.

- ***Modification of Loss Disallowance Rule for Sales of Shares in RICs that Regularly Distribute Exempt-Interest Dividends***. In general, losses realized by a shareholder on the sale or exchange of RIC shares that the shareholder has held for six months or less will be disallowed to the extent of any exempt-interest dividends that the shareholder received with respect to those shares. Under the Act, this loss disallowance rule will not apply to shareholders of a RIC that declares exempt-interest dividends on a daily basis, provided that the RIC satisfies certain other requirements. This provision, which was not included in the 2009 proposed legislation, applies to losses incurred on shares of stock for which the shareholder's holding period begins after the date of enactment.
- ***RICs with Non-Calendar Taxable Years***. Various provisions of the Act address the treatment of RICs with taxable years other than the calendar year, including a rule for allocating earnings and profits to distributions on or prior to December 31 in cases in which the RIC makes aggregate distributions in excess of its earnings and profits.
- ***Other Provisions***. Other changes introduced by the Act include (i) rules permitting a RIC to elect to defer until the following taxable year part or all of any late-year capital losses and certain late-year ordinary losses, (ii) technical amendments to the rules applicable to the computation of a RIC's earnings and profits, (iii) liberalization of the rules applicable to the declaration and distribution of "spillover" dividends (that is, certain dividends distributed after the end of a taxable year that are treated as distributed during the taxable year for purposes of the RIC distribution requirements) and (iv) repeal of the penalty for "deficiency" dividends.

Although the version of the new legislation that was passed by the House included a provision that would have treated income from investments in commodities as "qualifying income," that provision was dropped in the Senate. The House version of the legislation would also have repealed the current regulatory authority given to the Treasury Department to exclude from "qualifying income" foreign currency gains that are not directly related to a RIC's principal business of investing in stock and securities or options and futures with respect to stock or securities. It is unclear whether, or when, Congress will consider these provisions again.

- ▸ See a copy of the Act

NASAA Proposes Model Rule for the Exemption of Private Fund Advisers from State Registration

The North American Securities Administrators Association ("**NASAA**") recently issued a proposed model rule on registration and reporting requirements for "private fund" advisers at the state level. The rule corresponds with regulations established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") with respect to certain advisers to hedge funds and other private funds.

Effective July 2011, the Dodd-Frank Act eliminates the "private adviser exemption" in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"), which exempts many private equity and hedge fund advisers from registration under the Advisers Act. The Dodd-Frank Act also established an exemption from registration for advisers that (i) have less than $150 million in assets under management in the United States and (ii) solely advise "private funds" (i.e., funds that rely on the exclusions from the Investment Company Act of 1940 (the "**Investment Company Act**") in Section 3(c)(1) or 3(c)(7) of that act). Such exempt advisers, along with advisers to "venture capital funds," are referred to as "exempt reporting advisers" according to proposed SEC rules and must file reports with the SEC and maintain certain books and records.

While they are not required to register under the Advisers Act, exempt reporting advisers are not excluded from the definition of "investment adviser" under the Advisers Act. Accordingly, states are not preempted by federal law from requiring such advisers to register at the state level.

NASAA's proposed model rule is designed to apply to the state level the new federal laws and SEC implementing regulations applicable to these exempt reporting advisers. Under the proposed model rule, in order for an adviser to be exempt from registration requirements in an adopting state, the adviser must:

- not be subject to a disqualification pursuant to Rule 262 under the Securities Act of 1933;
- only advise "private funds" (as defined above) that qualify for the exclusion from the definition of "investment company" under Section 3(c)(7) of the Investment Company Act;
  - Importantly, the model rule excludes 3(c)(1) private funds as a basis for an exemption from state registration.
- file with the state all reports and amendments that an exempt reporting adviser would be required to file with the SEC; and
- pay the fees specified by the relevant state.

In addition, the model rule provides that (i) the exemption would not apply to investment advisers registered with the SEC and that such SEC registered advisers must comply with applicable state notice filing requirements, (ii) investment adviser representatives associated with the exempt reporting adviser would also be exempt from state registration and (iii) reports filed by the adviser with the state be filed electronically using the IARD.

Because the NASAA's proposal directly corresponds to the SEC's proposed implementing regulations of the relevant Dodd-Frank Act provisions, the NASAA has indicated that the model rule may be altered to adapt to any changes the SEC makes to its proposed rules. For more information regarding the SEC's proposed rules, please see the Davis Polk Client Memoranda ***SEC Proposes Rules Implementing New Exemptions from Advisers Act Registration Under the Dodd-Frank Act*** and ***SEC Issues Proposal Implementing Advisers Act Registration and Reporting Amendments Under the Dodd-Frank Act***.

The NASAA seeks comments on the proposed model rule, especially with regards to its scope. Comments must be submitted by January 24, 2011.

- ► See a copy of the proposed model rule

SEC Extends No-Action Relief for an FCM that Custodies Assets for Registered Funds for Cleared CDS Transactions

On December 3, 2010, the SEC's Division of Investment Management issued a letter extending the period of effectiveness of the no-action relief it had previously granted on July 16, 2010 to the CME Group Inc. under Section 17(f) of the Investment Company Act of 1940 (the "**Investment Company Act**") in instances where a registered investment company (a "**Fund**") or its custodian places and maintains cash and/or certain securities in the custody of the Chicago Mercantile Exchange (the "**CME**") or a CME clearing member (a "**CME Clearing Member**") that is a futures commission merchant ("**FCM**") registered with the Commodity Futures Trading Commission for purposes of meeting the CME's or a CME Clearing Member's margin requirements for certain credit default swap contracts ("**CDS**") that are cleared by the CME (the "**Prior CME Letter**").

Section 17(f) of the Investment Company Act and the rules thereunder govern the safekeeping of Fund assets, and generally provide that a Fund may custody securities and other assets only with certain persons. While Rule 17f-6 under the Investment Company Act provides that Funds may place and maintain assets with an FCM to effect a Fund's transactions in exchange-traded futures contracts or commodity options, Rule 17f-6 does not permit Funds to place and maintain assets with an FCM to effect

CDS transactions. In granting no-action relief in the Prior CME Letter, the SEC staff noted that, among other considerations, the CME and CME Clearing Members are already subject to various requirements that argue in favor of flexibly applying the custody requirements of the Investment Company Act. The assurances under the Prior CME Letter would have expired upon the expiration of certain other conditional exemptions granted to the CME and CME Clearing Members by the SEC (the "**Commission Order**"), which was scheduled to occur on November 30, 2010. The Commission Order recently was extended until July 16, 2011 (the "**New Commission Order**"), and this no-action letter confirmed that the no-action assurances under the Prior CME Letter would be similarly extended. For a summary of the Prior CME Letter, see the ***August 16, 2010 Investment Management Regulatory Update***.

The extension of the Prior CME Letter will expire when the New Commission Order is no longer effective or is rescinded, whichever is earlier.

- See a copy of the no-action letter from the SEC
- See a copy of the letter requesting no-action relief
- See a copy of the New Commission Order

Litigation

Recent New York "Pay-to-Play" Enforcement Actions

As previously reported in several Investment Management Regulatory Updates, including, among others, the ***April 6, 2010, November 12, 2010 and December 17, 2010 Investment Management Regulatory Updates***, the New York State Attorney General's Office has been conducting an on-going investigation into pay-to-play practices involving the Office of the New York State Comptroller and the New York State Common Retirement Fund (the "**CRF**"), the country's third-largest public employee pension fund with an estimated value of $124.8 billion as of June 30, 2010. The investigation, which was initiated in May of 2009, has resulted in eight guilty pleas, including pleas by several prominent public officials, and numerous settlement agreements from firms and individuals to return more than $170 million to the CRF and the State of New York. Additionally, twenty-one firms and four individuals have adopted former New York Attorney General (now Governor) Andrew Cuomo's Public Pension Fund Reform Code of Conduct, which, among other things, bars complying firms from using placement agents to solicit commitments from any public pension fund in the United States.

The Attorney General recently announced three additional settlement agreements in connection with this continuing investigation. Each settlement is discussed below.

NY Attorney General Reaches Settlement with Hedge Fund Manager, HFV Management, LP

On December 15, 2010, then New York Attorney General Andrew Cuomo announced a settlement with Dallas-based hedge fund manager HFV Management, LP ("**HFV**") over HFV co-founder Barrett Wissman's involvement in a pay-to-play scheme with the CRF.

The settlement concerns a $100 million commitment that HFV received from the CRF and that was secured by an arrangement between Wissman and Henry "Hank" Morris, chief political advisor to then-Comptroller Alan Hevesi. In June 2003, the CRF did not have a hedge fund program and the CRF investment committee did not recognize hedge funds as an asset class. According to the settlement agreement, Morris influenced the CRF to invest for the first time in hedge funds and in December 2004, the HFV Multi-Strategy Fund (the "**HFV Fund**") became one of the first hedge funds to receive an investment from the CRF. Morris then ensured that the CRF made a $100 million investment in the HFV Fund. Wissman arranged for HFV to pay a portion of the management fees it received from the CRF to two companies, Nosemote, LLC ("**Nosemote**"), a company owned solely by Morris, and Searle & Co.

("**Searle**"). Morris received 100% of the fees paid to Nosemote and 95% of the fees paid to Searle, totaling approximately $603,099.

As part of the settlement, HFV has agreed to adopt the Attorney General's Public Pension Fund Reform Code of Conduct. Wissman had previously pled guilty to a felony under New York's Martin Act and agreed to pay a $12 million penalty. HFV had previously paid a penalty of $150,000 as part of a settlement reached with the SEC.

- See a copy of the settlement agreement
- See a copy of the press release

NY Attorney General Reaches Settlement with Odyssey Investment Partners, LLC

On December 15, 2010, then New York Attorney General Andrew Cuomo also announced a settlement agreement with New York-based private equity firm Odyssey Investment Partners, LLC ("**Odyssey**"), manager of Odyssey Fund III (the "**Odyssey Fund**").

The settlement is based on an investment in the Odyssey Fund that was allegedly improperly obtained from the CRF. According to the settlement, in 2003 Morris falsely told the Chairman of Odyssey that the CRF had its own placement agent, Searle. As a result, Odyssey used Searle to obtain an investment in the Odyssey Fund from the CRF. Morris failed to tell Odyssey that he was affiliated with Searle and would obtain 95% of all fees Odyssey paid to Searle. Through Morris's efforts, the Odyssey Fund received a $20 million investment from the CRF, and Odyssey paid a total of $400,000 in fees to Searle, of which Morris received $380,000.

Odyssey has agreed to adopt the Attorney General's Public Pension Fund Reform Code of Conduct. Odyssey has also agreed to pay a $400,000 penalty to the state of New York.

- See a copy of the settlement agreement
- See a copy of the press release

NY Attorney General Announces Agreement with Co-Founder and Former Principal of Quadrangle Group, LLC

On December 30, 2010, then New York Attorney General Andrew Cuomo announced an agreement with Steven Rattner, the co-founder and former principal of Quadrangle Group, LLC ("**Quadrangle**"). The settlement arises out of a $150 million investment in Quadrangle made by the CRF, allegedly through the use of a pay-to-play arrangement. Rattner has agreed to pay $10 million in restitution to the state of New York and has agreed to a five-year ban from appearing before any public pension fund in New York state. The agreement ends two lawsuits filed against Rattner by the New York Attorney General and, according to the New York Attorney General, resolves the last major action of their multi-year investigation into pay-to-play violations in New York state public pension funds.

Rattner reached a settlement in November 2010 with the SEC in connection with the same allegations. For more information on Rattner's settlement with the SEC, please see the ***December 17, 2010 Investment Management Regulatory Update***. Quadrangle reached its own settlements with the SEC and the New York Attorney General for its role in the same alleged pay-to-play arrangement, which were publically announced in April 2010. More information about the Quadrangle settlements can be found in the ***May 10, 2010 Investment Management Regulatory Update***.

- See a copy of the 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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