June 19, 2012

Investment Management Regulatory Update

SEC Rules and Regulations

SEC Staff Responds to Questions About Reporting on Part 1A of Form ADV

On June 8, 2012, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued responses (the "**Responses**") to two questions regarding reporting on Part 1A of Form ADV. The first question related to Item 1.O of Form ADV, which requires an investment adviser to report whether it had $1 billion or more in assets on its balance sheet on the last day of its most recent fiscal year. The Responses clarify that "assets" refers to the investment adviser's total assets and not the assets managed on behalf of clients. Thus, for example, an investment adviser that has $5 billion in regulatory assets under management but only $300 million in total assets on its own balance sheet for the most recent fiscal year would answer "no" to Item 1.O.

The second question related to Item 2.A(1) of Form ADV, which large advisory firms may check to establish their eligibility for SEC registration. An investment adviser must file an "annual updating amendment" within 180 days of its fiscal year end to update its responses to all Form ADV items (including Item 2.A). The Responses clarify that an SEC-registered investment adviser that files an annual updating amendment reporting that it is not eligible for SEC registration must withdraw from registration within 180 days of its fiscal year end, *unless* the investment adviser subsequently becomes eligible for SEC registration within that 180-day period. Thus, for example, if an SEC-registered investment adviser reports having regulatory assets under management of less than $90 million on its annual updating amendment, but increases its regulatory assets under management to $90 million or more during the 180-day period, the investment adviser may further amend its Form ADV and check Item 2.A(1) to remain registered with the SEC.

For more information on Form ADV generally, please see the June 29, 2011 Davis Polk Client Memorandum, ***SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940***.

- See a copy of the Responses

SEC Further Extends Deadline for Compliance with Pay-to-Play Rule's Ban on Certain Third-Party Solicitation

On July 1, 2010, the SEC adopted Rule 206(4)-5 (the "**Pay-to-Play Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**") which, among other things, prohibits an SEC-registered investment adviser, certain advisers exempt from registration (including so-called exempt reporting advisers and foreign private advisers) and their "covered associates" from providing or agreeing to provide, directly or indirectly, a "payment" to a third party (such as a solicitor or placement agent) to "solicit" a "government entity" for investment advisory services on behalf of such adviser, *unless* such third party is a "regulated person." A "regulated person" is defined in the Pay-to-Play Rule as (i) an SEC-registered investment adviser in compliance with the political contribution restrictions of the Pay-to-Play Rule, (ii) an SEC-registered broker-dealer that is a member of the Financial Industry Regulatory Authority ("**FINRA**") or (iii) a municipal advisor registered with the SEC under Section 15B of the Securities Exchange Act of 1934 (the "**Exchange Act**") that is subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board ("**MSRB**"), *provided* that, in the case of clauses (ii) and (iii), the SEC determines by order that FINRA and MSRB have pay-to-play rules that are (A) substantially equivalent or more stringent than the Pay-to-Play Rule and (B) consistent with the objectives of the Pay-to-Play Rule.

As discussed in the ***April 19, 2012 Investment Management Regulatory Update***, on June 22, 2011, the SEC extended the date by which advisers must comply with the ban on third-party solicitation under the Pay-to-Play Rule from September 13, 2011 to June 13, 2012. In a June 8, 2012 rule release (the "**Release**"), the SEC further extended the compliance date from June 13, 2012 until nine months after the compliance date of an as-of-yet unadopted final SEC rule requiring municipal advisor firms to register under the Exchange Act. Once such a final rule is adopted, the SEC will issue the new compliance date for the ban on third-party solicitation.

For more information regarding the Pay-to-Play Rule, please see the ***July 14, 2010, April 15, 2011, February 21, 2012 and April 19, 2012 Investment Management Regulatory Updates***.

- See a copy of the Release

Industry Update

Initial Form PF Filing Deadlines Approaching

Investment advisers registered or required to register with the SEC under 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 purposes 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**") and commodity trading advisors ("**CTAs**") and 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.

The information reported on Form PF and shared with the Financial Stability Oversight Council will generally remain confidential, although both the SEC and the CFTC are allowed to use Form PF information in their regulatory programs, including examinations, investigations and enforcement actions. The Form PF adopting release also notes that the SEC and the CFTC may share information reported on Form PF with non-U.S. financial regulatory authorities pursuant to information sharing agreements in which the non-U.S. authority agrees to keep the information confidential. Please see the ***November 18, 2011 Investment Management Regulatory Update*** for a discussion of the final Form PF rules.

Frequency of Reporting

Large liquidity fund advisers are required to file Form PF on a quarterly basis within 15 days after the end of each of their fiscal quarters. Large hedge fund advisers are required to file Form PF on a quarterly basis within 60 days after the end of each of their fiscal quarters. Finally, large private equity fund advisers and small private fund advisers are required to file Form PF annually within 120 days after the end of their fiscal year. For explanations of the terms large liquidity fund adviser, large hedge fund adviser, large private equity fund adviser and small private fund adviser, please see the ***November 18, 2011 Investment Management Regulatory Update***.

Initial Filing Deadlines

Large Liquidity Fund Advisers with $5 Billion in AUM. For advisers with at least $5 billion in combined assets under management attributable to liquidity funds and registered money market funds as of the end of their most recently completed fiscal quarter prior to June 15, 2012, the compliance date is June 15, 2012. Thus, an adviser with a June 30 fiscal quarter end and $5 billion in combined liquidity fund and registered money market fund assets as of March 31, 2012 must file its initial Form PF by July 15, 2012—15 days after June 30, 2012.

Large Hedge Fund Advisers with $5 Billion in AUM. For advisers with at least $5 billion in assets under management attributable to hedge funds as of the end of their most recently completed fiscal quarter prior to June 15, 2012, the compliance date is also June 15, 2012. Thus, an adviser with a June 30 fiscal quarter end and $5 billion in hedge fund assets under management as of March 31, 2012 must file its initial Form PF by August 29, 2012—60 days after June 30, 2012.

Large Private Equity Fund Advisers with $5 Billion in AUM. For advisers with at least $5 billion in assets under management attributable to private equity funds as of the last day of their first fiscal year ending on or after June 15, 2012, the compliance date is June 15, 2012. Thus, an adviser with a June 30 fiscal year end and $5 billion in private equity assets under management as of June 30, 2012 must file its initial Form PF by October 28, 2012—120 days after June 30, 2012.

All Other Private Fund Advisers. For all other private fund advisers that do not fit into one of the above categories, the compliance date is December 15, 2012. Thus, a small private fund adviser with a December 31 fiscal year end must file its initial Form PF by April 30, 2013—120 days after December 31, 2012.

Form PF Reporting

All Form PF filers are required to complete Sections 1a and 1b, while hedge fund advisers are required to complete Section 1c for each hedge fund that they advise. Large hedge fund advisers are required to complete Section 2, large liquidity fund advisers are required to complete Section 3 and large private equity fund advisers are required to complete Section 4. Advisers must file Form PF electronically through the Form PF filing system on the Investment Adviser Registration Depository. The filing fee is $150.

- See a copy of the SEC's adopting release
- See a copy of the fact sheet

SEC Officials Discuss Three-Part Strategy to Examine Newly Registered Investment Advisers and Other Key Compliance Issues

Senior officials of the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") recently announced that the SEC will employ a three-part strategy to examine newly registered investment advisers. As a result of SEC rules implementing certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), most investment advisers with $100 million or more in assets under management formerly relying on the so-called private adviser exemption were required to register with the SEC and come into compliance with the obligations of a registered investment adviser by March 30, 2012. For a more detailed discussion of certain amendments to the Advisers Act effected by the Dodd-Frank Act, please see the June 29, 2011 Davis Polk Client Memorandum ***SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940***. More than 1,350 investment advisers that manage one or more private funds have registered with the SEC since the effective date of the Dodd-Frank Act on July 21, 2011 according to OCIE deputy director Norm Champ.

Speeches by OCIE director Carlo V. di Florio at the Private Equity International Private Fund Compliance Forum on May 2, 2012 and by Norm Champ at the New York City Bar Association on May 11, 2012 (collectively, the "**SEC Speeches**") outlined the SEC's new three-part strategy. The initial phase of the strategy will involve industry outreach and educational initiatives, which are intended to share the SEC's "expectations and perceptions of the highest-risk areas." The initial phase will be followed by a coordinated series of examinations of a "significant percentage" of newly registered investment advisers. These examinations are expected to focus on assessing the highest risk areas of new registrants' businesses, as well as allowing the SEC to "risk-rate" such registrants. Finally, the three-part strategy will conclude with the SEC publishing a series of "after-action" reports that would inform investment advisers of "the broad issues, risks, and themes identified during the course of the examinations."

The SEC Speeches also highlighted three key compliance issues for investment advisers resulting from their role as fiduciaries to their advisory clients: (i) the fair allocation of fees and expenses between the investment adviser and its advisory clients (emphasizing particular caution when allocating fees and expenses among funds co-investing in the same investment vehicle) and timely, accurate and complete disclosure to clients of such allocations; (ii) the identification and proper disclosure and mitigation of conflicts of interest resulting from the type and structure of investments their private funds typically make; and (iii) effective risk management structures and processes. With respect to risk management, the SEC Speeches raised key questions such as (1) whether the investment adviser has control, compliance and risk management functions that are integrated into the firm yet sufficiently independent so as to be effective, (2) whether senior managers effectively oversee risk management and (3) whether the investment adviser has the proper staffing and structure to adequately set risk parameters, foster a culture of effective risk management and oversee risk-based compensations systems and risk profiles.

Di Florio further highlighted several conflicts of interest that the SEC has encountered during recent examinations and that will likely continue to be a focus in future examinations of registered investment advisers. Included among these conflicts of interest were (i) the improper shifting of management company expenses to fund clients; (ii) the charging of questionable fees to portfolio companies; (iii) opaque fee disclosures; (iv) the favoring of side-by-side funds and preferred separate accounts by shifting expenses to less favored funds; (v) the investment by one or more funds managed by the investment adviser into both equity and debt of a company; (vi) inadequate disclosure regarding the ability of a portfolio company to hire a related party to the investment adviser to provide consulting or investment banking services; (vii) weak or non-existent controls on the flow of information between the investment adviser's business lines where there may be the potential for confidential information to be improperly shared; and (viii) poor physical security over the investment adviser's office space during business hours. Di Florio advised registrants to be proactive in identifying conflicts of interest and remediating them with strong policies, procedures and risk controls. He also urged advisers to document their due diligence on transactions and valuations and to be forthcoming with the SEC staff regarding any conflicts-related problems.

- See a copy of di Florio's speech
- See a copy of Champ's speech

CFTC Adopts Recordkeeping and Reporting Requirements for "Historical Swaps"

On May 18, 2012, the CFTC adopted Part 46 final rules (the "**Final Rules**") for recordkeeping and reporting of "historical swaps." Historical swaps include "pre-enactment swaps"—swaps entered into before the enactment of the Dodd-Frank Act on July 21, 2010 but not terminated or expired as of that date—and "transitional swaps"—swaps entered into between July 21, 2010 and the upcoming effective date of the CFTC's swap reporting rules.

Recordkeeping Requirements. The Final Rules require all market participants to keep records regarding historical swaps to which they are a counterparty. The data that must be kept, the form the data must be kept in and the speed with which the data must be retrievable depends on whether the counterparty is a swap dealer ("**SD**"), a major swap participant ("**MSP**") or an end-user, and whether the swap expired or was terminated before April 25, 2011.

Reporting Requirements. The Final Rules designate a "reporting counterparty" with the responsibility of reporting specified swap data to a swap data repository ("**SDR**"). A reporting counterparty may use third-party services to comply with the rules but remains responsible for ensuring compliance. The Final Rules require the reporting counterparty to a historical swap to provide an "initial data report" to the SDR on the relevant compliance date that includes the minimum primary economic terms data listed in Appendix I to the Final Rules. In addition, the Final Rules require the reporting counterparty to an uncleared historical swap to report any change in the data in the initial report to the same SDR to which the initial report was made. However, the Final Rules do not require derivatives clearing organizations to report or retain continuation data for cleared historical swaps.

In addition, the Final Rules require the reporting counterparty to report any errors or omissions in reported data "as soon as technologically practicable" after discovering the error. Non-reporting counterparties that discover an error or omission are required to notify the reporting counterparty, who in turn is required to report the error to the SDR. These requirements only apply if the parties "discover" an error or omission; neither counterparty is required to verify proactively the accuracy of SDR records. Finally, the initial data report for each historical swap in existence on or after April 25, 2011 must include the legal entity identifier of the reporting party as well as the reporting party's internal identifier for the non-reporting counterparty.

Compliance Dates. SDs and MSPs will need to comply with the Final Rules, and provide initial data reports, with respect to interest rate swaps and credit default swaps by 60 days after the SEC and CFTC publish final rules defining "swap" in the Federal Register (the "**First Compliance Date**"). Compliance by SDs/MSPs for other swap asset classes is required 90 days after the First Compliance Date. Compliance by non-SDs/MSPs is required 180 days after the First Compliance Date.

For more information on the Final Rules, please see the June 5, 2012 Davis Polk Client Memorandum, ***CFTC Adopts Historical Swap Recordkeeping and Reporting Requirements***.

- See a copy of the CFTC's Final Rules

CFTC Proposes Further Exemptions and Clarifications on Existing Exemptions from Aggregation Requirements under its Part 151 Position Limit Rules

On May 30, 2012, the CFTC published proposed rules (the "**Proposal**") to provide additional exemptions and clarification on several existing exemptions from the aggregation requirements found in the CFTC's Part 151 position limit rules that were adopted in October 2011 ("**Part 151**"). Part 151 creates position limits for futures and options on 28 exempt (metals and energy) and agricultural commodities and swaps, futures, and options that are economically equivalent to those contracts. Please see the ***November 18, 2011 Investment Management Regulatory Update*** for a discussion of the final position limit rules.

Although Part 151 provides some exemptions from the aggregation requirements, the Proposal would significantly liberalize the aggregation provisions of Part 151.

Owned Entity Exemption. Part 151 requires that a person aggregate all referenced contract positions in all accounts or positions in which the person directly or indirectly has a 10% or greater ownership or equity interest, with exceptions for passive ownership as a limited partner or other types of similar ownership (subject to specified conditions). The Proposal would broaden this exemption by allowing a person to disaggregate the positions of an entity in which the person has no greater than a 50% ownership or equity interest. In order to rely on this exemption, the person and the owned entity would need to comply with several enumerated conditions, including that neither the person nor the owned entity have knowledge of the trading decisions of the other and that the person submit a notice filing in accordance with the procedures under CFTC Rule 151.7(h).

Information Sharing Exemption. The Proposal would also clarify the exemption provided in CFTC Rule 151.7(i), which permits disaggregation if the sharing of information in connection with aggregation "would cause either person to violate federal law or regulations." Under Part 151, a person relying on this exemption must file an opinion of counsel that the sharing of information in connection with aggregation would cause a violation of federal law or regulations. The Proposal modifies this exemption by allowing a person to rely on the exemption if the sharing of information in connection with aggregation "creates a reasonable risk that either person could violate state or federal law or the law of a foreign jurisdiction, or regulations adopted thereunder." While the Proposal would retain the requirement for the filing of an opinion of counsel, the opinion would be required only to provide that the sharing of information creates a "reasonable risk" that either person would violate applicable law.

Comments on the Proposal must be received on or before June 29, 2012. The CFTC did not provide for a delay in the effectiveness of Part 151, under which the position limits generally become effective 60 days after the term "swap" is further defined by the CFTC and the SEC. This suggests that the CFTC intends to finalize the Proposal prior to the implementation of the Part 151 position limit rules.

For more information on the Proposal, please see the May 22, 2012 Davis Polk Client Memorandum, ***CFTC Proposes Exemptions from Aggregation under its Position Limits Rule***.

- See a copy of the CFTC's notice of proposed rulemaking

CFTC Chairman Discusses Key Provisions of Prospective Dodd-Frank Title VII Cross-Border Guidance

On May 21, 2012, in a speech at the 2012 FINRA Annual Conference, CFTC Chairman Gary Gensler discussed key provisions of the CFTC's upcoming guidance on the cross-border application of Title VII of the Dodd-Frank Act. Section 722(d) of the Dodd-Frank Act provides that Title VII shall apply to swap activities outside the United States that "have a direct and significant connection with activities in, or effect on, commerce of the United States." The CFTC is expected to release its recommendations and seek public comment on the cross-border application of swaps market reforms sometime this June. According to Chairman Gensler, the proposed cross-border guidance will address how Title VII's registration, transaction-level and entity-level requirements for swap dealers and major swap participants would apply to non-U.S. swap dealers and non-U.S. major swap participants, including those that are affiliated with U.S. financial institutions.

Chairman Gensler also said the forthcoming guidance is likely to cover (i) the circumstances under which a non-U.S. entity must register under the CFTC's recent swap dealer registration rules, (ii) the meaning of U.S. facing transactions, (iii) a tiered approach for requirements for non-U.S. swap dealers, (iv) substituted compliance with entity-level requirements and (v) limited exclusions for transaction-level requirements.

For more information on Chairman Gensler's speech, please see the May 21, 2012 Davis Polk Client Newsflash ***CFTC Chairman Gensler Previews Key Elements of Dodd-Frank Title VII Cross-Border Guidance***.

- See a copy of Chairman Gensler's speech

Litigation

SEC Settles with Former Fund Executive for FCPA and Advisers Act Violations

On April 25, 2012, the SEC settled charges with Garth Peterson, a former managing director in a bank's real estate investment and fund advisory business, in connection with alleged violations of the anti-bribery, books and records and internal control provisions of the Foreign Corrupt Practices Act (the "**FCPA**") and aiding and abetting violations of the anti-fraud provisions of the Advisers Act. The SEC contended that Peterson had secretly acquired millions of dollars worth of investments from the bank's real estate funds for himself, a Canadian attorney and a Chinese official who, in turn, steered business to the bank's real estate funds and used his influence to obtain approvals necessary from the Chinese government for certain transactions to close.

According to the SEC's complaint filed in the U.S. District Court for the Eastern District of New York, Peterson developed a personal relationship with the Chinese official who was the chairman of Yongye Enterprises (Group) Co. (the "**Chinese Entity**"), a Chinese state-owned entity through which Shanghai's Luwan District managed real estate developments in Shanghai. The Chinese official had the authority to make investment decisions for the Chinese Entity. The SEC's complaint alleged that Peterson led "[the bank's] efforts to build a Chinese real estate investment portfolio for its real estate funds by cultivating a relationship with the Chinese official to take advantage of his ability to steer opportunities to [the bank] and his familiarity with and influence in helping with governmental approvals. . . ."

The SEC alleged that Peterson's misconduct began in 2004 when he encouraged the bank to sell part of its real estate fund's interest in a Shanghai real estate deal to an entity that Peterson falsely represented to the bank on numerous occasions as being a subsidiary of the Chinese Entity when, in fact, the entity was controlled by Peterson, the Chinese official and the Canadian attorney. The SEC's complaint stated that Peterson negotiated both sides of the transaction and arranged for the entity to purchase the interest from the real estate fund for less than its fair market value. In addition, the SEC noted that Peterson openly credited the Chinese official with helping to obtain necessary government approvals for this transaction. The SEC cited another instance in 2005 when Peterson again negotiated both sides of a transaction in which he secretly acquired an interest from another real estate fund of the bank in a real estate deal for himself and the Canadian attorney. The SEC noted that at the same time of these investments, Peterson and the Chinese official expanded their personal business dealings by investing together in Chinese franchises of U.S. fast food restaurants. Peterson failed to disclose all of these investments in the annual disclosures that the bank required as part of his employment.

The SEC further claimed that in a 2006 transaction in which one of the bank's real estate funds acquired an interest in a property from the Luwan District, Peterson caused the fund to pay a $2.2 million finder's fee to an unidentified Shanghai investor. The investor transferred $1.6 million of this fee to Peterson in exchange for Peterson's promise to help the investor participate in future business transactions with the bank. Peterson then transferred $700,000 of this fee to the Chinese official.

In settling with the SEC, Peterson agreed to be permanently barred from the securities industry, pay more than $250,000 in disgorgement and relinquish his interest in certain Chinese real estate valued at approximately $3.4 million that he secretly acquired through the misconduct alleged by the SEC. The proposed settlement is subject to court approval. The U.S. Department of Justice (the "**DOJ**") has filed a related criminal complaint against Peterson.

The bank was not charged by the SEC or the DOJ in this matter. The SEC's complaint noted that the bank had policies and internal controls intended to prevent improper payments to foreign government officials. In addition, the bank had trained Peterson on the FCPA on numerous occasions and had provided Peterson with at least 35 FCPA compliance reminders. A compliance officer of the bank had also informed Peterson that employees of the Chinese Entity were government officials for purposes of the FCPA. Peterson had annually certified his adherence to the bank's code of conduct, including certifications aimed at identifying corruption risks and activities that would violate the FCPA. U.S. Attorney Loretta Lynch noted that Peterson had "used a web of deceit to thwart [the bank's] efforts to maintain adequate controls designed to prevent corruption. Despite years of training, he circumvented those controls for personal enrichment." In addition to having robust internal controls, the SEC's press release noted that the bank had cooperated with the SEC's inquiry and conducted a thorough internal investigation to determine the scope of the improper payments and other alleged misconduct.

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

OFAC Settles with Investment Adviser over Alleged Iranian Economic Sanctions Violation

On May 21, 2012, the U.S. Department of the Treasury's Office of Foreign Assets Control ("**OFAC**") announced that Genesis Asset Managers, LLP ("**GAM US**"), a registered U.S. investment adviser, agreed to pay $112,500 to settle potential civil liability for an apparent violation of the Iranian Transactions Regulations, 31 C.F.R. part 560 (the "**ITR**").

GAM US is the investment manager for Genesis Emerging Markets Fund ("**GEMF**"), a Guernsey-organized fund. Pursuant to an investment advisory contract between GAM US and its London-based subsidiary, Genesis Investment Management LLP ("**GIM UK**"), GIM UK provides investment advice and recommendations to GAM US relating to GEMF. According to OFAC's settlement notice, the alleged violation occurred in 2007 when GIM UK, acting as GAM US's agent, purchased approximately $3 million of shares for GEMF in a Cayman Islands fund that invests exclusively in Iranian securities.

Although GAM US's non-U.S. subsidiary GIM UK made the purchase of securities at issue, OFAC apparently considered GAM US to be responsible for the acts of GIM UK, its agent, pursuant to delegated authority. OFAC cited several aggravating factors in this case, including the facts that GAM US had "failed to exercise a minimal degree of caution or care in the conduct that led to the apparent violation of the ITR" and that its officers were aware of the conduct giving rise to the alleged violation. OFAC also noted that GAM US did not have an OFAC compliance program in place, thus illustrating the importance to U.S. investment managers of rigorously implementing economic sanctions policies and procedures. The settlement amount could have been substantially higher had GAM US not fully and promptly cooperated with OFAC following its voluntary disclosure of the matter and taken remedial measures that OFAC viewed as appropriate.

- See a copy of OFAC's settlement notice

SEC Brings Influence Peddling Scheme Charges Against Former Detroit Officials and Investment Adviser to the City's Pension Funds

On May 9, 2012, the SEC brought charges in the U.S. District Court for the Eastern District of Michigan against former Detroit mayor Kwame Kilpatrick ("**Kilpatrick**"), former Detroit treasurer Jeffrey Beasley ("**Beasley**"), MayfieldGentry Realty Advisors, LLC ("**MGRA**"), a registered investment adviser, and Chauncey Mayfield ("**Mayfield**"), the CEO and majority owner of MGRA, for engaging in an influence peddling scheme involving Detroit's pension funds. The SEC charged each of the defendants with violating Section 10(b) of the Exchange Act and Rules 10b-5(a), 10b-5(b) and 10b-5(c) thereunder. The SEC also charged MGRA and Mayfield with violating Section 17(a) of the Securities Act of 1933 and Sections 206(1) and 206(2) of the Advisers Act[1] and charged Kilpatrick and Beasley with aiding and abetting the Sections 206(1) and 206(2) anti-fraud provision violations.

According to the SEC's complaint, Kilpatrick and Beasley, both members of the boards of trustees of the pension funds, solicited and received more than $125,000 of travel and other perks from Mayfield and MGRA in 2007, including a trip via private jet to Las Vegas where Kilpatrick, Beasley and their associates were treated to luxury hotel accommodations, rounds of golf, concerts, meals and other entertainment, as well as private jet and other travel expenses for Kilpatrick and Beasley and their family and friends. The SEC alleged that none of these perks were business related. During this same period of time, Mayfield and MGRA, which had managed assets of the pension funds since 2002, were recommending to the trustees that the pension funds invest more than $115 million in a REIT controlled by MGRA. The trustees, including Kilpatrick's and Beasley's proxies, voted in favor of the REIT investments and, according to the SEC, Mayfield and MGRA received millions of dollars in fees as a result.

The SEC alleged that all of the defendants were investment fiduciaries to the pension funds under state law and, therefore, had a duty to disclose to the pension funds and the trustees the perks received by Kilpatrick and Beasley from Mayfield and MGRA and the conflicts of interest they presented. In addition, the advisory agreements between MGRA and the pension funds provided that MGRA would immediately disclose to the pension funds any actual or potential conflicts of interest. According to the SEC's complaint, however, none of the defendants made any such disclosures and such failure to disclose constituted fraud on the pension funds.

The SEC is seeking disgorgement of ill-gotten gains derived from the defendants' alleged misconduct plus prejudgment interest, civil monetary penalties and permanent injunctions from future violations of the federal securities laws and from participation by Kilpatrick and Beasley in any decisions involving investments in securities by public pensions.

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

[1] The investment advisers' alleged misconduct predated the enactment of the Adviser's Act Pay-to-Play Rule, Rule 206(4)-5 of the Advisers Act, which restricts "pay-to-play" practices by investment advisers seeking to provide investment advisory services to public pension funds and other state and local government clients.

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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