Davis Polk
CLIENT NEWSLETTER

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Investment Management Regulatory Update

SEC Rules and Regulations

SEC Issues Proposed Rules Implementing Advisers Act Exemptions and Other Amendments Under the Dodd-Frank Act

On November 19, 2010, the SEC issued a release (the "**Exemptions Release**") proposing rules to implement certain provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") that exempt certain advisers from registration under the Investment Advisers Act of 1940 (the "**Advisers Act**"). Among other things, the SEC's proposal:

- defines "venture capital fund" for the purposes of the new Advisers Act exemption for advisers to venture capital funds;
- proposes a new rule that would exempt from registration certain private fund advisers with less than $150 million in assets under management in the United States; and
- clarifies the meaning of certain terms used in the new exemption for foreign private advisers.

On the same day, the SEC issued a companion release (the "**Implementing Release**") in which it proposed rules and rule amendments, including various amendments to Form ADV, to implement certain provisions of Title IV of the Dodd-Frank Act that amend the Advisers Act. The SEC's proposal would implement:

- the increased statutory threshold for adviser registration with the SEC;
- the reporting requirements of certain advisers exempt from registration;
- conforming and other changes to Form ADV; and
- certain rule amendments, including amendments to the SEC's "pay-to-play" rule in light of changes made by the Dodd-Frank Act.

Both releases are discussed in greater detail in 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***.

Comments are due to the SEC on each of these proposals by January 24, 2011.

- See a copy of the Exemptions Release containing the full text of the proposed rules
- See a copy of the Implementing Release containing the full text of the proposed rules
- See a copy of the press release and fact sheet issued by the SEC

Industry Update

Federal Reserve Board Proposes Volcker Rule Transition Rules

On November 17, 2010, the Federal Reserve Board (the "**Fed**") released proposed rules to implement the conformance period during which banking entities must bring their activities and investments into compliance with the restrictions imposed by new Section 13 of the Bank Holding Company Act, commonly referred to as the "**Volcker Rule**." The Fed is requesting comments on the proposed rules, due January 10, 2011.

The Volcker Rule generally prohibits banking entities from engaging in proprietary trading and, subject to certain exceptions, from sponsoring or investing in hedge funds and private equity funds. It also places additional capital requirements, quantitative limits and other restrictions on systemically important nonbank financial institutions that engage in such activities. The Volcker Rule will become effective July 21, 2012 or one year after the issuance of final regulations implementing the Volcker Rule, whichever is earlier.

Under the statute and the proposed rules, banking entities must generally bring their activities and investments into compliance with the requirements and restrictions imposed by the Volcker Rule within two years after the effective date, subject to the authority of the Fed to extend on a case-by-case basis the two-year conformance period by up to three additional one-year periods and, for certain illiquid funds, up to an additional five years.

Extended Transition Period for Illiquid Funds

To address the difficulties a banking entity may encounter in conforming its investments in, or relationships with, illiquid funds, the Volcker Rule permits a banking entity to request an additional extension of up to five years for investments in, or obligations to provide additional capital to, illiquid funds. This extension is in addition to the 2-year general conformance period and the three 1-year extensions. This additional extension is only available where necessary to allow a banking entity to fulfill a contractual obligation that was in effect on May 1, 2010. Under the proposed rules, any extended transition period will terminate automatically on the date on which the banking entity is no longer under such a contractual obligation to invest in or provide additional capital to the illiquid fund.

Illiquid Fund

Under the Volcker Rule, to be considered an "illiquid fund," a hedge fund or private equity fund, as of May 1, 2010, must have been either (i) "principally invested in illiquid assets" or (ii) "invested in, and contractually committed to principally invest in, illiquid assets." In either case, the fund must make all of its investments "pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets."

Illiquid Assets

The proposed rules define an illiquid asset as an asset that is not a "liquid asset" or an asset that, because of statutory or regulatory restrictions applicable to the fund, cannot be transferred to an unaffiliated person. In the latter case, the asset may be considered an illiquid asset only for so long as such statutory or regulatory restrictions are applicable.

"**Liquid assets**" are defined as:

- cash or cash equivalents;
- assets traded on a recognized, established exchange, trading facility or market on which there exist independent, bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular asset almost instantaneously;
- assets for which there are bona fide, competitive bid and offer quotations in recognized inter-dealer quotation systems or similar systems or for which multiple dealers furnish bona fide, competitive bid and offer quotations to brokers and dealers on request;
- assets with prices that are quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;
- assets with initial terms of one year or less the payments on which at maturity can be settled, closed out, or paid in cash or other liquid assets described in the bullet points above; and
- any other assets the Fed determines, based on all the facts and circumstances, to be liquid assets.

Specific examples of illiquid assets cited by the release accompanying the proposed rules include (i) investments in portfolio companies, (ii) real estate investments (except those made through real estate investment trusts), (iii) venture capital investments and (iv) investments in hedge funds or private equity funds that are not publicly traded and invest in illiquid assets.

Principally Invested

Under the proposed rules, a fund is "principally invested in illiquid assets" if at least 75% of its consolidated total assets (as reflected on the fund's financial statements prepared in accordance with applicable accounting standards) are composed of illiquid assets or risk-mitigating hedges entered into in connection with and related to individual or aggregate positions in, or holdings of, the illiquid assets.

Contractually Committed

Under the proposed rules, a fund is "contractually committed to principally invest in illiquid assets" if organizational documents or other documents that constitute a contractual obligation of the fund, which were in effect as of May 1, 2010, provide for the fund to be principally invested in illiquid assets beginning on the date when capital contributions are first received for the purpose of making investments and ending on the expected termination date of the fund.

Investment Strategy

Under the proposed rules, a fund has an "investment strategy to principally invest in illiquid assets" if the fund either (i) markets or holds itself out to investors itself as intending to principally invest in illiquid assets or (ii) has a documented investment policy of principally investing in illiquid assets.

Contractual Obligation

In addition to the aforementioned criteria, in order to be eligible for the extended conformance period for illiquid funds under the Volcker Rule, the banking entity's investment in an illiquid fund, or its obligation to provide additional capital to the illiquid fund, must be necessary to fulfill a "contractual obligation" that was in effect on May 1, 2010.

The proposed rules provide that a banking entity will be considered to have a "contractual obligation" to take or retain an equity, partnership or other ownership interest in an illiquid fund if, under the terms of such interest in the fund or other contractual agreements with the fund, the banking entity is prohibited from (i) redeeming all of such interests in the fund and (ii) selling or transferring all such interests to any person that is not an affiliate of the banking entity. A banking entity has a contractual obligation to provide additional capital to the illiquid fund if the banking entity is required under the terms of its interest in the fund or other contractual arrangements with the fund to provide additional capital to such fund. In either case, a banking entity will *only* be considered to have a contractual obligation if (i) the obligation may not be terminated by the banking entity or any of its subsidiaries or affiliates under the terms of its agreement with the fund and (ii) in the case of an obligation that may be terminated with the consent of third parties, the banking entity and its subsidiaries and affiliates have used their reasonable best efforts to obtain such consent and such consent was denied.

Requests to Extend Conformance Period

Under the proposed rules, a banking entity seeking an extension of the conformance period must (i) submit a written request for the extension to the Fed at least 90 days prior to the end of the applicable conformance period, (ii) provide reasons the extension should be granted addressing certain factors and (iii) provide a detailed explanation of its plan for divesting or conforming the activities or investments.

Under the proposed rules, any request for an extension by a banking entity must address, to the extent relevant:

- whether the activity or investment:
  - involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties;
  - would result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;
  - would pose a threat to the safety and soundness of the banking entity; or
  - would pose a threat to the financial stability of the United States;
- market conditions;
- nature of the investment or activity;
- date that the contractual obligation of the banking entity to make or retain an investment in the fund was incurred and when it expires;
- contractual terms governing the banking entity's interest in the fund;
- degree of control held by the banking entity over investment decisions of the fund;
- types of assets held by the fund;
- date on which the fund is expected to wind up its activities and liquidate or its investments may be redeemed or sold;
- total exposure of the banking entity to the activity or investment and the risks that disposing of or maintaining the investment or activity may pose to the banking entity or the financial stability of the United States;
- cost to the banking entity of disposing of the activity or investment within the applicable period; and
- any other factors the Fed deems relevant.

The proposed rules also allow the Fed to impose conditions on any extension as it deems necessary to, among other things, protect the safety and soundness of banking entities or the financial stability of the United States.

Systemically Important Nonbank Financial Companies

While the Volcker Rule does not prohibit nonbank financial companies designated as systemically important from engaging in proprietary trading, or from maintaining investments in or relationships with hedge funds and private equity funds, the Fed may impose capital charges, quantitative limits or other restrictions on such companies. Under the proposed rules, a systemically important nonbank financial company is provided a similar two-year conformance period, which commences from the date on which the company is designated as systemically important and may be extended by up to three one-year periods.

The proposed rules only address issues related to the conformance period and do not address other aspects of the Volcker Rule, which are subject to separate rulemaking requirements.

- See a copy of the proposed rule

European Parliament Passes Final AIFM Directive on the Regulation of Fund Managers

On November 11, 2010, the European Parliament voted to approve the Directive on Alternative Investment Fund Managers (the "**Directive**"), which implements a new regulatory framework for the supervision of alternative investment fund managers ("**AIF Managers**") that conduct business in the European Union (the "**EU**"). An AIF Manager is any legal person whose regular business is managing one or more alternative investment funds ("**AIFs**"). In general, AIFs encompass a wide variety of investment funds, regardless of their legal form or whether they are listed, not already regulated by the UCITS Directive. The Directive is expected to take effect in 2011 and each member state of the EU (each, an "**EU Member State**") must codify the Directive as national law by 2013. See the ***June 10, 2010, April 6, 2010, February 5, 2010*** *and* ***May 8, 2009 Investment Management Regulatory Updates*** for more background on the Directive.

The Directive allows AIF Managers to manage AIFs in the EU and market AIFs in the EU to "professional investors", which are defined as any investor considered to be a professional client or who may be treated as a professional client pursuant to a prior directive from 2004, and, subject to certain conditions, to retail investors. If an EU Member State intends to allow marketing to retail investors, such EU Member State must inform the European Commission (the "**EC**") and the European Sales and Marketing Association ("**ESMA**") about the types of AIFs that an AIF Manager intends to market and about any additional requirements that the EU Member State imposes for the marketing of AIFs to retail investors. An EU Member State must inform the EC and ESMA within a year after such EU Member State enacts the Directive. Authorization under the Directive not only allows an AIF Manager to manage AIFs established within the AIF Manager's home EU Member State, but also allows an AIF Manager to market to professional investors within the EU generally and manage AIFs established in EU Member States other than the AIF Manager's home EU Member State.

Scope and Application of the Directive

The Directive applies to AIF Managers that manage or market one or more AIFs in the EU. The application of the Directive with respect to the marketing of AIFs in the EU generally depends on whether (i) the manager is an EU AIF Manager or a non-EU AIF Manager and (ii) the fund is an EU AIF or a non-EU AIF. An EU AIF Manager is defined as any AIF Manager which has its registered office within an EU Member State. An EU AIF includes (i) any AIF which is authorized or registered in an EU Member State and (ii) any AIF which is not authorized or registered in an EU Member State but nonetheless has its registered office and/or its head office in an EU Member State. A Non-EU AIF is defined under the

Directive as any AIF which is not an EU AIF and a non-EU AIF Manager is defined under the Directive any AIF Manager which is not an EU AIF Manager.

For an EU AIF Manager marketing an EU AIF, once the manager is authorized under the Directive in one EU Member State, and complies with certain rules under the Directive, the EU AIF Manager is authorized to "passport" its services and market an EU AIF to professional investors in all EU Member States. Non-EU AIF Managers and non-EU AIFs (regardless of whether they are managed by an EU AIF Manager or a non-EU AIF Manager) can avail themselves of the EU marketing passport regime, subject to certain conditions and restrictions, after a transition period of two years following the initial two-year implementation period during which the EU Member States must codify the Directive.

Before a non-EU AIF Manager can utilize the Directive's passport regime, for marketing either an EU AIF or non-EU AIF throughout the EU Member States, it must become authorized under the Directive by its "Member State of reference" and generally comply with all the requirements under the Directive. In order for a non-EU AIF to become authorized under the Directive, certain conditions must be satisfied including:

- cooperation agreements must be in place between the competent authorities of the EU Member State of reference and the AIF Manager's home country, ensuring an efficient exchange of information that allows the competent authorities to carry out their obligations under the Directive;
- the AIF Manager must appoint a legal representative established in its Member State of reference, which will be the contact person for the investors of the relevant AIF, the ESMA and for the competent authorities, and this person should be able to perform certain compliance functions under the Directive;
- the AIF Manager's home country must not be listed as a "non-cooperative country" by the Financial Action Task Force ("**FATF**") on anti-money laundering and terrorist financing;
- the AIF Manager's home country must have an agreement with the Member State of reference that complies with Article 26 of the OECD Model Tax Convention and ensures an effective exchange of tax information; and
- the laws or supervisory authorities of the AIF Manager's home country must not frustrate the effective exercise by the competent authorities of their supervisory functions under the Directive.

In order for an authorized non-EU AIF manager to market a non-EU AIF throughout the EU, certain additional conditions must be satisfied with respect to the home country of the non-EU AIF:

- cooperation agreements must be in place between the competent authorities of the EU Member State of reference and the home country of the AIF in order to ensure an efficient exchange of information that allows the competent authorities to carry out their obligations under the Directive;
- the AIF's home country must not be listed as a "non-cooperative country" by the FATF on anti-money laundering and terrorist financing; and
- the AIF's home country must have an agreement with the Member State of reference and with each other Member State in which the shares of the non-EU AIF will be marketed, which fully complies with Article 26 of the OECD Model Tax Convention and ensures an effective exchange of tax information.

In addition to the passport regime, non-EU AIF Managers and all AIF managers marketing non-EU AIFs may market AIFs directly into individual EU Member States provided that such EU Member State allows the marketing of such AIFs into its territory under its own national securities laws. Certain additional conditions and restrictions apply depending on the type of manager (*i.e.,* EU or non-EU) and type of AIF (*i.e.*, EU or non-EU). For a non-EU AIF Manager marketing an AIF (either an EU AIF or a non-EU AIF) directly into an EU Member State, the following conditions and requirements apply:

- the AIF Manager must comply with certain reporting and disclosure obligations—including the requirement to provide investors an annual report—under the Directive (but not other provisions of the Directive);
- cooperation agreements for the purpose of systemic risk oversight must be in place between the competent authorities of the relevant EU Member State where the AIF is marketed and the home country of the AIF Manager (and, if applicable, the home country of the AIF being marketed) in order to ensure an efficient exchange of information that allows the competent authorities to carry out their obligations under the Directive; and
- the AIF Manager's home country (and, if applicable, the home country of the AIF being marketed) must not be listed as a "non-cooperative country" by the FATF on anti-money laundering and terrorist financing.

Importantly, under this regime the AIF Manager would need to comply with only certain of the provisions of the Directive, as opposed to the entire Directive. However, non-EU AIF Managers who choose to market in the EU without a passport would not be able to market throughout the EU unless they marketed into each individual EU Member State (and would be subject to any restrictions at the individual EU Member State level). Marketing to professional investors directly into Member States under the Directive would be available to non-EU AIF Managers upon codification of the Directive by the EU Member States. However, as discussed above, the EU passport regime is available to non-EU AIF Managers only after an additional two-year transition period following codification of the Directive by EU Member States.

Exemptions

The Directive will generally not apply to AIF Managers that manage one or more AIFs whose only investors are the AIF Manager or its affiliates, provided that none of those investors itself is an AIF.

The Directive also will not apply to:

- AIF Managers which, either directly or indirectly, manage portfolios of AIFs whose assets under management, including any assets acquired through use of leverage, in total do not exceed EUR 100 million;
- AIF Managers which, either directly or indirectly, manage portfolios of AIFs whose assets under management in total do not exceed EUR 500 million when the portfolios of the AIFs consist of other AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF; or
- funds and managers regulated under the UCITS Directive.

Entities such as holding companies, supranational institutions including the World Bank and the International Monetary Fund, national central banks, national, regional and local governments and bodies or other institutions that manage funds supporting social security and pension systems, employee participation schemes or employee savings schemes and securitization special purpose entities are also exempt from the Directive.

Limitations on Management and Marketing Activities

The Directive prohibits AIF Managers (except non-EU AIF Managers that market in EU Member States without using the EU passport) from engaging in activities outside of portfolio management and risk management as well as certain enumerated administrative activities, marketing activities and activities related to the assets of the AIF. Furthermore, the Directive compels such AIF Managers to comply with various new requirements, including additional reporting obligations, and imposes certain restrictions with respect to the management of AIFs. The Directive requires such an AIF Manager to provide the competent authorities of its home EU Member State with information necessary to monitor compliance with certain conditions of the Directive on a continuous basis.

Capital Requirements

In addition to the aforementioned requirements, the Directive requires that AIF Managers (except non-EU AIF Managers that market in EU Member States without using the EU passport):

- have sufficient initial capital and "own funds" (as referred to in a prior directive from 2006) in accordance with specified thresholds;
- have their head office and registered office located in the same EU Member State; and
- ensure that persons who conduct business on their behalf be of good repute and experience in relation to the investment strategies pursued by the AIF managed by the AIF Manager.

Enhanced Risk Management Guidelines

The Directive compels AIF Managers (except non-EU AIF Managers that market in EU Member States without using the EU passport) to implement and monitor annually risk management systems in order to identify, measure, manage and monitor risks relevant to each AIF investment strategy. Such risk management systems must:

- include a documented and regularly updated due diligence process when investing on behalf of the AIF,
- ensure that the risks associated with the investment position of the AIF can be properly identified, measured, managed and monitored on an ongoing basis, including through the use of appropriate stress testing procedures and
- ensure that the risk profile of the AIF corresponds to the size, portfolio structure and investment strategies and objectives of the AIF as described in the AIF's corporate governance and/or offering documents.

Such AIF Managers also will have to implement specific safeguards against conflicts of interest to allow for the independent performance of risk management activities, which will be reviewed by the competent authorities of the AIF Manager's home EU Member State.

Limitations on Leverage

The Directive requires an AIF Manager (except a non-EU AIF Manager that markets in EU Member States without using the EU passport) to set a maximum level of leverage it can employ on behalf of each AIF it manages. An AIF Manager must also demonstrate that such leverage limits are reasonable and that such AIF Manager complies with them at all times. Competent authorities will assess the risks posed by an AIF Manager's use of leverage and, after notifying ESMA, the European Systemic Risk Board and, as the case may be, the competent authorities of the relevant AIF, will impose limits to the level of leverage that such AIF Manager may employ.

Remuneration Policies

EU Member States must require AIF Managers (except non-EU AIF Managers that market in EU Member States without using the EU passport) to have remuneration policies and practices for certain categories of staff, including senior management, "risk takers", control functions and any employee receiving total remuneration on par with that of senior management and "risk takers", whose professional activities have a material impact on the risk profiles of AIFs they manage. Such policies must be consistent with and promote effective risk management and must not encourage risk-taking that is inconsistent with the risk profiles or corporate governance documents of the AIF managed by the AIF Manager.

Appointment of Separate Depositary

AIF Managers (except non-EU AIF Managers that market in EU Member States without using the EU passport) must appoint a separate depositary with respect to an AIF. The depositary should be responsible for (i) the proper monitoring of the AIF's cash flows and for ensuring that investors' money is booked correctly on accounts opened in the name of the AIF and (ii) the safe-keeping of the AIF's assets. The safe-keeping of assets can be delegated to a third party, which in turn could delegate this function to another third-party. However, the Directive requires that both the delegation and sub-delegation should be subject to strict requirements with respect to the suitability of the third party and the due skill, care and diligence that the depositary should employ to select, appoint and review such third party.

Acquisition of Non-Listed Companies

EU Member States must require that, when an AIF acquires, individually or jointly, control of a "non-listed company,"[1] the AIF Manager ensures that such AIF makes available its intentions concerning the future business of the non-listed company and the likely repercussions on employment, including any material change in the conditions of employment, to (a) the non-listed company and (b) the shareholders of the non-listed company. In addition, the AIF Manager shall request and use its best efforts to make sure that the board of directors of the non-listed company makes available to the company and its shareholders:

- the identity of the AIF Manager that manages the controlling AIF;
- the policy for preventing and managing conflicts of interests, in particular between the AIF Manager, the AIF and the company, including information about the specific safeguards established to ensure that any agreement between the AIF Manager and/or the AIF and the company will be at arms length; and
- the policy for external and internal communication relating to the company, particularly with regards to employees.

When an AIF reaches a position to exercise control of a non-listed company, such AIF shall provide the competent authorities of its home EU Member State and the investors of the AIF with information regarding the financing of the acquisition. These requirements apply to all AIF Managers including non-EU AIF Managers that market in EU Member States without using the EU passport.

Implementing regulations for the Directive have not yet been promulgated. However, the Directive compels EU Member States to adopt appropriate administrative measures or sanctions against persons who violate the Directive.

- ► See a copy of the Directive, as enacted
- ► See a copy of the FAQ
- ► See a copy of the EC press release issued after the European Parliament vote

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FINRA Urges SEC to Create One or More Self-Regulatory Organizations to Oversee Investment Advisers; Expresses Willingness to Fill the Role

In a November 2, 2010 letter from Richard G. Ketchum, Chairman and CEO of the Financial Industry Regulation Authority ("**FINRA**"), FINRA advised the SEC to create one or more self-regulatory organizations ("**SROs**") to oversee investment advisers, and expressed FINRA's willingness to take on that role. The letter came in anticipation of a January deadline established by a key provision of the Dodd-Frank Act, by which the SEC is required to advise Congress on the desirability of creating one or more SROs for investments advisers.

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[1] "Non-listed company" under the Directive means any company which has its registered office in the EU and whose shares are not admitted to trading on a "regulated market" (within the meaning of a prior 2004 directive).

In his letter to the SEC, Ketchum stressed the need to increase resources devoted to the examination of investment advisers. He argued that, "given the SEC's funding limits, it is unlikely that the [SEC], despite its best efforts, will be able to accomplish this on its own," pointing to the SEC's constrained resources, which have been exacerbated by the new duties and programs created under the Dodd-Frank Act. As an example of the SEC's limited funding, Ketchum pointed to the disparity between the frequency of examinations of broker-dealers and investment advisers, noting that while 55% of broker-dealers are examined each year by the SEC and FINRA, only 9% of investment advisers are examined annually by the SEC. Given the SEC's limited funding, Ketchum stated that the authorization by the SEC of one or more SROs to oversee investment advisers is "the most practical way to address the resource problem."

Ketchum also discussed the structure and duties that such SROs should have. SRO applicants, he said, should be subject to requirements similar to the standards set forth in Sections 15A and 19 of the Securities Exchange Act of 1934, which set forth certain standards and guidelines applicable to registered securities associations and SROs. These standards, he said, would ensure public accountability, prevent undue industry influence and provide transparency in the SRO's regulatory activities. The governing body of an investment adviser SRO, Ketchum wrote, should have a majority of its board seats held by public representatives, with the remaining seats being held by members of the investment adviser industry, to ensure industry representation. This governing structure, Ketchum noted, would help create an SRO that acts independently and in the public interest. Ketchum also stressed that ongoing and comprehensive SEC oversight would be central to the success of an investment adviser SRO. As an example, he listed several aspects of the SEC's oversight of FINRA to illustrate how this should be executed.

To evidence the benefits of SRO regulation generally, Ketchum argued that SROs have a long and successful history in U.S. securities markets. He discussed the characteristics of SROs that he said make them particularly well-positioned to act as effective regulators. Among these, Ketchum mentioned private funding, which allows SROs to commit resources to oversee its members without cost to taxpayers. In addition, Ketchum mentioned that certain spending restrictions associated with federal funding can prevent a federal agency from being able to address quickly important regulatory issues. Ketchum also noted that an SRO has the ability to impose higher standards of conduct beyond those established by law.

Included in Ketchum's appeal for SRO regulation, he expressed the willingness of FINRA to fill such a role. He wrote that FINRA, if it were to seek authorization as an investment adviser SRO, would establish a separate affiliate with its own board of governors in order to create programs tailored to the advisory industry.

Ketchum's argument, and especially the idea of FINRA attaining the SRO role, has been met with some industry opposition. Among those expressing disagreement was the Investment Advisers Association (the "**IAA**"). The IAA argued that the diverse nature of the investment advisory profession and its principles-based regulatory framework make an SRO approach inappropriate. It also argued that FINRA's rules-based approach to regulating broker-dealers makes it a particularly unsuitable candidate for the job. In a letter to the SEC, executive director of the IAA, David Tittsworth, said the IAA opposed the idea of FINRA becoming an SRO for investment advisers "due [to] a lack of accountability, lack of transparency, costs, track record and bias favoring the broker-dealer regulatory model." Both Tittsworth and Richard H. Baker, the president and chief executive of the Managed Funds Association, said investment advisers would rather pay user fees to the SEC to solve any federal resources problem than have FINRA act as an SRO overseeing investment advisers.

- See a copy of Ketchum's letter

Litigation

Former Quadrangle Principal Steven Rattner Enters into Settlement with the SEC and Faces Charges from the New York Attorney General

On November 18, 2010, the SEC charged Steven Rattner, the co-founder and former principal of Quadrangle Group LLC (“**Quadrangle**”), for his role in a pay-to-play scheme involving New York’s largest pension fund, the New York State Retirement Fund (the “**CRF**”). On the same day, New York Attorney General Andrew Cuomo’s office filed two lawsuits against Rattner based on similar charges. Quadrangle reached its own settlement with the SEC and the New York Attorney General, which was publicly announced in April 2010, for its role in the same pay-to-play scheme. For more information on the Quadrangle settlement, please see the ***May 10, 2010 Investment Management Regulatory Update***.

According to the SEC, in the fall of 2003 and at the suggestion of Henry Morris, a political adviser and chief fundraiser to former New York State Comptroller Alan Hevesi, Rattner arranged for the distribution of a low-budget film called “Chooch” through a Quadrangle affiliate, GT Brands, for the brother of David Loglisci, who was the Chief Investment Officer of the New York State Comptroller at the time. After meeting with Loglisci’s brother for the first time, the SEC alleges, Rattner contacted Loglisci about investing in a new Quadrangle private equity fund.

The SEC alleges that in late 2004, Morris approached Rattner and offered placement agent services to Quadrangle. Although Quadrangle was already working with a placement agent, Quadrangle agreed to pay Morris placement agent fees as well, according to the SEC.

According to the SEC’s complaint, after Morris began working for Quadrangle and Rattner informed him that the distribution deal for Chooch was in progress, Loglisci told Rattner that the CRF would make a $100 million investment in the Quadrangle fund.

The SEC alleges that Rattner arranged for third-party campaign contributions to Hevesi’s re-election campaign in an effort to influence Hevesi. According to the SEC, Morris encouraged Rattner to make a financial contribution to Hevesi’s campaign. Although Rattner had a personal policy against contributing to politicians with influence over public pension funds, he arranged for a friend and the friend’s wife to each contribute $25,000 to Hevesi’s re-election campaign, according to the SEC. Approximately one month after the contributions were made, Loglisci committed an additional $50 million CRF investment to the Quadrangle fund, according to the complaint. In March 2010, Loglisci pled guilty to a felony violation of New York State’s Martin Act for his role in the pay-to-play practices involving the CRF, as previously reported in the ***April 6, 2010 Investment Management Regulatory Update***.

Without admitting or denying the SEC’s allegations, Rattner entered into a settlement with the SEC in which he agreed to pay approximately $6.2 million to the SEC (approximately $3.2 million in disgorgement and a $3 million penalty). He also agreed to a two-year bar from associating with any investment adviser or broker-dealer. The settlement is pending district court approval.

The New York Attorney General’s office has filed two lawsuits against Rattner on similar charges. The Attorney General alleges that Rattner defrauded the CFR and its beneficiaries by paying over $1 million in sham placement fees to Morris, arranging for the distribution of Chooch and obtaining contributions for Hevesi’s re-election campaign.

The first lawsuit adds Rattner as a defendant to a forfeiture action that is pending against Morris and Logisci, seeking recovery of $13 million obtained by Rattner, as well as millions of dollars in future fees and profits. The second lawsuit was filed against Rattner under New York State’s Martin Act and the Executive Law. That lawsuit seeks over $13 million in civil recoveries, millions of dollars in future fees and profits and additional remedies, including injunctive relief. As part of the Martin Act lawsuit, the Attorney General is seeking to ban Rattner permanently from the securities business in the state of New York.

- See a copy of the SEC's complaint
- See a copy of the SEC's press release
- See a copy of the SEC's litigation release
- See a copy of the Attorney General's press release (includes links to various court documents)

Recent Hedge Fund Enforcement Action Involving Insider-Trading

FBI Raids Offices of Three Large Hedge Funds

On November 22, 2010, FBI agents, acting under the authorization of court-issued search warrants, seized documents from the offices of three large hedge funds, Level Global Investors LP, Diamondback Capital Management LLC and Loch Capital Management LLC. The raids are an example of the escalation of the government's inquiry into insider trading and illustrate the use of a variety of tools by law enforcement agencies to investigate insider trading.

The FBI raids are part of a larger three-year investigation into insider-trading currently underway by the Manhattan U.S. Attorney's office, the FBI and the SEC. In addition to the FBI raids, the Manhattan U.S. Attorney's office has sent subpoenas to several prominent asset managers. According to news reports, the subpoenas are seeking trading, communications and other information as part of their insider-trading investigation.

Employee of Expert-Network Firm Arrested in Connection with Insider Trading

An employee of the Silicon Valley-based expert-network firm Primary Global Research LLC, Don Ching Trang Chu, was arrested on November 24, 2010 on charges of insider trading. The arrest is part of a three-year investigation by the FBI, the U.S. Attorney's Office and the SEC into insider trading. In general, expert-network firms provide services to hedge funds seeking information about companies. Expert-network firms connect consultants, including current and former employees of publicly traded companies, with fund managers in order to provide this information.

According to news reports, Chu is accused of providing inside information to a hedge fund manager and of arranging meetings between the hedge fund manager and employees of a publicly traded company in order to facilitate the disclosure of nonpublic information from the employees to the hedge fund managers. According to news reports, the hedge fund manager, Richard Lee, had previously worked with Raj Rajaratnam, the founder of the Galleon Group hedge fund who currently faces charges in a separate insider trading case. For more information on the Galleon case, see the ***November 11, 2009 Investment Management Regulatory Update***.

According to news reports, the complaint against Chu alleges that Chu provided inside information concerning Atheros Communications Corp., a technology company, to Lee. Chu also allegedly arranged a meeting between Lee and the employee of a technology company in which unreleased quarterly earnings of the company were disclosed to Lee, according to reports. In addition, Lee's hedge fund allegedly directed a prime broker to send Chu's firm soft dollar payments in exchange for the use of its consultant network.

The arrest highlights the increasing scrutiny being placed on the activities of expert-network firms. The investigations into the activities of expert-network firms are focusing on whether these firms are being used as conduits for the leaking of inside information to hedge funds and other asset managers. Though expert-network firms may have internal policies to prevent consultants from disclosing confidential information, compliance with such policies may be difficult to monitor, according to news reports.

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Big Lots Sues Research Firm in Florida State Court in Connection with its Research Practices

On November 22, 2010, the discount retail chain Big Lots Inc. filed suit in Florida state court against a Florida-based research firm, Retail Intelligence Group, LLC ("**RIG**"). Big Lots alleges that RIG wrongfully obtained trade information and confidential and proprietary information about the retail chain from store managers and sold it to investors in Big Lots stock, who traded on the basis of the information. According to the complaint, RIG's actions caused a material drop in the share price of Big Lots' common stock.

The complaint alleges that RIG wrongfully induced store managers of Big Lots stores to disclose confidential information regarding store performance to RIG researchers. According to the complaint, store managers were asked to complete detailed surveys concerning the performance of Big Lots stores. Store managers were induced to complete the surveys, according the complaint, by the potential for future employment opportunities with RIG, who allegedly hires former store managers. The questions in the RIG survey allegedly induced store managers to disclose confidential information regarding store inventories, payroll, sales volume and promotional strategies. RIG then used this information to compile research reports, which it sold to investors, according to the complaint.

Big Lots argues that RIG's process of obtaining and selling confidential store information constituted (i) violations of Florida's Uniform Trade Series Act, (ii) interference with Big Lots' business relationships and (iii) inducement of Big Lots employees to breach their fiduciary duties to Big Lots by disclosing confidential information about the company to RIG. Big Lots alleges that the information wrongfully obtained and sold by RIG caused a drop in the price of its stock. On October 20, 2010, the day the relevant RIG report was released, the closing price of Big Lots stock on the New York Stock Exchange was $33.31. By November 3, 2010, the stock had fallen to $31.41, a decline of approximately 6%. According to the complaint, the S&P 500 Index rose by approximately 2% during the same period.

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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