Davis Polk
CLIENT NEWSLETTER

January 23, 2012

Investment Management Regulatory Update

SEC Rules and Regulations

SEC Amends Net Worth Standard for Individual Accredited Investors

On December 21, 2011, the SEC issued a final rule release adopting amendments (the "**Amendments**") to Rules 215 and 501 under the Securities Act of 1933 (the "**Securities Act**") to conform to Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") which amended the definition of "accredited investor" for individual investors. Effective July 21, 2010, Section 413(a) of the Dodd-Frank Act amended the net worth standard pursuant to which an individual investor qualifies as an "accredited investor" by having an individual net worth (or joint net worth with his or her spouse) in excess of $1 million by expressly ***excluding the value of the investor's primary residence*** from such calculation. However, the Dodd-Frank Act required that the SEC revise the Securities Act rules to conform to that amendment.

As discussed in the ***February 14, 2011 Investment Management Regulatory Update***, on January 25, 2011, the SEC proposed Securities Act amendments to implement this aspect of the Dodd-Frank Act, and the Amendments, as adopted, largely conform to the proposed rules. Consistent with the proposal, the Amendments exclude from the calculation of an individual investor's net worth the value of an investor's primary residence as well as any "[i]ndebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities," but any excess indebtedness over the value of the residence must be treated as a liability and deducted from the individual's net worth.

In addition, the Amendments add the following two new provisions that were not part of the SEC's proposal: (1) a 60-day look-back provision pursuant to which any debt secured by an individual investor's primary residence that is incurred during the 60 days prior to the sale of securities to the individual must be treated as a liability in calculating an individual's net worth, even if the total amount of indebtedness does not exceed the estimated fair market value of the primary residence, unless the incremental indebtedness results from the acquisition of the primary residence; and (2) a grandfathering provision that permits the application of the previous net worth standard (*i.e.*, no exclusion of the value of an individual's primary residence) in connection with the investor's exercise of pre-existing rights to acquire securities if (i) such rights were held by the investor on July 20, 2010 (*i.e.*, the day before the Dodd-Frank Act took

effect), (ii) the investor qualified as an accredited investor based on net worth at the time the investor acquired such rights, and (iii) the investor held securities of the same issuer, other than such rights, on July 20, 2010. According to the SEC's rule release, the grandfathering provision would be applicable, for example, in the case of an investor who, on July 20, 2010, owns both common stock of an issuer and pre-emptive rights to acquire additional common stock of the same issuer, as well as in the case of an investor who, on July 20, 2010, owns both preferred stock of an issuer and a right of first offer to purchase equity securities of the same issuer offered at a later time. With respect to the 60-day look-back provision, the SEC indicated that the provision would help to prevent investors from inflating their net worth by borrowing against their primary residence shortly before a sale of securities in order to qualify as an accredited investor, and would similarly reduce the incentive for unscrupulous salespeople to induce investors to game the system in that way.

The SEC declined to adopt any changes to address two additional issues on which the SEC had requested comment in its rule proposal – namely, whether the SEC should define the term "primary residence" and whether special rules should apply to the treatment of debt secured by a primary residence where the individual investor invests the proceeds from the debt in securities. According to the SEC, the term "primary residence" has "a commonly understood meaning as the home where a person lives most of the time" and defining the term in the final rules would add "unnecessary complexity." The SEC also did not adopt special rules that would include as a liability in the net worth calculation debt secured by an investor's primary residence (even when below the fair market value of the residence) where the proceeds of such debt were used to invest in the security offering at issue. According to the SEC's rule release, the 60-day look-back provision is simpler than such a tracing provision would be and also provides a substantial disincentive for salespeople to induce investors to take on debt for the purpose of investing in an offering.

The SEC also adopted technical and conforming amendments to various rules under the Securities Act, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 and to Form D.

The Amendments will take effect on February 27, 2012.

- See a copy of the SEC's final rule release
- See a copy of the SEC press release

SEC Schapiro Seeks Authority to Impose Larger Penalties for Securities Law Violations

On November 28, 2011, in a letter to Senator Jack Reed, Chairman of the Senate Subcommittee on Securities, Insurance and Investment, SEC Chairman Mary Schapiro proposed certain statutory changes to increase the civil monetary penalties that the SEC is authorized to seek for certain serious securities law violations. According to Schapiro's letter, these changes would "more closely link the size of monetary penalties to the scope of harm to investors and associated investor losses, and substantially raise the financial stakes for securities law recidivists."

In order to give the SEC "greater flexibility with regard to monetary penalties in cases where the misconduct is very serious, repeated, or involves substantial investor losses," Schapiro's proposal would (i) increase the cap applicable to tier-three securities law violations (*i.e.*, the most serious) from $150,000 to $1 million per violation for individuals and from $725,000 to $10 million for entities, (ii) increase the maximum penalty available in federal court actions under an alternative calculation formula (found in the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act, and the Securities Exchange Act of 1934) from "the gross amount of pecuniary gain" by the defendant to three times such amount and make such penalty available in administrative proceedings as well, and (iii) allow the SEC to seek penalties in both civil and administrative actions based on the amount of "investor losses" incurred as a result of a defendant's conduct. In addition, in order to enhance the SEC's recourse against repeat offenders, Schapiro's proposal would authorize the SEC (1) to seek three times the

otherwise applicable penalty if the defendant "has been criminally convicted for securities fraud or become subject to a judgment or order imposing monetary, equitable, or administrative relief in any SEC action alleging fraud," during the previous five years and (2) to seek civil penalties against individuals and entities that violate federal court injunctions or SEC orders, rather than having to rely on the civil contempt remedy.

Schapiro's letter was sent the same day that Judge Jed Rakoff of the U.S. District Court for the Southern District of New York rejected a plan by the SEC to settle a securities fraud case against Citigroup Global Markets Inc., criticizing in particular the SEC's policy of allowing defendants to settle charges without admitting or denying the allegations. *SEC v. Citigroup Global Markets Inc.,* 2011 U.S. Dist. LEXIS 135914 (S.D.N.Y. 2011). Robert Khuzami, Director of the SEC's Division of Enforcement, has spoken out against Judge Rakoff's decision and noted that "securities law generally limits the disgorgement amount the SEC can recover to Citigroup's ill-gotten gains, plus a penalty in an amount up to a defendant's gain" and that "[t]he SEC does not currently have statutory authority to recover investor losses." The SEC has appealed the Citigroup decision and, although there are no criminal proceedings in the Citigroup case, announced on January 6, 2012 that the SEC will no longer permit defendants that admit relevant conduct in parallel criminal proceedings to "neither admit nor deny" that conduct in settlement orders. For further discussion of this change in SEC practice, please see the January 9, 2012 Davis Polk Client Newsflash ***SEC Changes "Neither Admit Nor Deny" Practice for Criminal Conviction Cases***.

Schapiro's letter indicates that her staff will be preparing "draft legislative language for the[] five proposals" set out in her letter. We will continue to monitor developments in this area.

- See a copy of Schapiro's letter
- See a copy of the Citigroup decision
- See a copy of Khuzami's statement

Industry Update

Federal Reserve Issues Proposed Rules on Enhanced Prudential Standards for Large Bank Holding Companies and Systemically Important Nonbank Financial Companies

On December 20, 2011, the Federal Reserve proposed rules to implement the enhanced supervisory and prudential requirements in Sections 165 and 166 of the Dodd-Frank Act. These proposed rules represent the Federal Reserve's primary effort, one and a half years after the enactment of the Dodd-Frank Act, to put in place prudential standards that will govern the largest bank holding companies in the United States and any nonbank financial firm designated in the future by the Financial Stability Oversight Council as systemically important and subject to Federal Reserve oversight (collectively, "**Covered Companies**"). Among other standards, the proposed rules would impose on Covered Companies significant capital requirements, a formal regulatory liquidity standard, a requirement to hold a sufficient quantity of "highly liquid assets" to survive a projected 30-day liquidity crisis and to put in place monitoring and compliance regimes, new liquidity risk management and governance requirements for boards of directors, risk committees and senior management, and caps on net exposure to counterparties. Comments on the proposed rules are due by March 31, 2012.

Please see the December 23, 2011 Davis Polk Client Memorandum ***Summary of the Federal Reserve's Proposed Rules for Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*** for a summary of the proposed rules.

Litigation

New Initiative to Evaluate Hedge Fund Returns Leads to Four SEC Enforcement Actions

The SEC recently announced four separate actions against three advisory firms and six individuals for misconduct involving fraudulent fund valuation, misrepresentation of critical information to investors and misuse of fund assets. These actions are part of an SEC initiative, known as the "Aberrational Performance Inquiry," which seeks to use "proprietary risk analytics to evaluate hedge fund returns" and to target "[p]erformance that appears inconsistent with a fund's investment strategy or other benchmarks," according to a December 1, 2011 SEC press release.

The SEC charged two individuals – Michael Balboa and Gilles De Charsonville – with securities fraud for conspiring to overvalue the returns and net asset value ("**NAV**") of a now defunct emerging markets debt hedge fund. According to the SEC's complaint, between January and October 2008, Balboa, the fund's former portfolio manager, supplied De Charsonville, a broker at BCP Securities, LLC, and another purportedly independent broker with "bogus" valuations for two of the fund's illiquid securities holdings, and the brokers, in turn, provided the valuations to the fund's independent valuation agent and outside auditor, leading to the overvaluation of the fund's NAV by up to $163 million. According to the SEC, the scheme enabled Balboa to raise $410 million in new investments, avoid $230 million in potential redemptions and earn approximately $6.5 million in fees, and De Charsonville received substantial kickbacks for participating. The U.S. Attorney's Office for the Southern District of New York also announced the filing of criminal charges against Balboa and his arrest.

The SEC also charged ThinkStrategy Capital Management, LLC and its sole managing director, Chetan Kapur, with deceptive conduct in connection with a hedge fund and a fund of funds they advised. The SEC's complaint alleges that over a period of nearly seven years, ThinkStrategy and Kapur "disseminated false and materially misleading information to investors concerning the performance, longevity, and assets" of the funds and "engaged in a pattern of deceptive marketing" with respect to the management team's credentials and size. Kapur and ThinkStrategy also allegedly misrepresented the due diligence process utilized to select funds and managers for their fund of funds portfolio, by failing to use a "rigorous due diligence process" as promised to investors which led to the selection of funds that later turned out to be Ponzi schemes or other fraudulent enterprises. According to an SEC order, Kapur agreed to settle the case without admitting or denying the charges.

In another enforcement action, the SEC charged Patrick G. Rooney and Solaris Management, LLC ("**Solaris**"), investment advisers to hedge fund Solaris Opportunity Fund, LP (the "**Solaris Fund**"), with fraud for misusing the fund's assets in furtherance of their own interests. According to the SEC's complaint, Rooney "radically changed the [Solaris] Fund's non-directional investment strategy" by investing all of the fund's assets in Positron Corp., a company in financial trouble that Rooney had been chairman of since 2004, and thereby converting it into "a single-stock fund with a concentrated, undiversified, and illiquid position in a cash-poor company with a history of net losses." Rooney allegedly misled investors by failing to disclose the change in investment strategy, his affiliation with Positron or the Solaris Fund's $3.6 million investment in the company.

In addition, the SEC initiated administrative proceedings against LeadDog Capital Markets, LLC, an unregistered investment adviser, and its owners Chris Messalas and Joseph LaRocco for material misrepresentations and omissions made to induce investors to invest in a hedge fund they advised. According to the SEC, the misrepresentations and omissions related to the fund's liquidity, Messalas' disciplinary history and his and LaRocco's relationship to the fund's illiquid investments, among other things.

Based on the foregoing allegations, the SEC charged each of the defendants with securities fraud for (i) violating Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Rule 10b-5 thereunder and (ii) violating, or aiding and abetting violations of, Section 206(4) of the Investment

Advisers Act of 1940 (the "**Advisers Act**") and Rule 206(4)-8 thereunder. Each of the defendants (excluding De Charsonville) was also charged with fraud under Section 17(a) of the Securities Act of 1933. In addition, the SEC charged Balboa, Rooney and Solaris with violating, and De Charsonville with aiding and abetting violations of, Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraud against a client or prospective client, and charged De Charsonville with violating FINRA Rule 5210, which prohibits a broker from circulating communications that purport to quote bid or asked prices for a security unless the broker believes that the quotation represents a bona fide bid or offer for the security. Rooney and Solaris were also charged with aiding and abetting the Solaris Fund's violation of Section 13(d) of the Exchange Act and Rule 13d-1 thereunder by failing to file a Schedule 13D with the SEC within 10 days following the fund's acquisition of beneficial ownership of more than 5% of a class of Positron's securities.

- See a copy of the SEC's press release
- See a copy of the complaint against Balboa and De Charsonville
- See a copy of the complaint against Kapur and ThinkStrategy
- See a copy of the complaint against Rooney and Solaris
- See a copy of the order against LeadDog Capital, Messalas and LaRocco

---

SEC Settles Charges Against Three Investment Advisers for Compliance Failures

On November 28, 2011, the SEC announced the settlement of charges that three registered investment advisers – OMNI Investment Advisors Inc. ("**OMNI**"), Feltl & Company, Inc. ("**Feltl**") and Asset Advisors, LLC ("**Asset Advisors**") – failed to adopt and implement compliance policies and procedures as required by Rule 206(4) under the Advisers Act. Under such rule, registered investment advisers are required to (1) adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, (2) conduct an annual review of the policies and procedures to ensure adequacy and effectiveness of implementation and (3) designate a chief compliance officer ("**CCO**"). According to an SEC press release, these cases arose from "an initiative within the SEC Enforcement Division's Asset Management Unit to proactively prevent investor harm by working closely with agency examiners to ensure that viable compliance programs are in place at firms."

During an examination in November 2010, the SEC allegedly discovered that OMNI had no compliance program or CCO from September 2008 to November 2010 and did not conduct an annual review during that period, despite having received a deficiency letter from the SEC in 2007. According to the SEC's order against OMNI, in response to a request from the SEC, OMNI provided a compliance manual dated November 3, 2010 which was not specific to OMNI's business and which named Gary R. Beynon (OMNI's CEO and sole owner) as CCO despite the fact that he was living in Brazil. Following the November 2010 exam, Beynon, who remained in Brazil, allegedly performed no supervisory or compliance functions and then backdated his signature on various new advisory agreements provided to the SEC in response to a May 2011 subpoena. In addition, according to the SEC, OMNI failed to enforce its code of ethics.

According to the SEC, Feltl, a dually-registered broker-dealer and investment adviser, had inadequate compliance policies and procedures from 2008 to 2011, because its compliance manual focused on Feltl's brokerage business to the exclusion of its advisory business and its CCO spent almost all of his time on compliance issues relating to the brokerage business. These failures allegedly caused Feltl to engage in numerous principal transactions without obtaining the consent of its advisory clients or making the proper disclosures in violation of Section 206(3) of the Advisers Act which the SEC identified in a December 2010 deficiency letter and to charge undisclosed fees to clients in its wrap fee program in violation of Section 206(2). In response to two SEC exams, Feltl conducted its first annual review in November 2010 and, following receipt of the deficiency letter, adopted a separate compliance manual for its advisory business in April 2011 and transferred its advisory accounts to a separate clearing platform

from its brokerage accounts in June 2011. In addition, the SEC found that Feltl failed to adopt a code of ethics until June 2010 or to obtain employee securities disclosure reports until March 2011.

According to the SEC, Asset Advisors, which registered with the SEC in 2004, did not adopt compliance policies and procedures until May 2007 when the SEC announced an impending exam and failed to implement such policies and procedures even after their adoption. In fact, according to the SEC, the comments it provided on Asset Advisors' compliance manual were not implemented until 2009 when the SEC announced a second exam. Additional comments provided in June 2010 were also not implemented, according to the SEC, until March 2011, after the SEC announced that it was opening an investigation of Asset Advisors. In addition, Asset Advisors allegedly did not conduct an annual review or enforce its code of ethics in 2008 or 2010.

Based on such conduct, the SEC found that each of OMNI, Feltl and Asset Advisors willfully violated (and that Beynon willfully aided and abetted and caused OMNI's violations of) (1) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder; and (2) Section 204A of the Advisers Act and Rule 204A-1 thereunder, which require (i) access persons to submit quarterly securities transaction reports as well as holdings reports upon being hired and annually thereafter, (ii) access persons to obtain pre-approval before purchasing certain securities, and (iii) a registered investment adviser to provide a code of ethics and any amendments to supervised persons and obtain written acknowledgement of receipt. In addition, the SEC found that OMNI willfully violated (and that Beynon willfully aided and abetted and caused OMNI's violations of) Section 204(a) of the Advisers Act and Rule 204(a)(10) thereunder, which require a registered investment adviser to "maintain and preserve certain books and records," including "all written agreements . . . entered into by the adviser with any client . . . ."

Without admitting or denying the SEC's findings, each of the advisers agreed to settle the charges. The SEC censured the advisers, ordered each to cease and desist from future violations of the relevant provisions of the Advisers Act, and ordered payment of a civil penalty ($50,000 for Beynon and Feltl, and $20,000 for Asset Advisors). In addition, each adviser agreed to provide a copy of the SEC's order to persons that were advisory clients during the relevant dates. The order against OMNI also barred Beynon from associating in a compliance or supervisory capacity with any broker, dealer or investment adviser, among others, or serving or acting as an employee, officer, director, and so forth, of any registered investment company. (According to the order, OMNI withdrew its SEC registration in August 2011.) Feltl agreed to retain an independent compliance consultant to review its compliance policies and procedures, and to adopt all of the consultant's recommendations (or propose an alternative policy if any recommendation is considered unduly burdensome). Feltl also agreed to post a copy of the SEC's order prominently on its website and to pay disgorgement and prejudgment interest. Asset Advisors, in turn, agreed to close its operations and withdraw its SEC registration and to transfer its existing advisory accounts to a registered investment adviser with fully-developed and implemented written compliance policies and procedures, a fully-developed and enforced written code of ethics and a designated CCO.

- See a copy of the SEC's press release
- See a copy of the SEC order against OMNI and Beynon
- See a copy of the SEC order against Feltl
- See a copy of the SEC order against Asset Advisors

Second Circuit Upholds the Constitutionality of New York City "Pay-to-Play" Law

On December 21, 2011, the U.S. Court of Appeals for the Second Circuit upheld a New York City "pay-to-play" law against various constitutional challenges. *Ognibene v. Parkes*, 2011 U.S. App. LEXIS 25301 (2d Cir. 2011). According to the court's opinion, Local Law 34 (the "**Law**"), which was passed in 2007, in relevant part: (1) lowers the caps applicable to campaign contributions from individuals and entities that have "business dealings" with New York City (the "**Affected Persons**") to $400 (as opposed to $4,950 for

contributors not within the purview of the Law) for candidates for city-wide offices, to $320 (as opposed to $3,850) for candidates for borough offices, and to $250 (as opposed to $2,750) for candidates for city council, (2) prohibits public matching for contributions from the Affected Persons, and (3) extends a ban on contributions from corporations to apply to partnerships, LLCs and LLPs as well. "Business dealings" include, among other things, "contracts for investment of pension funds" and transactions with "lobbyists" (as defined in the New York City Administrative Code). As discussed in the ***September 13, 2010 Investment Management Regulatory Update***, the Second Circuit also recently ruled on the constitutionality of certain aspects of Connecticut's pay-to-play law in *Green Party of Conn. v. Garfield,* 616 F.3d 189 (2d Cir. 2010), and the Second Circuit's decisions in both of these cases may highlight how courts will assess the constitutionality of similar laws, including the SEC's prohibition on "pay-to-play" practices by investment advisers in Rule 206(4)-5 under the Advisers Act, which was adopted in 2010.

The plaintiffs in *Ognibene*, which include Republican Party members, the New York State Conservative Party, lobbyists and businesses, challenged the three provisions of the Law highlighted above – the "doing business" contribution limit, the non-matching provision and the entity ban – on First and Fourteenth Amendment grounds, among others. The district court granted summary judgment to the defendants, which include members of the New York City Campaign Finance Board and the New York City Conflicts of Interest Board, as well as the acting city clerk. *Green Party of Conn. v. Garfield*, 590 F. Supp. 2d 288 (D. Conn. 2008). The plaintiffs subsequently appealed. In affirming the district court's decision, the Second Circuit (with two of the judges concurring) considered whether the aforementioned provisions of the Law were "closely drawn to address a sufficiently important state interest" and found that each was sufficiently closely-drawn. In doing so, the court distinguished *Green Party* and two recent Supreme Court decisions, *Citizens United v. Fed. Election Comm'n*, 130 S. Ct. 876 (2010) and *Arizona Free Enterprise Club's Freedom 17 Club PAC v. Bennett*, 131 S. Ct. 2806 (2011).

The Second Circuit agreed with the district court that the "doing business" contribution limits are "closely drawn" because combating corruption or "the public perception" thereof (*quid pro quo* or otherwise) is a sufficiently important justification for placing limits on direct donations to a candidate (as distinct from restrictions on independent corporate campaign expenditures which were struck down in *Citizens United* as overly burdensome limitations on speech). The court was not persuaded that actual "evidence of recent scandals" was needed to justify the contribution limits, and distinguished *Green Party* in this regard because that case addressed a total ban on contributions, as opposed to mere limits. Citing the district court, the Second Circuit reasoned that "to require evidence of actual scandals for contribution limits would conflate the interest in preventing actual corruption with the separate interest in preventing apparent corruption." Finding "no doubt that the threat of corruption or its appearance is heightened when contributors have business dealings with the City" and citing studies by the City Council on the issue, the court held that it is "reasonable and appropriate" to place additional limitations on contributions by Affected Persons. Nor was the court persuaded by defendants' arguments that the Law's "doing business" provisions were overbroad, under-inclusive, poorly tailored or discriminatory based on viewpoint.

The court also found the Law's non-matching provision to be "closely drawn to address a sufficiently important governmental interest," noting in part that, unlike in *Bennett*, the provision "does not impose different limits on different candidates" running for the same position but rather limits all Affected Persons in the same way for each type of candidate. With respect to the entity ban, the court held that such a ban was sufficiently justified by anti-corruption interests and by an interest in "preventing the evasion of valid contribution limits" by giving individual contributors the opportunity to use a different organizational form in making a contribution. As with the "doing business" and non-matching provisions, the court was not persuaded by the plaintiffs' argument that the entity ban was over-inclusive.

We will continue to monitor developments in this area.

- See a copy of the court's opinion

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.

John G. Crowley	212 450 4550	john.crowley@davispolk.com
Nora M. Jordan	212 450 4684	nora.jordan@davispolk.com
Yukako Kawata	212 450 4896	yukako.kawata@davispolk.com
Leor Landa	212 450 6160	leor.landa@davispolk.com
Gregory S. Rowland	212 450 4930	gregory.rowland@davispolk.com
Danforth Townley	212 450 4240	danforth.townley@davispolk.com
Caroline R. Adams	212 450 4061	caroline.adams@davispolk.com

Any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend any transaction or matter addressed herein.

© 2012 Davis Polk & Wardwell LLP

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's privacy policy located at davispolk.com for important information on this policy. Please add Davis Polk to your Safe Senders list or add dpwmail@davispolk.com to your address book.