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Investment Management Regulatory Update

Industry Update

President Obama Signs Into Law Legislation Repealing Dodd-Frank's Broad SEC Confidentiality Provisions

On October 5, 2010, President Obama signed into law legislation that repeals Section 929I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), which had exempted the SEC, in certain instances, from requests for disclosure under the Freedom of Information Act ("**FOIA**").

According to SEC Chairman Mary Schapiro's testimony before the House of Representatives Committee on Financial Services, the confidentiality provisions codified in Section 929I of the Dodd-Frank Act were designed to facilitate the free flow of information between the SEC and the companies regulated by the SEC. Chairman Schapiro indicated that such protections were vital in providing the comfort that regulated entities needed to share confidential information openly during examinations because it eliminated the risk that sensitive information disclosed might ultimately become public. Opponents of Section 929I argued that these provisions created a "blanket exemption" for the SEC from FOIA disclosure and clouded the very transparency that the Dodd-Frank Act meant to encourage. In an attempt to assuage these concerns, the SEC promulgated guidance last month on the application of Section 929I, emphasizing that the purpose of the provisions is to "protect the confidential and proprietary information of regulated entities and foster an open examination process," not to protect the SEC or an SEC employee. Ultimately, this proved to be insufficient to prevent the repeal of Section 929I.

It is important to note, however, that even with the repeal of Section 929I, the SEC is not left without any ability to prevent the disclosure of confidential information. The new legislation, while repealing the broader confidentiality protections under Section 929I of the Dodd-Frank Act, extends the applicability of FOIA Exemption 8.

FOIA Exemption 8

Chairman Schapiro argued that FOIA Exemption 8 was less useful in the SEC's expanded investigatory role because it contained an ambiguity in a key term. FOIA Exemption 8 states that relief from disclosure will be afforded to matters "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." Neither the text nor the legislative history of Exemption 8, however, clearly defined the term "financial institution." Although the SEC believed that all entities it regulates, supervises and examines are "financial institutions" and therefore covered by FOIA Exemption 8, it was unclear whether courts would rule the same way.

The new legislation attempts to resolve this issue by clarifying that, for purposes of FOIA, any entity the SEC is responsible for regulating, supervising or examining is a "financial institution." Accordingly, the SEC should be able to use this broader exemptive authority under FOIA Exemption 8 to oppose many requests for information obtained during examinations of funds and their advisers. It remains to be seen, however, whether the clarification of FOIA Exemption 8 will ultimately provide the SEC with the same power to withhold from disclosure information relating to funds and their advisers obtained in examinations as it had under the broad confidentiality provisions provided in Section 929I of the Dodd-Frank Act.

- See a copy of the final bill signed into law
- See a copy of Mary Schapiro's statement

Financial Stability Oversight Council Requests Public Comment on Making Recommendations for Implementing the Volcker Rule

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") includes provisions commonly referred to as the "Volcker Rule" which, subject to certain exceptions and transition periods, restricts the ability of banks and their affiliates to invest in and sponsor private funds, to engage in proprietary trading and to engage in prime brokerage and other transactions with sponsored or advised funds. For a more comprehensive summary of the Volcker Rule, please see the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010*** and the ***July 14, 2010 Investment Management Regulatory Update***.

Section 619 of the Dodd-Frank Act requires the Financial Stability Oversight Council (the "**FSOC**") to study and make recommendations on implementing the Volcker Rule. The FSOC's study and recommendations are required to be considered by the various agencies responsible for developing and implementing regulations relating to the Volcker Rule. The FSOC has requested public comment in order to assist it in conducting the study and formulating its recommendations. All comments are due by November 5, 2010.

Please see the FSOC's request for comment, which is linked below, for the full list of questions. Among other items, the FSOC is soliciting comments on the factors and considerations that should be taken into account with regard to:

- implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds;

- the definitions of "banking entity", "hedge fund", "private equity fund", "such similar funds", "sponsor" and "illiquid fund";
- the transactions or activities that would involve or result in a material conflict between a banking entity and its clients, customers or counterparties, or would result, directly or indirectly, in a material exposure by a banking entity to high-risk assets or high-risk trading strategies; and
- the types of practices, transactions or corporate structures that have historically involved increased risks or may involve increased risks in the future.
  - See a copy of the request for comment

SEC Clarifies that Certain Soft Dollar Arrangements Do Not Establish an Adviser-Client Relationship

In a September 21, 2010 no-action letter (the "**Letter**") addressed to BNY ConvergEx Group, LLC ("**ConvergEx**"), the SEC clarified that an adviser-client relationship under the Investment Advisers Act of 1940 (the "**Advisers Act**") is not created between a registered broker-dealer and discretionary accounts ("**Accounts**") of an investment manager (a "**Manager**") solely by reason of such broker-dealer's provision of research services to the Manager and the Manager's use of such research in making investment-related decisions for an Account.

ConvergEx's request to the SEC for interpretive advice was related to research services provided under the safe harbor in Section 28(e) (the "**28(e) Safe Harbor**") of the Securities Exchange Act of 1934 through client commission arrangements ("**CCAs**"). The 28(e) Safe Harbor allows Managers to purchase brokerage and research services from a broker-dealer for an Account using the Account's funds without breaching its fiduciary duties to the Account, if certain conditions are met. CCAs, a type of soft dollar arrangement designed to meet the 28(e) Safe Harbor conditions, allow broker-dealers that provide research to Managers (a "**Research BD**") to receive payment for such research from brokerage commissions generated by trades executed for the Managers' Accounts, in lieu of direct payment. The particular type of CCA that ConvergEx offered, and which was the subject of its request to the SEC, is one that would permit a Manager to accumulate and consolidate, in a pool maintained by ConvergEx, "commission credits" generated from brokerage transactions executed for the Manager's Accounts by ConvergeEx-affiliated broker-dealers (a "**Providing BD**") as well as other registered broker-dealers. Under this arrangement, the Manager could request third-party research provided by a Research BD not affiliated with ConvergEx or the Manager, including research specifically tailored to the investment needs of an Account, which ConvergeEx would purchase for the Manager using hard dollars in reduction of the Manager's accumulated commission credits.

The Letter clarified that a CCA, on its own, does not result in an adviser-client relationship between the Research BD and the Account, when the CCA has the following characteristics: (i) the Manager advises the Account and is subject to fiduciary obligations as a matter of law, (ii) the Manager has discretionary investment authority over the Account, (iii) the Research BD and "persons associated with" (as defined in Section 202(a)(17) of the Advisers Act) the Research BD do not have discretionary authority over the Account (other than discretion as to the execution price or time to execute an order of the Manager for the Account), (iv) the Research BD and its affiliated persons do not provide investment advice directly to the Account, do not have a contractual investment management agreement with regard to the provision of advice to the Manager for the benefit of the Account and do not receive compensation from the Account for investment advice, (v) the Manager is not a "person associated with" the Research BD, (vi) the Account is not involved in selecting the research services that the Research BD provides to the Manager and (vii) the Manager retains independent responsibility for the good faith valuation of brokerage and research services under the 28(e) Safe Harbor. The Letter also explained that the staff's position would not change if the Research BD received payment for providing research services to a Manager via an arrangement outside of the 28(e) Safe Harbor.

In support of this position, the Letter referenced ConvergEx's argument that the 28(e) Safe Harbor is "predicated on the notion that the research services are provided to the [Manager] and not the [Account]." ConvergEx also argued that concerns over the application of Section 206(3) of the Advisers Act, which restricts principal transactions between an adviser and its clients, caused some Research BDs to be unwilling to accept payment for providing Managers with proprietary research. The Letter also cited ConvergEx's belief that "unbundling" execution and research charges benefits clients by allowing Managers to better assess the value of the unbundled research paid for by commissions.

- See a copy of the Letter

Standard & Poor's Proposes Changes to its Methodology for Rating Market Value Securities Issued by Leveraged Closed-End Funds

Standard & Poor's ("**S&P**") has proposed changes to the way it rates market value securities and is seeking comments on such proposal (the "**Proposal**") through October 29, 2010. The Proposal focuses on the market value analysis S&P applies when it rates certain market value securities, including market value collateralized debt obligations, structured investment vehicles, certain extendible asset-backed commercial paper programs and certain securities issued by leveraged closed-end funds regulated under the Investment Company Act of 1940 (the "**Investment Company Act**"). See the ***July 14, 2008, September 8, 2008, January 13, 2009*** and ***April 7, 2009 Investment Management Regulatory Updates*** for various news reports about auction rate securities and discussions of difficulties with the auction process for certain auction rate securities issued by closed-end funds.

According to the Proposal, market value securities are securities that rely on the liquidation of collateral as their primary source of repayment. The Proposal notes that the principal risk inherent in market value securities is the fluctuation of the value of the underlying collateral over time. S&P is reviewing its methodology and assumptions for rating these types of market value securities to improve the comparability of the ratings with those in other sectors, such as corporate, municipal and sovereign securities and other structured finance products. The Proposal expresses S&P's view that "recent market conditions have demonstrated uncertainty as to the ability of asset managers to sell assets in a timely manner and at prices that are comparable to historical levels," citing as examples the price volatility that was observed between 2007 and 2008 for 'AAA' structured finance assets, corporate loans and U.S. Treasury securities.

Under the Proposal, the only market value securities that could potentially receive 'AAA' ratings are (i) market value securities invested in sovereign securities issued by the U.S., the U.K., Germany or France, which are denominated in U.S. dollars, Euros or British pounds sterling and for which sufficient historical market price performance data is available and (ii) market value securities issued by regulated investment funds that "demonstrate superior asset management capabilities and practices."

To assess such capabilities and practices of a regulated investment fund, S&P would focus its ratings analysis on the following characteristics of the fund: (i) management experience, (ii) the track record of the organization managing the portfolio, (iii) corporate governance and independent oversight, (iv) internal controls, (v) disclosure and transparency, (vi) asset/liability management policies and practices, (vii) the amount of leverage in the capital structure of the issuer and (viii) the alignment of management, ownership, and debtholder interests. It is S&P's view that the regulatory framework within which leveraged closed-end funds operate (such as the Investment Company Act and certain U.S. tax laws) generally brings into being the type of management and governance characteristics that would support an 'AAA' rating on their debt or preferred stock, even if the funds invest in assets other than sovereign securities. Similarly, securities of non-U.S. funds are eligible for 'AAA' ratings if such funds operate within a regulatory and oversight framework similar to that within which U.S. registered funds operate.

These views, however, only support S&P's decision to render securities issued by these funds *eligible* for 'AAA' ratings; S&P does not guarantee such rating. To achieve an 'AAA' rating, a security must meet other criteria spelled out in the Proposal, such as (i) allowing a minimum amount of time to liquidate the assets backing the market value security, *e.g.*, in the case of a closed-end fund, the fund's governing documents and the terms of the security must permit the fund a minimum amount of time to dispose of portfolio securities in situations where the fund is required to liquidate assets (in order to prevent the forced sale of fund assets at depressed prices), (ii) a haircut rate (which generally differs depending on the asset type and the remaining time to maturity) and (iii) concentration limits. When S&P applied the proposed criteria to a sample of 90 securities issued by leveraged closed-end funds that are currently rated 'AAA', only one could withstand S&P's proposed 'AAA' stress scenario. S&P indicated in the Proposal that the revised criteria would affect ratings on securities issued by 220 registered leveraged closed-end funds.

NFA Submits Petition to Limit Exclusion from Commodity Pool Operator Definition for Registered Investment Companies

The National Futures Association (the "**NFA**") has submitted a revised petition to the Commodity Futures Trading Commission (the "**CFTC**") to amend CFTC Rule 4.5, which currently provides an exclusion from the definition of a commodity pool operator (a "**CPO**") for certain qualifying entities, including registered investment companies ("**RICs**").

Under current CFTC Rule 4.5, RICs are excluded from the definition of CPO, and consequently, are largely excluded from oversight and regulation by the CFTC and the NFA. In its petition, the NFA requested that the CFTC restore the exclusion's pre-2003 conditions where a person claiming the exclusion had to represent that the relevant entity (i) will use commodity futures or options contracts solely for hedging purposes or, in cases of non-hedging purposes, will limit the aggregate initial margin and premiums on such positions to five percent of the liquidation value of the qualifying entity's portfolio (net of all unrealized profits and losses) and (ii) will not be marketed to the public as a commodity pool or a vehicle for trading in commodity futures or options contracts. In August 2003, after an extensive comment period, the CFTC chose to eliminate these conditions in part because the "otherwise regulated nature" of the qualifying entities specified in Rule 4.5, which includes RICs, would provide adequate customer protection.

In its petition, the NFA cited several RICs using the Rule 4.5 exclusion that have been marketed to customers, including retail investors, as vehicles for investing in commodity futures and options. Ultimately, the NFA fears that by eliminating the "no-marketing" restriction and the "five percent trading test," the CFTC has effectively permited retail investing in the commodity futures markets without sufficient regulatory oversight.

If the CFTC adopts the NFA's petition, RICs no longer qualifying for the exclusion could be considered CPOs and thus be subject to applicable registration, disclosure and reporting requirements of the CFTC and NFA. In some cases, certain investment advisers that currently operate under an exemption from registration as a commodity trading advisor (a "**CTA**") could also be forced to register (unless otherwise exempt).

The NFA previously submitted a petition on June 29, 2010 requesting that the pre-2003 conditions be restored for all entities using the Rule 4.5 exclusion. The revised petition replaces the June petition and limits the scope of its request to apply only to RICs using the Rule 4.5 exclusion.

- See a copy of the revised NFA Petition

SEC Conducting "Sweep Exams" on Investment Advisers of Alternative Investments, Including Funds of Funds

During the past month, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC has sent a letter (the "**Letter**") to certain investment advisers notifying them that the OCIE was examining the advisers' due diligence and other policies and practices, primarily focused on their evaluation of alternative investment options, including hedge funds, private equity and venture capital funds and funds of funds. According to *The Wall Street Journal*, the OCIE is focused initially on firms with $100 million to $15 billion in assets under management.

In the Letter, the OCIE requests various documents or information in the following general categories: General Information, Privately Offered Funds, Due Diligence Process, Marketing and Financial Records. Certain documents and information requested by the OCIE are listed below:

General Information

- Compliance policies and procedures;
- A trade blotter that lists transactions for current and former clients, proprietary and/or trading accounts and access persons; and
- Any fee splitting or revenue sharing arrangements.

Privately Offered Funds

- A list of all private investment funds in which the adviser, an affiliate or related person has an interest and each fund's documentation; and
- Copies of any side letters with any of the alternative investments in which the adviser or its fund of funds has been invested.

Due Diligence Process

- A list of any third parties relied upon in the due diligence process and a description of their services;
- A list of investments reviewed for possible investment since a specified date, including investments that were rejected and an explanation for the rejection;
- A copy of any written questionnaires used in obtaining information regarding potential investments; and
- Any confidentiality agreements entered into with respect to an underlying fund investment.

Marketing

- All pitch books, presentations, brochures and other marketing materials provided to existing or prospective clients; and
- Names of third-party consultants for which the adviser provided responses to questionnaires.

Financial Records

- Adviser's balance sheet, income statement and cash flow statements as of the end of its two most recent fiscal years and the most current year to date; and
- Any loans from investors or clients to the adviser or sales of adviser's (or any affiliate's) stock to clients.

Head of SEC Enforcement Division Announces Mutual Fund Fee Initiative

On September 22, 2010, Robert Khuzami, head of the SEC's Division of Enforcement, announced that the Asset Management Unit, which is focused on mutual funds, private funds and investment advisers, has established a "Mutual Fund Fee Initiative" (the "**Initiative**") designed to examine whether mutual fund advisers charge excessive fees to their retail investor clients. For a discussion of the creation of this unit, please see the ***February 5, 2010 Investment Management Regulatory Update***. Khuzami announced the establishment of the Initiative in his testimony before the Senate Judiciary Committee during a broader discussion of improvements to the SEC's oversight and enforcement activity.

Examination of adviser fees, Khuzami stated, will be executed through the development of analytics to identify fees considered excessive by the Commission. Khuzami noted that these analytics would likely lead to examinations and investigations of advisers and their boards of directors regarding their duties under the Investment Company Act of 1940. It is unclear what exactly the analytics would consist of or how they would be applied.

The Initiative has been met with a variety of opinions and questions in the industry. Some have wondered if the use of analytics to examine excessive fees will lead to excessive fee cases brought by the SEC. They note that while excessive fee cases have often come from private plaintiffs, cases brought by the SEC historically have been rare. Moreover, the recent Supreme Court decision in *Jones v. Harris Associates L.P.*, 559 U.S. ___ (2010), generally affirmed existing precedents that courts should defer to the judgment of a fund's board of directors regarding the appropriate compensation for the fund's advisers, so long as the board engaged in a "robust" process that was "fully informed" and conducted with "care and consciousness" and the advisory fee was not "so disproportionately large" that it could not have been properly negotiated with the fund's board of directors. For a more detailed discussion of the *Jones v. Harris* case, please see the ***April 6, 2010 Investment Management Regulatory Update***.

We will continue to monitor developments in this area.

- See a copy of Khuzami's testimony

SEC's Norm Champ Discusses Examination and Registration Developments

Norm Champ, deputy director of the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") spoke recently about various developments in the SEC's policies and practices regarding enforcement, examination and registration.

At an IA Compliance Fall Conference in Philadelphia, Champ said that, while the predominant sources of examination leads come from tips, referrals and complaints, the OCIE also uses computer-aided risk assessment to identify firms for examination. Champ noted that consideration of whether to reveal inputs to the computer model that provides a list of targets for examination and associated risks of each is "a subject of active debate." He explained that while disclosure would work towards the SEC's goal of transparency, it could also show wrongdoers how to fake answers to important questions, resulting in evasion of detection.

In addition, Champ identified six focal points for examinations. First, he mentioned an evaluation of the compliance and control environment, specifically whether a firm has policies and procedures in place and whether it tests these policies and procedures to ensure compliance. He noted that investment advisers can expect an examination that addresses valuation issues, conflicts of interests and asset verification. Champ said examinations would also focus on performance advertising and portfolio management issues, including whether the firm's investment strategy is consistent with the one disclosed to its investors.

Champ also spoke about changes to the assets under management threshold for registration of investment advisers with the SEC under Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). For a more comprehensive summary of Title IV of the Dodd-

Frank Act, please see the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010***. In July 2011, the minimum assets under management threshold for SEC registration of many U.S. investment advisers will jump from $25 million to $100 million. Champ noted that while the SEC will lose registrants between the $25 and $100 million range, it will gain approximately 700 to 1,000 private fund advisers whose exemption from registration—the "private investment advisers" exemption under Section 203(b)(3) of the Investment Advisers Act of 1940—was abolished (effective July 21, 2011) by the Dodd-Frank Act.

Litigation

SEC Stays New Proxy Access Rules Pending Judicial Review

On October 4, 2010, the SEC issued an order granting the stay of Rule 14a-11 and related SEC rule amendments, including the amendment to Rule 14-8, pending judicial review of a challenge to the SEC's proxy access rules, as reported in the Davis Polk Client Newsflash ***SEC Stays Proxy Access Pending Court Review***. On September 29, 2010, the United States Chamber of Commerce (the "**Chamber**") and the Business Roundtable, an association of chief executive officers from various large companies (collectively, "**Petitioners**"), petitioned the U.S. Court of Appeals for the District of Columbia Circuit to vacate the SEC's newly adopted proxy access rules, which provide eligible shareholders with the right to nominate up to 25% of the company's board. Petitioners argue that the new proxy access rules are "arbitrary and capricious" and exceed the SEC's authority. Petitioners contend that the SEC failed to conduct an adequate cost-benefit analysis of the rules' effects on efficiency, competition and capital formation. The new rules become effective for larger companies in approximately one month while smaller companies, defined generally as those with a public float of less than $75 million, will have an additional three years to comply. For helpful background on the new proxy access rules, please see the Davis Polk Client Memorandum ***Summary of Proxy Access Rules*** and General Counsel Update ***Proxy Access Year One: What to Expect and What to Do Now***, as well as the ***September 13, 2010 Investment Management Regulatory Update***.

The SEC confirmed its support of the proxy access rules and the Council of Institutional Investors, a group which represents pension funds and other large investor groups, also voiced its support of the rules, noting that it plans to file an *amicus curiae* brief in support of the SEC.

- See a copy of the SEC order granting the stay of Rule 14a-11 and related amendments
- See a copy of the petition for review and motion for stay
- See a copy of the SEC adopting release containing a full text of the final rules

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Updates on SEC Enforcement Actions Against Investment Advisers

SEC Charges Bay Area Investment Adviser for Failure to Disclose Conflicts of Interest to Investors

On September 29, 2010, the SEC charged a California-based investment adviser with securities law violations for failure to disclose a conflict of interest when advising clients to exchange one series of partnership interests in an investment fund (the "**Fund**") for another series in the same fund. Valentine Capital Asset Management ("**VCAM"**) and its principal, John Leo Valentine, advised clients to switch between related investments without disclosing to clients that extra commissions would be charged or that additional costs would be incurred, the SEC found. In settling the matter, VCAM and Valentine agreed to a cease and desist order from violating an antifraud provision under Section 206(2) of the

Investment Advisers Act of 1940, censures, $70,000 in penalties and a return of approximately $400,000 to defrauded clients.

The Fund is a managed futures fund and commodity pool with two series of partnership interests, Series A and Series B. Investors in the Fund paid a 4% annual commission to the Fund, which was passed onto Valentine as selling agent. The aggregate commission for each series in the Fund was capped at 10%, which investors would reach after holding the series units for about two-and-a-half years. Once the commission cap was reached, the Fund would no longer pass commissions to the selling agent, but would instead rebate them to investors in the form of additional Fund units.

In 2005, Valentine advised clients to invest in Series A partnership interests of the Fund. In 2007, when clients began to reach the 10% cap, Valentine advised clients to switch investments to the Series B units. This switch caused clients to restart the 4% annual commission regardless of any progress they had made towards the 10% cap while investing in Series A. The SEC found that VCAM and Valentine failed to disclose to clients the material conflicts of interest involved in this switch, as clients were not specifically told of the additional commissions Valentine would make or the additional charges they would incur.

According to the SEC order, Valentine advised "many" of his clients to switch series between December 2007 and May 2008. Approximately 140 clients switched to Series B on Valentine's recommendation, the vast majority of whom had either reached or were soon to reach the 10% commission limit, resulting in VCAM and Valentine earning approximately an additional $400,000 in commissions, the SEC found. Although the Series Exchange Subscription Agreements of the Fund indicated that investors would be charged the maximum 10% commission for Series B units regardless of their investment in Series A units, the SEC found that "VCAM and Valentine were still required to make full and clear disclosures about any conflict of interest in recommending the changes."

Marc Fagel, Director of the SEC's San Francisco Regional Office, explained that "investors are entitled to understand the fees they are being charged by their advisers and whether any conflicts of interest might be influencing the investment advice they are receiving." VCAM and Valentine breached their fiduciary duty, he says, because "despite knowing that switching between funds would increase the costs to their clients, VCAM and Valentine did not fully disclose their conflicts in recommending the investment strategy."

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

SEC Charges Colorado Investment Adviser with Fraud and Breach of Fiduciary Duty in Recommending Hedge Funds to Elderly Investors

On September 7, 2010, the SEC charged Neal R. Greenberg, a Boulder, Colorado-based investment adviser, with fraud and breach of fiduciary duty for misrepresenting the diversification, risks and fees associated with investing in certain hedge funds managed by his two investment firms, Tactical Allocation Services LLC and Agile Group LLC.

The majority of Greenberg's clients were older, conservative investors who sought low-risk investments offering significant capital protection. Greenberg encouraged these clients to invest in his firm's Agile hedge funds, funds that used leverage and were concentrated in a small number of investments, including investments in other hedge funds through a call-option contract linked to the performance of a basket of hedge funds. According to the SEC, Greenberg made false or misleading oral and written statements characterizing these funds as low-risk investments that offered liquidity and "immense diversification", that used leverage in a low-risk manner and that could safely represent an investor's entire portfolio. Moreover, the offering documents of the Agile hedge funds contradicted the representations made by Greenberg regarding the suitability and risk profile of an investment in the Agile hedge funds. In 2008, after suffering significant losses, the funds suspended redemptions.

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

Former State Street Employees Charged with Misleading Investors About Subprime Investments

On September 30, 2010, the SEC brought administrative proceedings against two former State Street Bank and Trust Company ("**State Street**") employees, John Flannery and James Hopkins, charging them with misleading investors about exposure to subprime mortgages. State Street settled a case with the SEC for a related charge in February 2010, as reported in the ***March 9, 2010 Investment Management Regulatory Update***.

In 2002, State Street established two substantially identical funds which are referred to collectively as the Limited Duration Bond Fund (the "**Fund**"), a fund marketed as an alternative to a money-market fund for certain types of investors and which used an "enhanced cash" investment strategy. By 2007, however, nearly the entire Fund was invested in subprime residential mortgage-backed securities and other subprime investments. This exposure, however, was not disclosed to clients, and State Street continued to describe the fund as safer than a typical money-market fund. July 2007 marked the beginning of a series of allegedly misleading communications to investors regarding the effect of the problematic subprime market on the Fund. The SEC alleges that Flannery and Hopkins played a prominent role in disseminating such communications. At the same time, State Street provided certain investors with more information concerning the Fund's involvement in subprime mortgages, among them clients of State Street's internal advisory groups, one of which was directly under the management of Flannery.

According to the SEC, after receiving this information the internal advisory groups encouraged their clients, including the pension plan of State Street Corporation, to redeem from the Fund and related funds. Flannery and State Street's Investment Committee subsequently sold the Fund's liquid holdings and used the proceeds to meet the redemption requests of the better-informed investors, leaving the remaining investors in the Fund with mostly illiquid holdings.

The administrative proceedings will determine whether Flannery and Hopkins receive cease and desist orders or civil penalties. The ability to seek civil penalties in cease and desist proceedings is a new authority provided to the SEC under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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

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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