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SEC Rules and Regulations

SEC Issues Order Adjusting Asset Thresholds in the Definition of "Qualified Client"

On July 12, 2011, the SEC issued an order (the "**Order**") that raises the dollar amount thresholds in the assets-under-management and net worth tests in the definition of "qualified client" under rule 205-3 under the Investment Advisers Act of 1940 (the "**Advisers Act**"). Pursuant to the Order, the assets-under-management and net worth prongs of the definition of "qualified client" will be adjusted from $750,000 to $1,000,000 and $1,500,000 to $2,000,000, respectively. The SEC previously indicated on May 10, 2011 that it would issue the Order in a rule proposal regarding proposed amendments to rule 205-3, as discussed in the ***May 17, 2011 Investment Management Regulatory Update***.

Section 418 of the Dodd-Frank Act amends Section 205(e) of the Advisers Act to provide that, by July 21, 2011, and every 5 years thereafter, the SEC must adjust for inflation any dollar amount threshold contained in SEC rules issued under Section 205(e).

Rule 205-3 under the Advisers Act provides that a registered investment adviser may charge a performance fee to a client if such client is a "qualified client." The current definition of "qualified client" under rule 205-3 includes, among others, (i) a natural person that has at least $750,000 in assets under management with the adviser immediately after entering into the advisory contract and (ii) a natural person that the adviser reasonably believes, immediately prior to entering into the advisory contract, has a net worth (including assets held jointly with such person's spouse) of more than $1,500,000.

Under the Order, these standards are raised to $1 million for the assets-under-management test and $2 million for net worth test. According to the SEC, the revised dollar amounts take into account inflation by reference to the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce.

The Order will be effective on September 19, 2011.

The Order does not adopt certain other amendments to rule 205-3 that were proposed by the SEC on May 10, 2011, including (i) an amendment that would the exclude value of a natural person's primary residence from the net worth standard and (ii) a transition rule providing that the heightened dollar amount tests would not apply retroactively to performance fee arrangements already in place. The Order indicates the SEC is still considering these additional amendments.

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

SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940

On June 22, 2011, the SEC issued final rules and rule amendments to implement 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 "**Exemptions Release**"). Among other things, the final rules set forth in the Exemptions Release (i) define "venture capital fund" for the purposes of the new Advisers Act exemption for advisers to venture capital funds, (ii) exempt from registration certain private fund advisers with less than $150 million in assets under management in the United States and (iii) clarify the meaning of certain terms used in the new exemption for foreign private advisers.

In a companion release issued the same day (the "**Registration Release**"), the SEC adopted final rules that implement certain other amendments to the Advisers Act effected by the Dodd-Frank Act, including the increased assets under management threshold for adviser registration with the SEC, new reporting requirements for certain advisers exempt from registration, modified reporting requirements for registered advisers (including with respect to their private funds), conforming and other amendments to Form ADV and amendments to the SEC's pay-to-play rule in response to changes made by the Dodd-Frank Act. In the same release, as anticipated, the SEC extended until March 30, 2012 the date by which investment advisers currently relying on the private adviser exemption must register and come into compliance with the obligations of a registered adviser.

Finally, in a third release issued the same day (the "**Family Office Release**"), the SEC adopted its final rule implementing the new definition of "family office" as required by Title IV of the Dodd-Frank Act.

All three releases are discussed in greater detail in the Davis Polk Client Memorandum ***SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940***.

- See the Exemptions Release containing the full text of the final rules
- See the Registration Release containing the full text of the final rules
- See the Family Office Release containing the full text of the final rule

SEC and CFTC Defer Dodd-Frank Swaps Requirements

The CFTC and SEC took actions in June 2011 that are expected to defer most Dodd-Frank requirements regulating swaps and security-based swaps ("**SBS**") that would otherwise have gone into effect on July 16, 2011. The SEC issued an order on June 15, 2011 outlining provisions that will be effective on July 16 and granting temporary and other relief, on a provision-by-provision basis, to market participants from the majority of requirements that would otherwise have been effective on July 16, 2011. The CFTC proposed to grant temporary relief to market participants, subject to a 14-day public comment period. Prior to the SEC and CFTC actions, the effective date of many swap and SBS provisions was unclear.

The Dodd-Frank Act's swaps and SBS provisions generally become effective on the later of July 16, 2011 or, if the provision requires rulemaking, no earlier than 60 days after the publication of the final rule in the Federal Register. The Dodd-Frank Act requires the SEC and CFTC to finalize most required rules by July 16. Despite this, the CFTC and SEC have issued very few final rules to date. Among those rules not yet finalized are those defining "swap," "security-based swap," "mixed swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant" and "eligible contract participant." In granting and proposing temporary relief, the SEC and CFTC provided swap and SBS market participants with much-needed certainty.

For more information on the SEC and CFTC actions, please see the Davis Polk Client Memorandum, ***CFTC and SEC Act to Defer Dodd-Frank Swaps Requirements***.

Industry Update

U.S. House of Representatives Financial Services Committee Approves Bill that Would Exempt Private Equity Fund Advisers from Advisers Act Registration

On June 22, 2011, the U.S. House of Representatives Financial Services Committee approved the "Small Business Capital Access and Job Preservation Act," as amended by an amendment from Congressman Himes of Connecticut (the "**Bill**"). The Bill, if enacted, would provide an exemption from registration under the Investment Advisers Act of 1940 (the "**Advisers Act**") for advisers to private equity funds. The Bill would direct the SEC to define "private equity fund" for purposes of the exemption. Similar to the new exemptions available for advisers to venture capital funds and private fund advisers with less than $150 million in assets under management in the United States, eligible private equity fund advisers would also be subject to reporting and recordkeeping requirements as determined by the SEC.

The amended Bill includes a leverage limitation, which provides that each private equity fund of an adviser relying on the exemption must not have borrowed, and must not have outstanding, a principal amount in excess of twice its funded capital commitments.

Davis Polk will continue to monitor developments with the Bill.

- See a copy of the Bill
- See the Congressman Himes amendment

Litigation

Supreme Court Finds Investment Adviser Not Liable Under Rule 10b-5 For False Statements Made in Fund Prospectus

On June 13, 2011, the U.S. Supreme Court issued an important decision, *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525 (S. Ct. June 13, 2011), ruling that an investment adviser was not liable for false statements in a mutual fund prospectus under Rule 10b-5, even though it had substantially participated in the creation of the statements. More generally, the *Janus* case clarifies the scope of liability for "making" false statements under Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Rule 10b-5 thereunder. The Supreme Court's decision reverses the ruling of the U.S. Court of Appeals for the Fourth Circuit, which was previously covered in the ***August 16, 2010 Investment Management Regulatory Update***.

The Janus case concerned alleged false statements in certain prospectuses issued by Janus Investment Fund, a trust comprising several mutual funds (the "**Fund**"). Specifically, the prospectuses represented that the Janus mutual funds were not intended for market timing, and that Janus Capital Management

("**JCM**"), its investment adviser and an affiliate of the Fund, would adopt policies and procedures intended to prevent investors from engaging in market timing. The plaintiffs alleged that these representations were false because JCM had secretly agreed with certain investors to permit market timing in some of the funds. At all relevant times, JCM and the Fund shared common officers, but were organized as distinct legal entities and only one of the Fund's trustees was associated with JCM. The plaintiffs brought claims against JCM under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, asserting that JCM had caused the Fund to issue the prospectuses containing false representations. Section 10(b) and Rule 10b-5 make it unlawful for any person to make an untrue statement of a material fact in connection with the purchase or sale of securities.

In the decision, the Supreme Court concluded that "for the purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." The Court rejected the idea that individuals who help "create" statements made by others fall within the scope of liability under Section 10(b) and Rule 10b-5. Following this reasoning, the Court held that JCM could not be considered the maker of the statements in the prospectus of the Fund because, while JCM may have assisted in crafting the prospectus, the Fund filed the prospectuses with the SEC and nothing "on the face of the prospectuses indicate that any statements therein came from JCM rather than the Fund—a legally independent entity with its own board of trustees." The Court emphasized that this distinction is significant because only the "maker" of the statement is subject to the private cause of action for primary liability under Rule 10b-5.

The dissent argued that neither the language of Rule 10b-5 nor the Court's precedents required the rule that the majority had articulated. Citing the closeness of the relationship between JCM and the Fund, the dissent concluded that a court could find that JCM "made" the statements in question for purposes of Rule 10b-5. The dissent expressed concern about several potential implications of the majority's rule, including concern that the majority's rule would foreclose liability in "cases in which one actor exploits another as an innocent intermediary for its misstatements," an issue that the majority indicated in a footnote it was not reaching.

For more information on the Janus case, please see the Davis Polk Client Newsflash ***Supreme Court Limits False Statement Liability Under Rule 10b-5 to Those Who Actually Make Misstatements***.

- See a copy of the opinion

Federal District Court Holds No Private Right of Action for Certain Investment Company Act Violations

On June 6, 2011, the U.S. District Court for the Southern District of New York dismissed a suit by a mutual fund investor alleging that the mutual fund's payment of asset-based 12b-1 distribution fees to broker-dealers violated the Investment Company Act of 1940 (the "**Investment Company Act**"), holding that plaintiff had no private right of action against the defendant trustees and distributor. *Smith v. Oppenheimer Funds Distributor, Inc.*, No. 10 Civ. 7387, 7394 (LBS), 2011 U.S. Dist. LEXIS 60877 (S.D.N.Y. June 6, 2011). For prior coverage of federal litigation in California regarding 12b-1 distribution fees, see the ***July 14, 2010 Investment Management Regulatory Update***. Last year, the SEC proposed rules that would rescind Rule 12b-1 under the Investment Company Act and provide a new framework governing mutual fund distribution fees, as previously reported in the ***August 16, 2010 Investment Management Regulatory Update***.

Plaintiff held shares in two Oppenheimer mutual funds, Oppenheimer Gold & Special Minerals Fund and Oppenheimer Small & Mid-Cap Fund (together, the "**Funds**"), through a brokerage account at Merrill Lynch, Pierce, Fenner & Smith ("**Merrill Lynch**"). Each Fund finances distribution of its shares out of its respective assets pursuant to Rule 12b-1 under the Investment Company Act. The distribution fees were paid to the Fund's distributor, Oppenheimer Funds Distributor (the "**Distributor**"), which in turn forwarded such payments to retail broker-dealers, including Merrill Lynch, who distribute shares in the Fund.

Plaintiff alleged that these payments constituted "special compensation" in violation of the broker-dealer exclusion from investment adviser registration under Section 202(a)(11)(C) of the Investment Advisers Act of 1940 (the "**Advisers Act**") by Merrill Lynch, a broker-dealer relying on such exclusion. Specifically, Section 202(a)(11)(C) exempts from adviser registration any broker-dealer who provides investment advice that is only incidental to its conduct as a broker-dealer and for which it receives no special compensation.

According to the court, the Advisers Act contains no private right of action against a mutual fund, its trustees or distributors, so plaintiff brought his claims against the Distributor and the Funds' trustees based on an alleged private right of action under Section 47(b) of the Investment Company Act. Section 47(b) of the Investment Company Act provides that contracts that violate provisions of the Investment Company Act and accompanying regulations, or whose performance involves such violation, are unenforceable and subject to rescission. Plaintiff alleged two underlying violations of the Investment Company Act, namely that the Distributor and trustees violated (i) their fiduciary duty of care to the Funds under Section 36(a) of the Investment Company Act and (ii) Rule 38a-1 under the Investment Company Act, which sets forth certain compliance procedures and practices for registered investment companies. Among other things, Rule 38a-1 imposes a duty on mutual fund boards to oversee fund compliance with federal securities laws and ensure that shareholders are not harmed.

The court stated that Section 47(b) of the Investment Company Act only provides a private remedy of rescission, not an independent private right of action. The court noted that the Investment Company Act's remedial scheme provides for private rights of action only for certain specific, narrowly defined offenses. The court found that allowing Section 47(b) to endow all of the Investment Company Act's provisions with private rights of action would override this careful allocation of remedies. Thus, the court held that to bring a private action under Section 47(b), a plaintiff must allege an underlying violation of the Investment Company Act that itself provides a private right of action. However, with respect to plaintiff's two underlying claims, the court held that neither Section 36(a) of the Investment Company Act nor Rule 38a-1 provides a private right of action, because neither contains explicit "rights-creating" language. Moreover, Section 36(a) explicitly provides for enforcement by the SEC, suggesting that Congress intended to preclude other rights of action. Therefore, the court granted defendants' motion to dismiss, holding that plaintiff had no private right of action to bring the suit against the defendants. The court noted that plaintiff could still assert a claim under the Advisers Act directly against Merrill Lynch, although the court did not opine as to the viability of plaintiff's allegations.

- See a copy of the court's decision

SEC Brings Enforcement Action Against Washington-Based Hedge Fund Manager

On June 15, 2011, the SEC issued a cease-and-desist order against a Washington-based hedge fund manager, Pegasus Investment Management LLC ("**Pegasus**"), its Vice President and co-owner, Peter Bortel, and its President, co-owner and Chief Compliance Officer, Douglas Saksa. The enforcement action concerns an alleged arrangement between Pegasus and a proprietary trading firm whereby Pegasus kept for its own use undisclosed cash payments from the proprietary trading firm that should have been given over to hedge funds managed by Pegasus (the "**Funds**").

According to the SEC, Pegasus was approached in 2008 by a proprietary trading firm looking to engage in commodities futures strategies (the "**Firm**"). In an effort to obtain a commissions rate that would make its futures business cost-effective, the Firm allegedly entered into an arrangement with its broker and Pegasus whereby its brokerage fee was calculated based on a combination of the trade volumes of the Firm and the Funds. In exchange for benefiting from the Funds' trade volume, the Firm allegedly made monthly cash payments to Pegasus. According to SEC allegations, the agreement lasted approximately a year, garnering $90,000 in payments for Pegasus. Pegasus used this money for its own benefit, rather than for the benefit of the Funds and did not disclose the payments to Fund investors through its offering documents or in its Form ADV, according to the SEC.

According to the SEC settlement order, Pegasus's conduct constituted a willful violation of the antifraud provisions under Section 206(2) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). The SEC concluded in the settlement order that an adviser's fiduciary obligations preclude the adviser "from using client assets for the adviser's own benefit or the benefit of other clients, at least without client consent." Saksa, as Bortel's superior, failed adequately to supervise Bortel within the meaning of Section 203(e)(6) of the Advisers Act, the SEC concluded. Pegasus agreed to pay disgorgement of $90,000, plus prejudgment interest. Bortel and Saksa each agreed to pay civil money penalties of $50,000 and $25,000, respectively. Additionally, Pegasus, Bortel and Saksa agreed to a censure.

- See a copy of the SEC order

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