August 12, 2011

Investment Management Regulatory Update

SEC Rules and Regulations

SEC Adopts Large Trader Reporting Rule

On July 26, 2011, the SEC adopted Rule 13h-1 under the Securities Exchange Act of 1934 to require large trader registration and reporting. The rule requires persons who directly or indirectly exercise investment discretion and purchase or sell more than a specified amount of U.S.-listed stocks and options through a registered broker-dealer to register with the SEC as large traders by filing Form 13H. These large traders, which may include certain hedge funds and other large volume traders, must obtain a unique identification number and provide it to their registered broker-dealers. Registered broker-dealers must comply with monitoring, recordkeeping and reporting requirements with respect to registered large traders and persons who such broker-dealers know or have reason to know are large traders.

The rule will effectively require the ultimate parent companies of groups that may be large traders on a group-wide basis to develop corporate systems to enable them to identify all of their affiliates that have investment discretion with respect to U.S.-listed stocks and options. In addition, they must gather and report facts about the businesses, trading activities, regulation and brokerage relationships of the group on a combined basis.

The rule’s effective date is October 3, 2011. Large traders must register with the SEC by December 1, 2011, and registered broker-dealers must comply with the recordkeeping, reporting and monitoring requirements by April 30, 2012.

The adopted rule is discussed in greater detail in the Davis Polk Client Memorandum ***SEC Adopts Large Trader Reporting Requirements***.

- ► See a copy of the SEC release containing the full text of the final rules

Industry Update

SEC Issues No-Action Letter Regarding Compliance with the Independent Accountant Requirements Under the Custody Rule

On July 21, 2011, the staff of the Division of Investment Management (the "**Staff**") of the SEC issued a no-action letter (the "**Letter**") to Seward & Kissel LLP ("**Seward & Kissel**") concerning compliance by certain investment advisers with Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940.

The Custody Rule requires an SEC-registered investment adviser with custody of client funds and securities to take specific measures to safeguard these assets from loss, theft or misappropriation. These measures include, subject to certain exceptions, (i) maintaining clients assets with a "qualified custodian" that the adviser has a reasonable basis to believe provides account statements directly to the adviser's clients; (ii) undergoing an annual surprise examination by an independent accountant intended to verify the existence of such assets; and (iii) for advisers who do not use an independent qualified custodian, obtaining or receiving from the related person an internal control report (*i.e.*, an annual review of internal controls related to their custodial operations) prepared by an independent accountant. The Custody Rule requires the use of an independent accountant registered with and regularly inspected by the Public Company Accounting Oversight Board ("**PCAOB**") for certain of these requirements, including, as applicable, for the annual surprise examinations, preparation of internal control reports and, for advisers to private funds seeking to utilize an annual audit exception from compliance with certain provisions of the Custody Rule (the "**Annual Audit Provision**"), annual audits of their private funds. See the ***January 7, 2010 Investment Management Regulatory Update*** for a detailed overview of recent amendments to the Custody Rule.

Currently, only auditors to public companies are subject to such regular inspection by the PCAOB. Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, however, which was enacted on July 21, 2010, provides the PCAOB with authority to develop rules to establish a regular inspection program for auditors of brokers and dealers. Because PCAOB rules regarding such an inspection program had not yet been adopted, in a previous no-action letter to Seward & Kissel dated October 12, 2010, the Staff had clarified that it would not recommend enforcement action against an investment adviser that engages an auditor which is not subject to regular inspection by the PCAOB, but which audits the financial statements of a broker or a dealer, to audit the financial statements of a pooled investment vehicle for purposes of complying with the Annual Audit Provision. See the ***November 12, 2010 Investment Management Regulatory Update*** for a discussion of the no-action relief previously obtained by the applicant.

On June 14, 2011, the PCAOB adopted a temporary rule, originally proposed in December 2010, to establish an interim inspection program for registered public accounting firms' audits of brokers and dealers (the "**Temporary Rule**"). The PCAOB has indicated that it anticipates proposing rules for a permanent inspection program by 2013. Pursuant to Section 107(b) of the Sarbanes-Oxley Act, the Temporary Rule will not be effective until it is approved by the SEC. On July 6, 2011 the SEC published notice of the Temporary Rule and request for public comment.

In a telephone conversation with the SEC, Seward & Kissel requested guidance regarding the effect of the Temporary Rule on investment adviser compliance with the independent accountant requirements under the Custody Rule. The Letter provides that, in light of the Temporary Rule, the Staff would not recommend enforcement action to the SEC against an investment adviser who, for purposes of compliance with the Custody Rule, engaged an auditor to (i) perform an annual surprise examination of an investment adviser who maintains, or who has custody because a related person maintains, client funds or securities as a qualified custodian in connection with advisory services provided to clients; (ii) prepare an internal control report; or (iii) audit the financial statements of a pooled investment vehicle in connection with the Annual Audit Provision, so long as such auditor was registered with the PCAOB and engaged to audit the financial statements of a broker or a dealer as of the commencement of the professional engagement period of the respective engagement and as of each calendar year-end.

The Letter specifies that the Staff's position applies until the earlier of (i) the date the SEC approves a PCAOB-adopted permanent program for the inspection of broker and dealer auditors; (ii) December 31, 2012; or (iii) the date the Temporary Rule is withdrawn or disapproved.

- See a copy of the Letter
- See a copy of the Temporary Rule
- See a copy of the SEC Release soliciting public comment on the Temporary Rule

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SEC Grants No-Action Relief from Advisers Act Registration to Wholly Owned Subsidiary that Solely Advises Foreign Funds in Which Parent is Sole Investor

On June 30, 2011, the SEC's Division of Investment Management issued a no-action letter to Zenkyoren Asset Management of America Inc. ("**ZAMA**") indicating that it would not take enforcement action against ZAMA, a wholly owned subsidiary that manages investments exclusively on behalf of its parent, a financial institution, if ZAMA does not register as an investment adviser under the Investment Advisers Act of 1940 (the "**Advisers Act**").

The letter requesting relief stated the following claims: ZAMA is a wholly owned subsidiary of National Mutual Insurance Federation of Agricultural Cooperatives, a Japanese insurance federation (the "**Parent**"). ZAMA has assets under management in excess of $150 million and does not hold itself out to the public as an investment adviser. ZAMA provides investment management services solely to four funds ("**Funds**"), each a series of a trust, in which the Parent is the sole investor. All investment management personnel of ZAMA are seconded from the Parent. The salaries of all personnel of ZAMA are paid by ZAMA. ZAMA intends to limit its advisory services only to the Funds and any future funds in which the Parent or a wholly owned subsidiary of the Parent is the sole investor. The Funds are designed to enable the Parent to pool and invest insurance premium proceeds in order to meet claim obligations and other operating costs of its insurance business. Finally, neither ZAMA nor the Parent has received any investment directives from any of the Parent's insureds or any third party.

Under Section 202(a)(11) of the Advisers Act, an investment adviser is "a person who, for compensation, engages in the business of *advising others*, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities" (emphasis added). ZAMA had previously relied on the "private adviser" exemption from registration under Section 203(b)(3) of the Advisers Act, which was repealed by the Dodd-Frank Wall Street Reform and Consumer Protection Act effective July 21, 2011. ZAMA requested relief from registration on the basis that it is not "advising others" regarding securities.

In granting no-action relief, the Division of Investment Management based its position primarily on three representations made by ZAMA: (1) ZAMA is a wholly owned subsidiary of the Parent and was established and has been operated for the sole purpose of providing investment advisory services to the Parent via the Funds, in which the Parent is the only investor; (2) ZAMA does not hold itself out to the public as an investment adviser; and (3) the Funds (and any additional funds established by the Parent in the future) to which ZAMA provides its services consist solely of the Parent's assets and are established and operated solely for the benefit of the Parent. The SEC noted that its position would not apply to a parent company which itself is a private fund (as defined in Section 202(a)(29) of the Advisers Act).

- See a copy of the SEC No-Action Letter

Litigation

SEC Settles with Dually Registered Broker-Dealer and Investment Adviser over Inadequate Insider Trading Policies

On July 11, 2011, the SEC announced a settlement with Janney Montgomery Scott LLC ("**Janney**"), a Philadelphia-based dually registered broker-dealer and investment adviser, over claims that Janney failed sufficiently to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information, in willful violation of Section 15(g) ("**Section 15(g)**") of the Securities Exchange Act of 1934 (the "**Exchange Act**"). Although the SEC's charges against Janney focused on violations of the Exchange Act by Janney as a broker-dealer, parallel considerations might be relevant to other regulated entities (such as registered investment advisers) that are required to adopt similar insider trading policies and procedures under other applicable federal securities laws (such as the Investment Advisers Act of 1940). For an example of a recent SEC order regarding failure of a registered investment adviser to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information, please see the ***February 14, 2011 Investment Management Regulatory Update***.

According to the SEC, from at least January 2005 through July 2009, Janney failed consistently to follow and enforce the policies and procedures set forth in its written compliance manual (the "**Manual**") intended to prevent the misuse of material, nonpublic information in violation of Section 15(g), including:

- *Failure to follow chaperone process.* The Manual permitted meetings between the personnel of the research and investment banking departments only when chaperoned by a member of the legal or compliance department, according to the SEC. The SEC alleged several instances where meetings nevertheless occurred without a compliance/legal chaperone present or where Janney otherwise failed to follow, enforce or maintain proper chaperone procedures, such as the following:
  - In May 2005, the heads of the research and investment banking departments held at least one meeting with other Janney banking and research personnel regarding business strategy with no chaperone present. Additionally, at least one instance occurred where compliance counsel reprimanded investment banking personnel for repeatedly disregarding the Manual's chaperone requirements and contacting research personnel directly for information.
  - Following the departure of Janney's compliance counsel in August 2005, a new member of the compliance department became responsible for chaperoning meetings. The SEC alleged that this new compliance chaperone was "less rigorous" than his predecessor, failing to keep abreast of deals on the company watch list and industry segments covered by analysts and to obtain information about companies to be discussed in advance of the chaperoned meetings.
  - In the fall of 2005, Janney began to use research analysts' expertise to help its investment bankers with new business opportunities. In addition, investment banking and research personnel began meeting on a biweekly basis to compare notes regarding companies covered by analysts, relationships with such companies and "personal color" on such companies. However, Janney did not revise the Manual to account for the new role of analysts, its impact on the nature of Janney's business or policies and procedures needed to prevent possible misuses of material, nonpublic information.
  - In January 2006, the compliance chaperone attended a meeting between a Janney investment banker who was advising a client on a pending merger and a Janney research analyst who covered the company. The compliance chaperone was allegedly unaware that

Janney was advising the pending merger and that the analyst covered the company. Thereafter, the research analyst and investment banking personnel had at least one 14-minute phone call; however, due to the compliance chaperone's "poor documentation," there were no records memorializing any request for a compliance chaperone that should have been made by the relevant personnel for this call, nor could anyone recall whether the call was chaperoned. Following these communications, the analyst recommended the stock of the company advised by Janney in the pending merger to at least three of Janney's institutional clients, who immediately bought the stock the day before the merger was publicly announced.

    - On several occasions, the heads of the investment banking and research departments would chaperone meetings in contravention of the Manual's chaperone requirements.

- *Failure to monitor employee trading activities.* Janney's compliance department maintained a "watch list" of companies used to identify those securities where the potential for insider trading existed and to monitor employee trading in such securities. However, according to the SEC, Janney failed to adequately monitor its employees' trading of securities placed on the watch list. For example:

    - Although Janney's policies required all employees to keep their trading accounts at Janney, permission to have accounts away from the firm was frequently granted to employees, making monitoring of improper trading activity more difficult.
    - A 2009 SEC examination found that, although Janney required certain employees to gain pre-clearance before trading in any stock, investment bankers were able to trade without pre-clearance.
    - Janney failed to obtain, and/or obtain in a timely manner, completed questionnaires and disclosure forms regarding the existence of outside employee accounts, as required of employees under Janney's written policies and procedures. Where Janney was aware of the existence of such outside accounts, it allegedly failed to request and review the account activity.
    - Although Janney received trade confirmations for outside accounts of certain employees, Janney failed to establish that the compliance department regularly compared these trade confirmations to the watch list in order to monitor for improper trading. Review of account statements for certain outside accounts was conducted by a business supervisor who lacked access to the watch list and therefore was unable to identify whether improper trading had occurred.

- *Failure to maintain email firewall.* The SEC alleged that Janney failed to properly maintain and enforce its email firewall intended to prevent email communication between analysts and investment bankers. Over a several-year period and on at least one occasion, investment bankers were able to breach the firewall and directly email research personnel, creating a risk that material nonpublic information could be exchanged or misused. According to the SEC, the firewall was breached as early as January 2005. Although Janney became aware of the breach by at least June 2008, the firewall problems were not properly remedied and breaches appeared to have continued as late as 2009.

As the Janney settlement exemplifies, SEC sanctions can be imposed against brokers and advisers for failing to establish, maintain and enforce adequate insider trading policies, even where no insider trading has occurred. Furthermore, the settlement demonstrates that policies and procedures established to prevent insider trading must be actually effective in preventing improper sharing of information (with any breaches promptly closed) and consistently implemented.

In settling the charges with the SEC, Janney agreed to (i) pay $850,000 in monetary penalties, (ii) a cease and desist order from committing or causing any violations of Section 15(g) and (iii) a censure. Janney also agreed to retain a qualified independent consultant to conduct a comprehensive review of and make recommendations regarding Janney's policies, practices and procedures relating to Section 15(g) and to adopt and implement the recommendations set forth by the consultant.

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

D.C. Circuit Vacates SEC Rule on Shareholder Access to Proxy Materials

On July 22, 2011, the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 14a-11 ("**Rule 14a-11**") under the Securities Exchange Act of 1934 (the "**Exchange Act**"), which would have required companies subject to the proxy rules under the Exchange Act, including investment companies registered under the Investment Company Act of 1940 (the "**Investment Company Act**"), to include shareholder nominees for election as directors in their proxy materials under certain conditions. The court found that, in adopting the rule, the SEC violated the Administrative Procedures Act by failing adequately to consider the rule's effect on efficiency, competition, and capital formation, as required by Section 3(f) of the Exchange Act and Section 2(e) of the Investment Company Act. See the ***July 22, 2011 Davis Polk Client Newsflash*** for a general discussion of the court's opinion. For a detailed overview of Rule 14a-11, please see the ***September 7, 2010 Davis Polk Client Memorandum***.

In its opinion, the court specifically addressed concerns raised by Rule 14a-11 with respect to registered investment companies. The court found that the SEC failed adequately to address whether the regulatory requirements of the Investment Company Act reduce the need for, and hence the benefit to be had from, proxy access for shareholders of registered investment companies. For example, the court noted that the SEC rationalized applying Rule 14a-11 to registered investment companies on the ground that registered investment company boards have significant responsibilities in protecting shareholder interests, such as the approval of advisory contracts, but then failed to consider that the Investment Company Act already requires shareholder approval of advisory contracts.

The court also found that the SEC failed to consider that Rule 14a-11 would impose greater costs upon registered investment companies, disrupting investment company governance structures with "no net benefit." In particular, the court stated that Rule 14a-11 would upset the unitary and cluster board structures typically utilized by investment company fund complexes with the introduction of shareholder-nominated directors who sit on the board of a single fund, thereby requiring multiple, separate board meetings and making governance less efficient.

The SEC has issued a statement indicating that its rule allowing shareholders to submit proposals for proxy access at their companies, which it adopted at the same time as Rule 14a-11, is unaffected by the court's decision.

- See a copy of the D.C. Circuit opinion
- See a copy of the SEC statement on the decision

SEC Settles with Hedge Fund Manager over Short Sale Violations

On July 8, 2011, the SEC announced a settlement with Boston-based investment adviser, Fontana Capital, LLC ("**Fontana Capital**") and Fontana Capital's Chief Investment Officer, portfolio manager and sole employee, Forrest Fontana, of administrative and cease-and-desist proceedings instituted by the SEC on January 7, 2011 regarding alleged short sale rule violations by Fontana Capital and Fontana. According to the SEC, Fontana Capital, at the direction of Fontana, violated Rule 105 of Regulation M under the Securities Exchange Act of 1934 ("**Rule 105**") on three occasions in 2008. Rule 105 generally makes it unlawful to purchase a security in a public offering after having sold the same security short within five days preceding the offering price's date. According to the SEC, Rule 105 "is designed to protect the independent pricing mechanism of the securities market shortly before follow-on or secondary offerings." For prior coverage of short sale violations, please see the ***February 5, 2010 Investment Management Regulatory Update***.

According to the SEC order, Fontana Capital and Fontana willfully violated Rule 105 by participating in three different public offerings from July 2008 through November 2008. In each instance, the SEC charged that Fontana shorted securities during the five business days prior to purchasing shares in the public offering, realizing an aggregate profit of $816,184.

The first instance involved a public offering by XL Capital Ltd. ("**XL Capital**"), a holding company based in Ireland. On July 25, 2008, Fontana directed the hedge funds advised by Fontana Capital to sell short 60,000 XL Capital shares at $18.98 each. Four days later, XL Capital priced a follow-on offering at $16 per share and Fontana directed the hedge funds to purchase 50,000 shares at this price. According to the SEC, Fontana Capital made $149,000 in profits by participating in the XL Capital public offering after having shorted the stock during the Rule 105 restricted period.

The second instance involved a public offering by Merrill Lynch & Co., Inc. ("**Merrill Lynch**"). On July 25, 2008, hedge funds advised by Fontana Capital sold short 40,000 shares of Merrill Lynch, at $27.30 per share. Four days later, Merrill Lynch priced a follow-on offering at $22.50 per share and Fontana directed the hedge funds to buy 200,000 shares. According to the SEC, Fontana Capital realized a profit of $507,184 from the short sale of Merrill Lynch shares.

In the final instance, the SEC charged that on November 6, 2008, hedge funds advised by Fontana Capital sold short 100,000 shares of Wells Fargo and Company ("**Wells Fargo**") stock at $28.60 per share. Wells Fargo priced a follow-on offering of its securities at $27 that same day. The next day, Fontana directed the hedge funds to buy 100,000 Wells Fargo shares, garnering $160,000 in profits.

Fontana Capital and Fontana have each agreed to censures and cease-and-desist orders from the SEC. Additionally, Fontana Capital and Fontana have agreed to be jointly and severally liable to pay disgorgement of $816,184, prejudgment interest of $3,606 and a civil penalty of $165,000.

- See a copy of the SEC order

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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