Investment Management Regulatory Update

November 26, 2013

SEC Rules and Regulations

- IM Guidance Update Clarifies Stance on Aggregating the Investments of Certain Investors Across Funds to Satisfy Qualified Client Standard
- SEC Extends No-Action Relief Regarding Compliance with the Independent Accountant Requirements Under the Custody Rule
- IM Guidance Update Addresses Status of Investment Advisers Providing Services "at Cost" or for No Compensation

Industry Update

- SEC's Division of Investment Management Answers Questions Concerning Form 13F
- Clarifying Amendments to Rule Prohibiting Loans by Commodity Pools to CPOs Go Effective

Notes from Europe: European Regulatory Developments

- Notification of Voting Rights in EU Issuers

SEC Rules and Regulations

IM Guidance Update Clarifies Stance on Aggregating the Investments of Certain Investors Across Funds to Satisfy Qualified Client Standard

In November 2013, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued an IM Guidance Update regarding the status of certain investors in private funds (including hedge funds and private equity funds) as "qualified clients" as defined in Rule 205-3 under the Investment Advisers Act of 1940 (the "**Advisers Act**").

Section 205(a)(1) of the Advisers Act and Rule 205-3 thereunder generally prohibit registered investment advisers from charging performance fees to certain private funds unless the investors in the fund meet the definition of qualified client. In order to be a qualified client under Rule 205-3, among other possibilities, a natural person must (i) have at least $1 million in assets under management with the adviser immediately after entering into the advisory contract (the "**assets-under-management test**") or (ii) be reasonably believed by the adviser, immediately prior to entering into the advisory contract, to (A) have a net worth (including assets held jointly with such person's spouse) of more than $2 million (excluding the value of a natural person's primary residence and debt secured by the primary residence up to the estimated fair market value of the primary residence at the time the advisory contract was entered into) (the "**net-worth test**") or (B) be a "qualified purchaser" as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 (the "**Investment Company Act**").

According to the IM Guidance Update, investment advisers "that operate a single advisory business through related investment advisers formed as separate legal entities that are registered jointly with the [SEC]" (in reliance on the no-action letter issued to the American Bar Association by SEC staff on January 18, 2012, as discussed in the ***February 21, 2012 Investment Management Regulatory Update***) (such related entities together, a "**Firm**"), may aggregate the investments of an investor who is a client of more than one private fund managed by the Firm in order to determine such investor's status as a qualified client. Thus, according to the IM Guidance Update, an investor that "may have invested less

than $1,000,000 in any one private fund, but more than $1,000,000 collectively in the private funds" that are managed by the Firm, may be considered a qualified client for purposes of Rule 205-3.

- **See a copy of the IM Guidance Update**

SEC Extends No-Action Relief Regarding Compliance with the Independent Accountant Requirements Under the Custody Rule

On November 5, 2013, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") that extends the termination date of relief that was previously provided in a July 21, 2011 no-action letter (the "**2011 Letter**") concerning compliance by certain investment advisers with Rule 206(4)-2 (the "**Custody Rule**") under the Advisers Act. As discussed in the ***August 12, 2011 Investment Management Regulatory Update***, without the adoption by the Public Company Accounting Oversight Board ("**PCAOB**") of a permanent program for the inspection of auditors of brokers and dealers, the position taken in the 2011 Letter would expire on December 31, 2013. The Letter extends the relief provided by the 2011 Letter until the earlier of (i) the date the SEC approves a PCAOB-adopted permanent program for the inspection of auditors of brokers and dealers; (ii) December 31, 2016; or (iii) the date the Temporary Rule (as defined below) is withdrawn or disapproved.

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 an internal control report (i.e., an annual review of internal controls related to custodial operations) prepared by an independent accountant. The Custody Rule requires the use of an independent accountant registered with and regularly inspected by the 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.

On June 14, 2011, the PCAOB adopted a temporary rule to establish an interim inspection program for registered public accounting firms' audits of brokers and dealers (the "**Temporary Rule**"). In an August 19, 2013 press release, the PCAOB indicated that it anticipates proposing rules for a permanent inspection program in 2014 or later.

The Letter provides that, in light of the Temporary Rule, the SEC 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 the annual surprise examination; (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.

- **See a copy of the Letter**
- **See a copy of the 2011 Letter**
- **See a copy of the August 19, 2013 PCAOB press release**

IM Guidance Update Addresses Status of Investment Advisers Providing Services "at Cost" or for No Compensation

In October 2013, the Division of Investment Management of the SEC issued an IM Guidance Update to address whether a person (or entity) who temporarily provide investment advice to a registered investment company (a "**RIC**") either "at cost" or for no compensation is an investment adviser under the Investment Company Act.

As discussed in the IM Guidance Update, Section 2(a)(20) of the Investment Company Act defines an investment adviser to a RIC to include any person "who pursuant to contract with such [RIC] regularly furnishes advice to such [RIC] with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company," but, Section 2(a)(20)(ii) excludes from the definition of investment adviser "a company furnishing such services at cost to one or more investment companies, insurance companies, or other financial institutions" (such as a company owned by and providing services exclusively to a financial institution). The IM Guidance Update reiterates SEC guidance that the exclusion provided by Section 2(a)(20)(ii) is not intended to exclude from the Section 2(a)(20) definition of investment adviser persons who provide investment advisory services temporarily at cost only to certain clients.

In addition, the IM Guidance Update emphasized that a person that temporarily provides investment advisory services to a RIC as a result of the assignment of an advisory contract, pursuant to Rule 15a-4 under the Investment Company Act (or pursuant to no-action relief), is not considered by the SEC to fall outside the scope of the Section 2(a)(20) definition of investment adviser. As discussed in the IM Guidance Update, Rule 15a-4 under the Investment Company Act allows a person to temporarily serve as investment adviser to a RIC under an interim contract without shareholder approval for a period of 150 days following the assignment of the advisory contract, subject to certain conditions, and, if the assignment of the advisory contract is not approved by the RIC's shareholders, the person may only be paid the costs it incurred in performing the interim contract.

- **See a copy of the IM Guidance Update**

Industry Update

SEC's Division of Investment Management Answers Questions Concerning Form 13F

On October 10, 2013, the staff of the SEC's Division of Investment Management issued responses updating the frequently asked questions ("**FAQs**") regarding Form 13F, including as it relates to the transition from the text-based Form 13F to the new online form and to provide additional clarification about the availability of confidential treatment. As discussed in the ***July 18, 2013 Investment Management Regulatory Update***, starting with the quarter ended June 30, 2013, Form 13F filers are required to use the new online version of Form 13F (which is available on the EDGAR Filing Website) and must complete their Form 13F Information Table in accordance with the EDGAR XML Technical Specification. The updated FAQs answer the following questions regarding Form 13F filings:

Voting Authority. As discussed in the ***August 20, 2013 Investment Management Regulatory Update***, for column 8 of Form 13F (which, in the XML version of Form 13F, had limited a filer's response to eight digits), relating to voting authority, filers that would otherwise be required to enter more than eight digits with respect to the number of securities a filer owns for a single issuer had been instructed to enter "99,999,999" and to provide the correct number on the cover page in accordance with Special Instruction 5 of Form 13F. According to the FAQs, column 8 has now been updated to accept responses with up to sixteen digits.

Confidential Treatment. The FAQs provide that confidential treatment is available for a Form 13F filing pursuant to Section 13(f)(4) of the Securities Exchange Act of 1934, which allows the SEC to prevent or delay public dissemination of information filed on Form 13F for "public interest" or investor protection reasons (in accordance with the exceptions under the Freedom of Information Act ("**FOIA**")). The FAQs refer to an IM Guidance Update that was issued by the Division of Investment Management of the SEC in October 2013, in which the Division discusses that an investment management firm's request for confidential treatment (a "**CT Request**") for commercial or financial information (e.g., investment positions) may be granted under FOIA exception 4, which protects "trade secrets and commercial or financial information obtained from a person and privileged or confidential," such as an ongoing acquisition or disposition program (an "**Ongoing Program**"). According to the IM Guidance Update, when submitting a CT Request for an Ongoing Program, an investment adviser should (i) provide certain details about the Ongoing Program (including information regarding the Ongoing Program's history and goals), (ii) explain how public disclosure of information on Form 13 would "reveal" the Ongoing Program, (iii) show that the Ongoing Program is "ongoing" so as to demonstrate that public disclosure on Form 13F is premature (according to the IM Guidance Update, this should include a description of the investment adviser's trading activity in respect of the reportable security and an explanation of how the program was "ongoing" if, during any period, the adviser did not transact in the reportable security), (iv) demonstrate the likelihood of substantial harm if information were to be publicly disclosed on Form 13F (including an explanation of prior market reaction to the public disclosure of the investment adviser's positions in respect of an issuer) and (v) justify the length of time for which the CT Request is being made.

The Division also issued an August 2013 IM Information Update in relation to the updated Form 13F FAQs.

- **See a copy of the FAQs**
- **See a copy of the IM Guidance Update**
- **See a copy of the IM Information Update**

Clarifying Amendments to Rule Prohibiting Loans by Commodity Pools to CPOs Go Effective

On September 13, 2013, an amendment to National Futures Association ("**NFA**") Compliance Rule 2-45, which generally prohibits registered commodity pool operators ("**CPOs**") from using "any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity," became effective. In connection with the amendment, the NFA also revised the rule's companion Interpretive Notice 9062 to specify that certain transactions involving commodity pools and their CPOs do not violate NFA Rule 2-45. These transactions include certain securities lending transactions, guarantee obligations, repurchase or reverse-repurchase agreements, and tax-related distribution transactions involving a CPO and specified types of commodity pools, as well as certain transactions involving a commodity pool that is a registered investment company or business development company effected pursuant to a loan arrangement permitted by the Investment Company Act, exemptive rules under the Investment Company Act or an SEC exemptive order or no-action letter.

The Interpretive Notice also requires a CPO that was exempt from registration with the CFTC prior to December 31, 2012 and, prior to registering, caused a commodity pool to make loans or advances that would have been prohibited by Compliance Rule 2-45, to notify the NFA of any such existing arrangements within 30 days of the later of (i) the effective date of the amendment or (ii) the date on which such CPO becomes an NFA member. The Interpretive Notice notes that such arrangements violate existing NFA compliance rules if the arrangements are not consistent with the commodity pool's current disclosure document or offering materials and both the loans or advances and the conflict of interest are not fully disclosed to investors. The Interpretive Notice further notes that existing arrangements also violate the NFA's rules if the loan or advance is not secured by marketable, liquid

assets and therefore could have a material effect upon the pool's ability to meet its obligations to investors.

- See a copy of the Amendment
- See a copy of the interpretive notice

Notes from Europe: European Regulatory Developments

Notification of Voting Rights in EU Issuers

On November 6, 2013, the text of Directive 2013/50/EU of the European Parliament and the Council of the European Union (the "**EU**") dated October 22, 2013 amending the Transparency Directive (2004/109/EC) (the "**Amended Transparency Directive**") was published in the Official Journal of the EU. The text of the Amended Transparency Directive, as published in the Official Journal, is the same as that which was initially published by the Council on October 17, 2013 (with the exception of the insertion of dates). The adoption of the Amended Transparency Directive is the culmination of a review process that commenced in May 2010 with the publication of a consultation paper by the European Commission on the modernization of the Transparency Directive. The changes will be relevant to companies listed on EU regulated markets and to investment managers who directly or indirectly hold voting rights in such issuers. The Amended Transparency Directive will become effective on November 26, 2013. EU member states ("**Member States**") are required to transpose the amendments into national law within 24 months after the effective date. and, therefore, the long-stop date for implementation of the Amended Transparency Directive is expected at or about the end of 2015. On this timeline, the changes would be applicable from at or about the end of 2015.

Broadly, under the Transparency Directive, shareholders who acquire or dispose of shares with voting rights attached are required to inform the issuer of their holdings when certain thresholds are reached. Those thresholds are set at 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%. The issuer is then required to disclose such holdings to the market. The existing regime for notification of major holdings of voting rights has been extended by the Amended Transparency Directive to include direct and indirect holdings of financial instruments having the same economic effect as the holding of shares, whether or not they confer a right to physical settlement. In broad terms, this will align the EU regime with the United Kingdom's (the "**UK**") current Disclosure and Transparency Rules ("**DTRs**") and specifically DTR 5. Investment managers should therefore review their systems and controls to ensure that they reflect the new requirements (this should largely involve moving towards the systems and controls that are currently in place for compliance with DTR 5 in the UK, noting however, that the thresholds may be different in other Member States, as discussed below).

The Amended Transparency Directive contains a number of other changes relating to the notification of major holdings of voting rights. In particular, it is worth noting that long positions cannot be netted-off against short positions relating to the same underlying issuer and the calculation of voting rights in relation to financial instruments that are exclusively cash settled must be on a "delta-adjusted" basis. These changes are also broadly in line with the current UK rules, although unlike the UK position, the European Securities and Markets Authority has been tasked with developing technical standards to specify the methods for determining delta in connection with the calculation of voting rights relating to exclusively cash settled financial instruments.

Finally, the home Member State will no longer be free to adopt more stringent requirements regarding the regime for notification of major holdings of voting rights, subject to certain exceptions. These include the permission to set both lower and additional notification thresholds, meaning that the UK may maintain its current disclosure thresholds (which are currently where voting rights held reach, exceed or fall below 3% and each 1% threshold thereafter).

For further discussion on the Amended Transparency Directive, please see the October 24, 2013 Davis Polk Client Memorandum, ***European Regulatory Snapshot: The Amended Transparency Directive***.

- See a copy of the Amended Transparency Directive

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**
Richard Small	**+44 20 7418 1379**	**richard.small@davispolk.com**
Robert F. Young	**212 450 4709**	**robert.young@davispolk.com**

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