Investment Management Regulatory Update

June 23, 2014

SEC Rules and Regulations

SEC Grants No-Action Relief to Closed-End Funds for Filing Post-Effective Amendments to Registration Statements

On April 18, 2014, the Staff of the Division of Investment Management of the SEC issued a no-action letter to several closed-end registered funds (collectively, the "**Gabelli Funds**"). In the letter, the Staff stated that it would not recommend enforcement action under Section 5(b) or 6(a) of the Securities Act of 1933 (the "**Securities Act**") against the Gabelli Funds if they file post-effective amendments to their shelf registration statements pursuant to Rule 486(b) under the Securities Act, even though they are not Interval Funds.

Rule 486(b) of the Securities Act generally provides that, when a registered closed-end management investment company making periodic repurchase offers under Rule 23c-3 under the Investment Company Act (an "**Interval Fund**") files a post-effective amendment to a registration statement, such amendment shall become immediately effective, or shall become effective within 30 days after the filing date pursuant to the registrant's designation, provided that such amendment is filed only for a limited set of purposes, including bringing financial statements up to date or making any non-material changes. In a no-action letter issued in 1998, the Staff noted that, even when a registered closed-end management investment company is not an Interval Fund, such investment company may still benefit from the flexibility to take advantage of favorable market conditions through continuous or delayed offerings of the securities.

According to the no-action letter, each of the Gabelli Funds represented that it had filed its registration statement to issue securities on a delayed and continuous basis pursuant to Rule 415(a)(1)(x) under the Securities Act. The Gabelli Funds further represented that each filing made in reliance on the requested relief would be in compliance with the requirements of Rule 486(b) of the Securities Act and that each Gabelli Fund would file a post-effective amendment containing a prospectus pursuant to Section 8(c) of the Securities Act prior to any offering of its common stock at a price below net asset value. Furthermore, according to the no-action letter, each Gabelli Fund would sell newly issued shares at a price no lower than the sum of the Fund's net asset value plus the per share commission or underwriting discount.

According to the no-action letter, the Division would not recommend enforcement action against the Gabelli Funds based on the facts and representations described above and in the letter in the event that the Gabelli Funds, even though they are not Interval Funds, file the post-effective amendments pursuant to Rule 486(b) of the Securities Act. The Division also noted that the Staff may withdraw this relief granted to any Gabelli Fund for any reason, particularly if such Gabelli Fund misuses Rule 486(b). The Division also stated that no other entity can rely on the letter due to the specific facts presented in the letter.

- **See a copy of the no-action letter**

Industry Update

Director of OCIE Discusses Private Equity Fund Compliance

On May 6, 2014, in a speech at the Private Equity International: Private Fund Compliance Forum 2014, Andrew Bowden, the Director of the Office of Compliance Inspections and Examinations ("OCIE"), discussed the initial findings of the Presence Test Initiative that was commenced in October 2012 and certain concerns resulting from these findings. Please see the ***November 27, 2012 Investment Management Regulatory Update*** for a discussion on the Presence Test Initiative. In his speech, Bowden focused on a number of trends in the private equity industry and shared a few observations from the Presence Test Initiative.

Specifically, Bowden made the following observations:

Limited Partnership Agreements. Bowden discussed several weaknesses in limited partnership agreements that OCIE had reviewed. According to Bowden, most limited partnership agreements characterize the fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser) broadly. As a result, investors can be charged fees and expenses that they had not reasonably expected. Bowden also noted that many limited partnership agreements provide insufficient clarity regarding certain key provisions such as valuation procedures, investment strategies and procedures for mitigating conflicts of interest. Furthermore, Bowden noted that "most" limited partnership agreements do not adequately enable investors to monitor their investments and the managers' operations.

Private Equity Industry Trends. In addition to his concerns regarding limited partnership agreements, Bowden summarized three risky trends in the private equity industry: (1) "zombie" advisers that profit from managing legacy funds past the expected termination date without making real investments; (2) compliance and governance issues resulting from consolidation of funds in the private equity industry (including the failure to properly allocate expenses and costs to separate accounts and side-by-side co-investments) and (3) compressing and converging returns that may lead to revenue shortfalls for managers and increase the possibility that managers will attempt to increase revenue by increasing fees and shifting expenses to their funds.

Presence Test Initiative Findings. Bowden shared a number of findings from the Presence Test Initiative. First, Bowden highlighted that OCIE has identified what it believes are "violations of law" or "material weaknesses" over 50% of the time with respect to how fees are collected and how expenses are handled. Bowden stated that the two most common deficiencies in this area are: (1) extra fees paid to consultants, or "operating partners," by the fund or portfolio companies without sufficient disclosure to the investors and (2) advisers shifting expenses from themselves to the investors during the middle of the fund's life (including by using process automation). Second, Bowden discussed instances of advisers charging hidden fees without adequate disclosure to the investors. Bowden gave the example of advisers charging an accelerated monitoring fee in connection with a termination of a monitoring agreement, and also cited charging undisclosed administrative fees and hiring related-party service providers whose services provide "questionable value" as "troubling practices." Third, Bowden touched on OCIE's observations regarding marketing and valuation. In particular, OCIE has observed circumstances where advisers used a valuation methodology different from what was initially disclosed to the investors. Bowden stated that OCIE examiners are focusing on inappropriate adjustments to the valuation, biased selections of data to be compared without disclosure, as well as changes to the valuation methodology without logical support. At the same time, OCIE examiners are also combing through marketing materials to ferret out any inconsistencies and misrepresentations, with a focus on performance marketing and misstatements about the investment team.

- **See a copy of Bowden's speech**

IM Information Update Requests Confirmations Accompanying Comparison Documents in Applications for Exemptive Relief

In May 2014, the SEC's Division of Investment Management issued an IM Information Update requesting that applicants for exemptive relief include certain confirmations with any application containing a comparison document based either on precedent (in the case of an initial filing) or a previous filing (in the case of an amended filing).

In the IM Information Update, the Staff explained that the use of marked versions by applicants increases the efficiency of the Staff's review, but that the Staff must be confident that the marked versions provided by applicants (or their counsel) precisely reflect the previous version submitted by the applicant (or the precedent) filed through EDGAR. Therefore, the Staff requested that applicants review marked versions for accuracy prior to submission and include the following confirmations when submitting marked versions:

Confirmation for initial filings: "I confirm that the marked version of the application attached to this email is a complete and accurate comparison of the application filed on EDGAR on [DATE] (file no. 812-____) to the application of [NAME] filed on EDGAR on [DATE] (file no. 812-____)."

Confirmation for amendments: "I confirm that the marked version of the application filed on EDGAR is a complete and accurate comparison of the application filed on EDGAR on [DATE] (file no. 812-____) to the immediately prior version of the application filed on EDGAR."

- **See a copy of the Information Update**

CFTC Announces Streamlined Process to Grant No-Action Relief from Registration for Delegating CPOs Registration

On May 12, 2014, the Division of Swap Dealer and Intermediary Oversight (the "**Division**") of the Commodity Futures Trading Commission (the "**CFTC**") issued CFTC Staff Letter No. 14-69 (the "**Letter**"), which provides a streamlined process for commodity pool operators ("**CPOs**") of a commodity pool to seek relief from registration if such CPO delegates certain rights and obligations to another party serving as the registered CPO of the commodity pool.

According to guidance issued by the CFTC on August 14, 2012, a general partner, managing member or board of directors of a commodity pool that is legally permitted to delegate its rights and responsibilities with respect to the operation of a commodity pool (in such capacity, a "**Delegating CPO**") to another person (the "**Designated CPO**") may do so, provided that (i) the Designated CPO is qualified to serve as CPO, (ii) the Designated CPO is registered as a CPO with the CFTC, (iii) the Designated CPO agrees to assume such rights and responsibilities (particularly with respect to compliance with the Commodity Exchange Act (the "**CEA**") and the rules promulgated thereunder) and (iv) the Delegating CPO agrees to remain jointly and severally liable with respect to any violations of the CEA. Please see the ***September 26, 2012 Investment Management Regulatory Update*** for further discussion of the August 2012 guidance.

According to the Letter, in recent years, the Division has received many requests for no-action relief from CPO registration involving delegation. In particular, a number of requests address a fact pattern where the Delegating CPO is a board member not assuming joint and several liability, and with little or no relationship with the delegate. In order to address the increased number of requests and clarify confusion with the August 2012 guidance, the CFTC has adopted a streamlined process for granting no-action relief when the following criteria are met:

1. The Delegating CPO (a) has delegated all of its investment management authority to the Designated CPO and (b) does not participate in any marketing activity or manage any property of the commodity pool.
2. The Designated CPO is a registered CPO.
3. The Delegating CPO is not subject to any statutory disqualification.
4. There is a business purpose for the Designated CPO to be a separate entity from the Delegating CPO.
5. The Designated CPO maintains all the relevant books and records of the Delegating CPO in compliance with Regulation 1.31.
6. If the Delegating CPO and the Designated CPO are both non-natural persons, then each party controls, is controlled by or is under the common control with the other party.
7. If the Delegating CPO is a natural person and satisfies certain conditions, such as, generally, a board member with little or no relationship with the Designated CPO, then such Delegating CPO does not need to assume joint and several liability. Otherwise, the Delegating CPO must assume joint and several liability for violations of the CEA with the Designated CPO.

According to the Letter, Delegating CPOs that satisfy all the criteria may request relief through a simplified request letter in the form attached to the Letter under the streamlined process. The Division also indicated that it would continue to review requests that do not meet the criteria under the standard process.

- **See a copy of the Letter**

Litigation

SEC Charges Private Fund Manager with Stealing Investor Money and Conducting Ponzi Scheme

On May 21, 2014, the SEC announced charges against a Sarasota, Florida based private fund manager (the "**Manager**") for defrauding investors in a Ponzi scheme. The SEC alleged that the Manager diverted money given to him from investors to himself and operated a Ponzi scheme using money from newer investors to pay fake returns to prior investors. The SEC also claimed that the Manager attempted to hide his fraud by sending investors documents falsely showing positive returns at a time when such investors were losing money.

The SEC charged the Manager with a violation of Sections 206(1), 206(2) and 206(4) of the Advisers Act because of the fraudulent acts that the Manager engaged in with respect to certain pooled investment vehicles and the materially misleading misstatements that the Manager made to current and prospective investors. The SEC also charged the Manager with violating Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act.

In its complaint, the SEC sought financial penalties, disgorgement of all ill-gotten gains plus prejudgment interest, and a permanent injunction against the Manager.

- **See a copy of the SEC Order**
- **See a copy of the Press Release**

Notes from Europe: European Regulatory Developments

ESMA Speech on Systemic Risks and Current Policies in the EU Fund and Industry – Can Asset Managers Be Too Big to Fail?

On June 10, 2014, the European Securities and Markets Authority ("**ESMA**") published the text of a speech given by Steven Maijoor, the Chairman of ESMA, at the 25th Annual Conference on the Globalization of Investment Funds held in Paris by the International Bar Association. Mr. Maijoor noted that the European Union is home to more than 3,000 asset management companies with over €10 trillion of assets under management, making the EU the second largest fund market worldwide.

Assessing systemic risks in the financial sector is, Mr. Maijoor stated, one of the most important tasks in the wake of the financial crisis. He noted that, while the EU's Undertakings for Collective Investment Schemes ("**UCITS**") and Alternative Investment Fund Managers Directive ("**AIFMD**") regimes have improved the functioning of markets, transparency and investor protection, these regulations need to be complemented by an efficient framework for addressing systemic risks. He acknowledged that asset management firms differ significantly from banking and insurance activities, and specifically that asset management firms manage assets on behalf of clients who agree to bear losses. It was further noted that asset managers do not generally suffer as much from declining asset prices as banks do. Nonetheless, Mr. Maijoor was of the view that asset management companies are still vulnerable to shocks and can propagate systemic risks to other financial institutions and markets as a result of (i) their interconnectedness to the rest of the financial system and (ii) the effect that their activities can have on asset prices.

Mr. Maijoor set out four specific characteristics of asset managers that pose a threat to the market:

- *Mimic Behavior*: the tendency of asset managers to buy or sell the same asset at the same time;
- *Group Thinking*: this can exasperate herding behavior when some models for pricing assets become dominant among asset managers;
- *Excessive Leverage*: either through borrowing or the use of derivatives can force funds to sell assets at depressed prices when facing higher haircuts and margin calls from creditors; and
- *Exposure to Runs*: this is particularly a risk for open-ended vehicles, with asset sales being made in response to redemptions spreading stress from certain types of portfolio assets to other portfolio assets and market segments.

Acknowledging that it is not possible to designate certain asset managers as systemically important in the same way as one can for banks, Mr. Maijoor suggested that, during the designation process of systemic entities in the asset management space, it would be important to also identify the activities that can foster directional market moves and contagion. Mr. Maijoor set out two specific examples. First, he noted that money market funds ("**MMF**") can be systemically relevant not only due to their size but due to the nature of their market activities, which lead to an increased interconnectedness with the money market and the banking sector in particular, meaning that a disorderly failure of an MMF could cause broader consequences such as contagion to the real economy and bail-out risks for their sponsor and, ultimately, public authorities. Second, he noted that securities financing transactions could also be a source of contagion and pro-cyclicality during a financial crisis. Mr. Maijoor concluded therefore, that while it was not possible to rule out that certain individual asset managers could be systemically relevant, the policy response may instead be, for example, to increase the transparency of activities that cause systemic risk and therefore to focus on the activity in question and not on individual institutions.

For a discussion of the potential application of the U.S. systemic risk regime to asset managers, see ***Gregory S. Rowland, Designation of Asset Managers and Funds as Systemically Important Non-Bank Financial Institutions: Process and Industry Implications (pts. 1 & 2), 20-3 THE INVESTMENT LAWYER 1 (2013), 20-4 THE INVESTMENT LAWYER 24 (2013)***.

With respect to the latest developments in relation to the AIFMD, Mr. Maijoor noted that ESMA currently has three priorities:

- the development of a Q&A document that will help ensure a common understanding of the application of key elements of the AIFMD;
- ESMA has begun the preparatory work in view of the opinion and advice that it must deliver by July 2015 regarding the possible extension of the passports from non-EU funds and managers; and
- ESMA is continuing in its efforts to clarify the reporting obligations on alternative investment fund managers and on building an IT system that will facilitate the centralization of data that is reported.

► **See a copy of Steven Maijoor's speech**

IOSCO Consults on Good Practices for Reducing Reliance on CRAs in Asset Management

On June 4, 2014, the International Organization of Securities Commissions ("**IOSCO**") published a consultation report on good practices for reducing reliance on credit rating agencies in asset management (CR04/14). The report is aimed at gathering the views and practices of investment managers, institutional investors and other interested parties with a view to developing a set of good practices on reducing over-reliance on external credit ratings in the asset management space. Noting the importance of asset managers having appropriate expertise and processes in place to assess and manage credit risk, especially with their investment decisions, the report lists some possible good practices that managers may consider when resorting to external ratings in order to avoid over-reliance on them.

The examples of good practices that managers should consider when using external ratings listed in the Report include:

- investment managers making their own determinations as to the credit quality of a financial instrument before investing and throughout the holding period, using external credit ratings as one element, among others, of the internal assessment process rather than the sole factor supporting the credit analysis;
- where external credit ratings are used, investment managers understand the methodologies, parameters and basis on which the opinion of the credit rating agency was produced, and have adequate means and expertise to identify the limitations of the methodology and assumptions used to form that opinion;

- regulators could encourage investment managers to disclose the use of external credit ratings and describe in an understandable way how these complement or are used for the manager's own internal credit assessment methods; and
- where an investment manager explicitly relies on external credit ratings among others to assess the credit worthiness of specific assets, a downgrade does not automatically trigger their immediate sale. Where the manager conducts its own credit assessment, a downgrade may trigger a review of the appropriateness of its internal assessment. In both cases, should the manager decide to divest, the transaction is conducted within a timeframe that is in the best interests of the investors.

The deadline for submitting comments to IOSCO with respect to the report is Friday, September 5, 2014.

- **See a copy of the IOSCO report**

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