Investment Management Regulatory Update

December 20, 2012

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SEC Staff Responds to Questions About Form PF

On November 20, 2012, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") posted additional responses (the "**Responses**") to frequently asked questions regarding Form PF. For details on previously posted SEC responses regarding Form PF, please see the ***July 16, 2012 Investment Management Regulatory Update*** and the ***August 22, 2012 Investment Management Regulatory Update***.

Investment advisers registered or required to register with the SEC under the Investment Advisers Act of 1940 (the "**Advisers Act**") that advise one or more private funds (*i.e.*, 3(c)(1) or 3(c)(7) funds) and that have at least $150 million in private fund assets under management ("**private fund advisers**") are required to file Form PF with the SEC for the purpose of reporting systemic risk information to the SEC. Additionally, private fund advisers that are also registered with the Commodity Futures Trading Commission (the "**CFTC**") as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**") and are required to file Form PF under the Advisers Act must file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are private funds. Such CPOs and CTAs may file Form PF with the SEC to satisfy certain CFTC filing requirements with respect to their commodity pools that are not private funds. Please see the ***November 18, 2011 Investment***

Management Regulatory Update for a discussion of the final Form PF rules and the ***June 19, 2012 Investment Management Regulatory Update*** for a discussion of the initial Form PF deadlines.

The Responses provided guidance on the following Form PF topics:

General Filing Information. The Responses noted that the Private Fund Reporting Depository has been updated to allow a reporting adviser to add a relying adviser or a special purpose vehicle as a related person in reliance on the no-action letter issued to the American Bar Association on January 18, 2012 in Question 1(b). This allows such related person to be included in Question 1(b) even though it does not have a separate CRD or SEC file number.

In addition, the Responses clarified that a reporting adviser may use the CFTC Interim Compliant Identifiers ("**CICIs**") of its reporting funds in response to questions that request a reporting fund's Legal Entity Identifier ("**LEI**"). The CFTC has designated DTCC-SWIFT as the provider of CICIs to certain market participants under the CFTC's jurisdiction and expects that CICIs will become LEIs when the global LEI system is established.

Private Fund Categorization. The Responses provided guidance related to the reporting on an adviser's Form ADV regarding a private fund that meets the definition of both a liquidity fund and a hedge fund. The reporting adviser should categorize any such private fund as "other" on the reporting adviser's Form ADV, Schedule D. According to the Responses, this will enable the reporting adviser to complete the sections applicable to liquidity funds and hedge funds with respect to such private fund. The Responses also instructed a reporting adviser that needs to change the categorization of a private fund on its Form ADV, Schedule D to file an other-than-annual amendment to its Form ADV to reflect such change before filing its Form PF.

Fund of Funds. The Responses also provided guidance on excluding the assets of disregarded private funds (*i.e.*, funds of funds) and any private fund's equity investments in other private funds for purposes of responding to Questions 3, 8, 9 and 10. If the reporting adviser chooses to exclude such disregarded private funds and equity investments in accordance with Instruction 7, then such disregarded private funds and equity investments should be excluded with respect to (i) reporting the breakdown of regulatory assets under management and net assets in Question 3 and (ii) reporting the reporting fund's gross asset value in Question 8 and net asset value in Question 9. However, the value of the reporting fund's equity investments in other private funds should still be reported in Question 10 even if the reporting fund is a disregarded private fund.

Rehypothecation of Collateral and Other Credit Support. The Responses clarified that when responding to Question 38 regarding the rehypothecation of collateral and other credit support by the reporting fund or by such reporting fund's counterparties, cash collateral should not be included in calculating the rehypothecation percentages.

- **See a copy of the Responses**

SEC Releases Guidance on Advisers Act Exemption for CFTC-Registered Investment Advisers that Advise Private Funds

On November 15, 2012, the SEC's Division of Investment Management released guidance on the exemption from registration under the Advisers Act provided by Section 203(b)(6)(B) of the Advisers Act for investment advisers that are registered with the CFTC as a CTA and advise a private fund (*i.e.*, a 3(c)(1) or 3(c)(7) fund). The exemption under Section 203(b)(6)(B) was added to the Advisers Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**").

As amended by the Dodd-Frank Act, Section 203(b)(6) of the Advisers Act contains two sections, Section 203(b)(6)(A) and Section 203(b)(6)(B), that exempt certain investment advisers that are registered with the CFTC as CTAs from registration with the SEC as an investment adviser. Section 203(b)(6)(A) exempts from registration any such CFTC-registered investment adviser whose business does not consist primarily of acting as an investment adviser (as defined in Section 202(a)(11) of the Advisers Act) and who does not act as an investment adviser to (i) an investment company registered under the Investment Company Act of 1940 (the "**Investment Company Act**") or (ii) a company that has elected to be treated as a business development company under Section 54 of the Investment Company Act and has not withdrawn its election. Section 203(b)(6)(B) exempts from registration any investment adviser that is registered with the CFTC as a CTA and that advises a private fund, so long as after the date of enactment of Title IV of the Dodd-Frank Act (the Private Fund Investment Advisers Registration Act of 2010), the business of such investment adviser does not become predominately the provision of securities-related advice.

The SEC's guidance clarified that the exemption under Section 203(b)(6)(B) is not available to a CFTC-registered investment adviser that advises a private fund if (i) such investment adviser also advises a registered investment company or a business development company or (ii) such investment adviser's business was prior to the enactment of the Dodd-Frank Act, and remains, predominately the provision of securities-related advice.

- **See a copy of the SEC's guidance**

SEC Adopts New Credit Quality Standard for BIDCOs Relying on Section 6(a)(5) of the Investment Company Act

On November 19, 2012, the SEC adopted Rule 6a-5 under the Investment Company Act, which establishes a credit quality standard for debt securities issued by investment companies or private funds (*i.e.*, 3(c)(1) and 3(c)(7) funds) that business and industrial development companies ("**BIDCOs**") may purchase. Rule 6a-5 becomes effective December 24, 2012.

Background. BIDCOs are companies that operate under state statutes to provide direct investment and loan financing, as well as managerial assistance, to state and local enterprises. Under Section 6(a)(5) of the Investment Company Act, BIDCOs are exempt from most provisions of the Investment Company Act as long as they comply with certain conditions set forth therein. Prior to the enactment of the Dodd-Frank Act, one of these conditions was that a BIDCO could not purchase securities issued by investment companies and private funds except for (i) debt securities that were rated as investment grade by at least one nationally recognized statistical rating organization ("**NRSRO**") and (ii) securities issued by a registered open-end investment company that invests at least 65% of its assets in debt securities described in clause (i) or securities that such registered investment company determines to be comparable in quality. The Dodd-Frank Act eliminated the investment grade rating requirement in Section 6(a)(5) and replaced it with a reference to "such standards of credit-worthiness as the [SEC] shall adopt." Rule 6a-5 was adopted in response to this Dodd-Frank Act mandate.

Rule 6a-5. Under Rule 6a-5, a debt security issued by an investment company or a private fund will be deemed to meet the credit-worthiness standard if the board of directors or members of a BIDCO (or its or their delegate) determines that the debt security, at the time of purchase, is (i) subject to no greater than moderate credit risk and (ii) sufficiently liquid that the security can be sold at or near its carrying value within a reasonably short period of time. Rule 6a-5 also limits a BIDCO's investments in registered open-end investment companies to those companies that invest at least 65% of their assets in debt securities meeting this standard. According to the SEC's adopting release, Rule 6a-5 establishes a standard of credit-worthiness designed "to achieve the same degree of risk limitation as the credit rating it replaces" and "to limit BIDCOs to purchasing debt securities issued by investment companies or private funds of sufficiently high credit quality that they are likely to maintain a fairly stable market value and may be liquidated easily, as appropriate, for the BIDCO to support its investment and financing activities."

Notably, Rule 6a-5 does not enumerate specific factors or establish a bright-line test for making this credit-worthiness determination. According to the adopting release, the credit-worthiness standard established by Rule 6a-5 is "clear enough for a BIDCO's board or members . . . to understand the risks acceptable under the rule." The adopting release also notes that the number and scope of factors that may be appropriate to making a credit-worthiness determination may vary significantly depending on the particular debt security. In addition, according to the adopting release, in evaluating an issuer's credit-worthiness, boards of directors or members of BIDCOs may consider credit quality reports prepared by NRSROs or other outside sources that are deemed reliable for making such credit-worthiness determination.

- **See a copy of the SEC's adopting release**

SEC Announces List of Federal Securities Law Rules to be Reviewed Over the Next 12 Months

On November 28, 2012, the SEC announced a list of rules under the Investment Company Act, the Securities Act of 1933 (the "**Securities Act**") and the Securities Exchange Act of 1934 (the "**Exchange Act**") to be reviewed by the SEC pursuant to Section 610 of the Regulatory Flexibility Act (the "**RFA**") during the next twelve months. The RFA requires the SEC to review its rules that have a significant economic impact upon a substantial number of small entities within ten years of the publication of such rules as final rules. The purpose of the review is to determine whether the rules should be continued without change, amended or rescinded. The RFA directs the SEC to consider (i) the continued need for the rule, (ii) the nature of public complaints and comments relating to the rule, (iii) the complexity of the rule, (iv) the extent to which the rule overlaps, duplicates or conflicts with other federal, state and local government rules and (v) changes in technological, economic and other conditions since the rule's release. Comments must be submitted to the SEC by January 3, 2013.

The Investment Company Act rules to be reviewed include:

(i) Rule 2a19-3, which exempts an individual from being disqualified as an independent director of a registered investment company (the "**fund**") solely because he or she owns shares of a registered, broad-based index fund that invests in the investment adviser or underwriter of the fund or their controlling persons.

(ii) Rule 5b-3, which allows a registered investment company (a) to treat the acquisition of a repurchase agreement as an acquisition of the underlying securities, subject to certain conditions, when determining whether it is in compliance with the diversification requirements set forth in Section 5(b)(1) of the Investment Company Act and the prohibition on acquiring an interest in a broker-dealer in Section 12(d)(3) of the Investment Company Act and (b) to treat the acquisition of a refunded security as an acquisition of escrowed government securities, subject to certain conditions, for purposes of the Section 5(b)(1) diversification requirements.

(iii) Rule 10e-1, which gives a registered investment company a grace period from the board composition requirements under the Investment Company Act if the company is unable to comply with these requirements due to the death, disqualification or bona fide resignation of a director. In such event, Rule 10e-1 gives the company a 90-day grace period if the board can fill the director vacancy and a 150-day grace period if a shareholder vote is required to fill the vacancy.

(iv) Rule 32a-4, which exempts a registered investment company from the requirement under Section 32(a)(2) of the Investment Company Act that shareholders vote on the selection of the company's independent public accountant if the company (a) establishes an audit committee, composed solely of directors who are not interested persons of the company, that oversees the company's accounting and auditing processes, (b) adopts a charter for the audit committee setting forth the committee's structure, duties, powers and methods of operation or sets out similar provisions in the company's charter or bylaws and (c) maintains and preserves permanently in an easily accessible place a copy of the audit committee's charter (and any modifications thereto).

(v) Rule 35d-1, which requires (a) a registered investment company named in a manner suggesting that it focuses on a particular type of investment or industry to adopt a policy to invest at least 80% of its assets in the investment or industry suggested by its name, (b) a registered investment company named in a manner suggesting that it focuses its investments in a particular country or geographic region to adopt a policy to invest at least 80% of its assets in investments that are tied economically to the particular country or geographic region suggested by its name, (c) a registered investment company named in a manner suggesting that its distributions are exempt from federal income tax or from both federal and state income tax to adopt a fundamental policy to (i) invest at least 80% of its assets in investments the income from which is exempt, as applicable, from federal income tax or from both federal and state income tax or (ii) invest its assets so that at least 80% of the income that it distributes will be exempt, as applicable, from federal income tax or from both federal and state income tax and (d) a registered investment company not to use a name that suggests that the company or its shares are guaranteed or approved by the U.S. government.

- **See a copy of the SEC's release**

Industry Update

CFTC Grants Registration Relief for Family Offices, Funds of Funds and Business Development Companies

The Division of Swap Dealer and Intermediary Oversight (the "**Division**") of the CFTC recently issued three no-action letters granting relief from the requirement to register as a CPO with the CFTC to certain family offices, operators of funds of funds and operators of business development companies, as further described below.

Family Offices

On November 29, 2012, the Division granted no-action relief from CPO registration to any "family office" within the meaning of Rule 202(a)(11)(G)-1 of the Advisers Act. In order for any such family office to rely on this relief, the family office must (i) file a claim by emailing the Division a statement, signed by the family office, that includes certain basic identification and contact information listed in the no-action letter and (ii) remain in compliance with Rule 202(a)(11)(G)-1 regardless of whether it seeks to be excluded from registration as an investment adviser under the Advisers Act. Claims for relief are effective upon filing so long as the claim is complete.

Any such family office that is operating as of December 1, 2012 must file the claim before December 31, 2012, and any such family office that begins operating after December 1, 2012 must file the claim within 30 days after it begins to operate as a family office. In addition, any such family office must confirm that it is a family office within the meaning of Rule 202(a)(11)(G)-1 before March 31, 2013 unless it begins to operate after such date, in which case it must make such confirmation within 30 days after it begins to operate as a family office.

- **See a copy of the CFTC's no-action letter granting relief to family offices**

Funds of Funds

On November 29, 2012, the Division also granted no-action relief from CPO registration to operators of funds of funds until the later of June 30, 2013 or six months from the date that the Division issues revised guidance on the application of the de minimis thresholds under CFTC Rules 4.5 and 4.13(a)(3) to operators of funds of funds.

The no-action letter responds to concerns from operators of funds of funds that, absent relief, such persons could be required to register with the CFTC by December 31, 2012 as a result of a fund of funds' indirect exposure to commodity interests. Appendix A to Part 4 of the CFTC regulations ("**Appendix A**") provides a mechanism to apply the de minimis thresholds of CFTC Rule 4.13(a)(3) to a fund of funds' operations. Although the CFTC rescinded Appendix A in February 2012, it indicated in August 2012 that operators of funds of funds could continue to rely on Appendix A until revised guidance was adopted, as discussed in the ***September 26, 2012 Investment Management Regulatory Update***. Nevertheless, operators of funds of funds expressed concerns that future material changes to the Appendix A guidance may pose operational challenges due to the lack of visibility that a fund of funds may have into the positions of its underlying funds. The CFTC had also received requests that future guidance be broadened to address the application of the de minimis thresholds of CFTC Rule 4.5 to operators of funds of funds that are registered investment companies under the Investment Company Act. As a result of the foregoing, the CFTC determined that it was appropriate to provide a temporary delay in the registration requirement for operators of funds of funds.

In order for an operator of a fund of funds to rely on this temporary relief, the operator must (i) file a claim by emailing the Division a statement, signed by the operator, that includes certain basic identification and contact information listed in the no-action letter before December 31, 2012 and (ii) remain in compliance with the following criteria:

(a) the person currently structures its operations in whole or in part as an operator of one or more funds of funds,

(b) the amount of commodity interest positions to which the fund of funds is *directly* exposed does not exceed the levels specified in CFTC Rule 4.5 or 4.13(a)(3)(ii) (as applicable),

(c) the person does not know or could not have reasonably known that the fund of funds' *indirect* exposure to commodity interests derived from contributions to its underlying funds exceeds the levels specified in CFTC Rule 4.5 or 4.13(a)(3)(ii) (as applicable) (either calculated directly or through Appendix A), and

(d) the fund of funds is either (a) an investment company registered under the Investment Company Act or (b) compliant with the requirements set forth in CFTC Rules 4.13(a)(3)(i), (iii) and (iv).

Claims for relief are effective upon filing so long as the claim is materially complete.

For more information on CFTC Rules 4.5 and 4.13(a)(3), please see the ***February 23, 2012 Client Memorandum: CFTC Adopts Amendments to Registration Exemptions for CPOs and CTAs and Proposes Harmonization Rules for Registered Fund CPOs*** and the ***September 26, 2012 Investment Management Regulatory Update***.

- **See a copy of the CFTC's no-action letter granting relief to operators of funds of funds**

Business Development Companies

On December 4, 2012, the Division granted no-action relief from CPO registration to an operator of any entity that has elected to be treated as a business development company ("**BDC**"). In order for any such operator of a BDC to rely on this relief, (i) the operator of the BDC must file a claim by emailing the Division a statement, signed by a person authorized to bind the BDC, that includes certain basic identification and contact information listed in the no-action letter and (ii) the BDC must satisfy the following criteria:

(a) the BDC has elected to be treated as a BDC under Section 54 of the Investment Company Act and continues to be regulated by the SEC as a BDC,

(b) the BDC will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options or swaps markets, and

(c) either (1) the BDC uses commodity futures, commodity options contracts or swaps solely for bona fide hedging purposes within the meaning and intent of CFTC Rules 1.3(z)(1) and 151.5, provided that with respect to any such instruments that do not come within the meaning and intent of such CFTC rules, the aggregate initial margin and premiums required to establish such positions do not exceed 5% of the liquidation value of the BDC's portfolio (after taking into account unrealized profits and losses on any such instruments it has entered into) or (2) the aggregate net notional value of commodity futures, commodity options contracts or swaps positions not used solely for bona fide hedging purposes within the meaning and intent of CFTC Rules 1.3(z)(1) and 151.5, determined at the time the most recent position was established, does not exceed 100% of the liquidation value of the BDC's portfolio (after taking into account unrealized profits and losses on any such positions it has entered into).

An operator of any such BDC that is operating as of December 1, 2012 must file the claim before December 31, 2012, and the operator of any such BDC that begins operating after December 1, 2012 must file the claim within 30 days after it begins to operate as a BDC. Claims for relief are effective upon filing so long as the claim is materially complete.

- **See a copy of the CFTC's no-action letter granting relief to operators of BDCs**

FSOC Issues Proposed Recommendations for Money Market Mutual Fund Reform

On November 13, 2012, the Financial Stability Oversight Council (the "**FSOC**") published proposed recommendations for money market mutual fund ("**MMF**") reform for public comment. As further discussed below, the FSOC's proposal sets forth three alternative recommendations for MMF reform: (i) a floating net asset value ("**NAV**"), (ii) a stable NAV with an NAV buffer and minimum balance at risk and (iii) a stable NAV with an NAV buffer and other measures. According to the FSOC, the proposal seeks to address "structural vulnerabilities of MMFs that leave them susceptible to destabilizing runs."

The FSOC issued the proposal pursuant to Section 120 of the Dodd-Frank Act, which gives the FSOC the authority to issue recommendations to primary financial regulatory agencies to apply new or heightened standards if current activities exist that could create or increase the risk of significant liquidity, credit or other related problems in the U.S. financial markets. The proposal follows the August 2012 announcement of then-SEC Chairman Mary Schapiro that the majority of the SEC commissioners would not support a staff proposal to reform the structure of MMFs. For further discussion of the SEC Chairman's statement, please see the ***September 26, 2012 Davis Polk Investment Management Regulatory Update***.

The FSOC's three alternative recommendations for MMF reform are as follows:

Floating NAV. The first recommendation would require MMFs to have a floating NAV that would fluctuate based on the value of the underlying portfolio holdings, rather than a stable NAV of $1.00 per share. This recommendation would require, among other things, removing the provisions of Rule 2a-7 of the Investment Company Act that allow MMFs to use the amortized cost method of valuation and the penny-rounding method of pricing to maintain a stable NAV. The FSOC recommended allowing existing MMFs to maintain a stable NAV for a phase-out period, potentially lasting as long as five years, and prohibiting new share purchases in the grandfathered stable-NAV MMFs after a predetermined date.

According to the FSOC, one advantage of a floating NAV is that investors would be more accustomed to fluctuations in NAV and, therefore, less likely to redeem en masse in the event that the MMF suffers losses. However, the FSOC acknowledged that this recommendation has certain disadvantages, including that significant tax, accounting and operational issues would need to be addressed in order to transition MMFs from a stable NAV to a floating NAV.

Stable NAV with NAV Buffer and Minimum Balance at Risk. The second recommendation would require MMFs to have an NAV buffer in order to absorb daily variations in the value of the underlying portfolio holdings and to allow the MMF to maintain a stable NAV. The size of the NAV buffer would be a tailored amount of assets of up to 1% in excess of those needed for a MMF to maintain a $1.00 share price. The size of the NAV buffer would depend on the riskiness of the MMF's assets. The FSOC recommended a one-year transition period to establish one-half of the buffer and a two-year transition period to establish the full buffer.

The NAV buffer requirement would be paired with a minimum balance at risk ("**MBR**") requirement, whereby MMFs would be required to hold back a redeeming investor's MBR, calculated as 3% of the investor's highest account value in excess of $100,000 during the previous 30 days, for a 30-day period. Redemptions that leave the investor's remaining balance with at least the MBR amount would not be subject to the 30-day delay. Any losses suffered by a MMF in excess of its NAV buffer would be first absorbed by the MBRs of investors that redeemed during the prior 30-day period.

The NAV buffer and MBR requirements would not apply to Treasury MMFs (*i.e.*, MMFs that invest at least 80% of their assets in cash, treasury securities and treasury repos), and the MBR requirement would not apply to investors with account balances of less than $100,000.

According to the FSOC, an advantage of this alternative is that the MBR requirement would create a disincentive for investors to redeem when an MMF is under stress (since their MBRs would be the first to bear any losses in excess of the MMF's NAV buffer) and would provide some protection for non-redeeming investors since they would not be forced to bear all of the MMF's losses that exceed its NAV buffer. However, the FSOC also acknowledged that this recommendation has several disadvantages, including that the NAV buffer and MBR would likely involve operational and technology costs.

Stable NAV with NAV Buffer and Other Measures. The third recommendation would require an NAV buffer similar to the one required under the second recommendation, but this buffer would be sized at 3% instead of 1% in order to provide more fulsome loss-absorption capacity. The NAV buffer could be combined with other measures to enhance the MMF's loss-absorption capacity and mitigate run vulnerabilities such as "more stringent investment diversification requirements, increased minimum liquidity levels, and more robust disclosure requirements." Due to the size of this buffer, the FSOC recommended a multiyear transition period, with a one-year transition period to establish one-sixth of the buffer and a two-year transition period to establish one-third of the buffer.

According to the FSOC, the three proposed recommendations are not necessarily mutually exclusive but may be implemented in combination to address MMFs' structural vulnerabilities. As an example, the proposal indicated that an MMF could be permitted to use a floating NAV or, if it prefers to maintain a stable NAV, implement the measures in the second or third recommendation.

Comment Period. The comment period ends on January 18, 2013. The FSOC will consider the comments and determine whether to issue a final recommendation to the SEC. If the FSOC issues a final recommendation, then, pursuant to the Dodd-Frank Act, the SEC will be required to either implement the FSOC's recommendations (or similar recommendations that the FSOC deems acceptable) or provide a written explanation to the FSOC as to why it has not followed the FSOC's recommendations.

- **See a copy of the FSOC's proposal**

Director of the OCIE Speaks on the Significance of Conflicts of Interest and Risk Governance

On October 22, 2012, Carlo V. di Florio, the Director of the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC, delivered a speech to the National Society of Compliance Professionals about the significant role that identifying and monitoring conflicts of interest must play in the design and implementation of an effective compliance and ethics program. He began by explaining that based on historical events and the experience of the SEC's National Exam Program, conflicts of interest "are a leading indicator of significant regulatory issues for individual firms, and sometimes even systemic risk for the entire financial system" and, therefore, the SEC and other regulators are particularly focused on risk management and risk controls within a firm to identify and manage such conflicts of interest. For further details on the SEC's National Exam Program, please see the ***November 27, 2012 Investment Management Regulatory Update***.

Di Florio identified the following types of conflicts of interest as currently being high priorities for SEC examinations: (i) compensation-related conflicts and incentives, (ii) portfolio management-related conflicts, (iii) affiliations between investment advisers and broker-dealers, (iv) valuation, (v) transfer agent conflicts and (vi) exchange conflicts. (It should be noted that the OCIE recently announced that it will be conducting "checkup" examinations, officially called Corrective Action Reviews, which will involve revisiting firms, likely without warning, roughly six to 10 months after an initial examination to determine whether deficiencies noted have been, or are in the process of being, corrected.)

In order for firms to assess and mitigate conflicts of interest, di Florio suggested that firms focus on three broad considerations. The first consideration is that a firm needs to have an effective process, led by a cross-functional leadership team, to identify and understand all conflicts in its business model. This process must include understanding the conflicts both in terms of their business implications and in relation to the relevant legal standards, as well as recognizing that conflicts are dynamic and the controls that are in place must be periodically reviewed to ensure they continue to be effective in mitigating such identified conflicts.

The second consideration is that a firm must have a good compliance and ethics program tailored to the particular firm. Di Florio referenced the U.S. Federal Sentencing Guidelines as providing helpful guidance on many of the key elements of an effective compliance program, including: standards and procedures, oversight, leadership, education and training, auditing and monitoring, incentives and discipline, and response and prevention.

The third consideration is that the process for addressing conflicts of interest must be fully integrated in a firm's overall risk governance structure. Di Florio said that a firm's business unit should act as the first line of defense in being aware of and managing conflicts of interest and that the firm's risk and control functions (such as those set out in the firm's compliance program) should act as the second line of defense. Internal auditors should act as an independent third line of defense and, importantly, senior management and the board of directors must be engaged throughout the process.

- **See a copy of di Florio's speech**

FINRA Announces Arbitration for Investment Advisers that are not FINRA-Regulated Firms

The Financial Industry Regulatory Authority Inc. ("**FINRA**") recently released guidance announcing that it has opened up its arbitration forum to investment advisers that are not members of FINRA and, therefore, are currently not subject to regulation by FINRA. FINRA will arbitrate disputes between such investment advisers and investors on a voluntary, case-by-case basis if (i) the parties submit a post-dispute agreement to arbitrate, (ii) the parties agree to pay all arbitration surcharge fees and (iii) the investor files a special written submission agreement signed by all parties to the arbitration. The special written submission agreement requires the parties to acknowledge, among other things, that FINRA may bar the investment adviser from the forum in future cases if it fails to pay any award, settlement agreement or FINRA fees and that FINRA cannot enforce awards entered against non-member investment advisers. Thus, the prevailing party may need to enforce an award against a non-member investment adviser in a court of competent jurisdiction. Final awards will be made publicly available.

- **See a copy of FINRA's guidance**

Litigation

Court Ruling Addresses Pension "Controlled Group" Liability for Private Equity Funds

The U.S. District Court for Massachusetts recently held that a private equity fund was not a "trade or business" for purposes of the controlled group liability rules under the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"). This opinion, which is currently being appealed, rejects the controversial position of the Pension Benefit Guaranty Corporation (the "**PBGC**") that a private equity fund can be held jointly and severally liable for the pension obligations of its portfolio companies. While the final outcome of the appeal and the applicability of the decision in other jurisdictions remain unclear, the opinion should provide some comfort to funds that hold portfolio companies that sponsor or contribute to underfunded pension plans that are subject to Tile IV of ERISA. The decision also serves as a friendly reminder of the potential risks and liabilities associated with portfolio company pension plans.

The issue in *Sun Capital Partners III, LP v. New England Teamsters*, Civil Action No. 10-10921-DPW (D. Mass. Oct. 18, 2012), was whether a pair of parallel private equity funds (the "**Sun Funds**") that indirectly owned 70% and 30% of a portfolio company should be jointly and severally liable for withdrawal liability incurred when the portfolio company withdrew from a multiemployer pension plan. Under ERISA, members of the same "controlled group" are jointly and severally liable for certain pension liabilities of the other members of the controlled group, including withdrawal liability in respect of multiemployer plans. An entity's controlled group generally includes all "trades or business" under "common control" with the entity (*i.e.*, having at least 80% common ownership).

Many practitioners have long believed that a properly structured investment fund should not be deemed a "trade or business" for purposes of the controlled group rules based on well-established tax principles that investment activities do not in and of themselves constitute engaging in a "trade or business." However, in 2007, the PBGC Appeals Board, to the consternation of many fund managers, issued an opinion holding that a private equity fund was a "trade or business" due to its active involvement, through its general partner and management company, in the management of the portfolio company, and accordingly held that the fund was jointly and severally liable for the portfolio company's pension liabilities.

The Sun Capital holding rejects the PBGC Appeals Board's ruling and sets out the following principles.

The court held that the Sun Funds were not "trades or businesses" because they were merely passive investment pools that existed only to receive investment income, which for federal tax purposes, does not constitute engaging in a trade or business. In coming to this conclusion, the court posited that (i) the management and consulting activities of the funds' management company were not attributable to the Sun Funds themselves, but rather were the works of an agent and (ii) the Sun Funds' appointment of directors to the portfolio company's board did not cause them to be engaged in a trade or business, but was rather an action taken in each fund's role as shareholder of the company.

The court also held that the Sun Funds' decision to split their investment in the portfolio company so they would have 70% and 30% ownership, respectively, did not constitute a transaction with a principal purpose of evading or avoiding liability under ERISA. This was the case even though the funds acknowledged that one purpose of dividing their ownership in this manner was to minimize exposure to potential future withdrawal liability by keeping their individual ownership under 80%. The court found that (i) because the Sun Funds listed other legitimate business purposes for the split, avoiding ERISA liability was not the primary purpose and (ii) the evade and avoid rule is intended to prevent employer sponsors from splitting up their businesses in order to avoid ERISA liabilities, not to prevent outside investors from structuring their investments to minimize risk of a future pension liability—particularly if that liability has not yet materialized at the time of the investment.

Though the Sun Fund ruling is helpful in moving the pendulum back from the PBGC's 2007 opinion, private equity funds should continue to use caution in structuring investments in portfolio companies with underfunded pension liabilities. In particular, private equity funds should continue to carefully consider the risks of purchasing an 80% or more ownership interest in a portfolio company. Even if the ruling that a private equity fund is not a trade or business is upheld, there would still be uncertainty around whether a fund's other 80%-held portfolio companies would be deemed to be in the same controlled group as one another. In addition, when splitting an investment among different funds, funds should take care to document the non-ERISA business purposes for the structure. Finally, when documenting the governance structure for a fund's investment in a portfolio company, it would be helpful to clearly identify a separate entity, like a management company, that will conduct any management activities for the fund.

- **See a copy of the court's opinion**

Jury Issues Mixed Verdict in Reserve Primary Fund Trial

On November 12, 2012, a federal jury in the U.S. District Court for the Southern District of New York issued a mixed verdict in the case involving Bruce Bent Sr., the founder of the Reserve Primary Fund (the "**Primary Fund**"), his son, Bruce Bent II, and the registered investment adviser and the distributor of the Primary Fund (collectively, the "**defendants**"). *SEC v. Reserve Management Co. Inc.*, No. 09 Civ. 4346 (S.D.N.Y. Nov. 12, 2012). The case stemmed from charges filed by the SEC in 2009 claiming that the defendants had misled the Primary Fund's investors, board of trustees and rating agencies in September 2008 about the impact of the Lehman Brothers bankruptcy on the Primary Fund's holdings. The Primary Fund, a money market fund, "broke the buck," meaning that its net asset value fell below $1.00 per share, when the value of the $758 million of Lehman securities held by it plummeted upon Lehman's bankruptcy filing in September 2008. According to the SEC, the defendants made a number of material misstatements and omissions, including that they misrepresented that the investment adviser would provide credit support to maintain the $1.00 net asset value. The SEC's complaint in 2009 charged the defendants with violating certain provisions of the Securities Act, the Exchange Act and the Advisers Act for such misstatements and material omissions. For a further discussion of the SEC's complaint, please see the ***May 8, 2009 Investment Management Regulatory Update***.

The jury cleared Bruce Bent Sr. of all charges. The jury also cleared Bruce Bent II of all charges other than one count of negligently violating Section 17(a) of the Securities Act. The jury found the investment adviser and the distributor guilty of various charges, including that they had knowingly or recklessly violated Section 17(a) of the Securities Act and that the investment adviser had knowingly or recklessly violated Section 206(4) of the Advisers Act. The defendants were not found liable for other serious charges, including various aiding and abetting allegations. On December 12, 2012, the SEC filed a motion petitioning for judgment as a matter of law and a new trial on certain claims against the defendants. We will continue to monitor the developments in this area.

- **See a copy of the SEC's 2009 complaint**
- **See a copy of the verdict form**

SEC Charges Mutual Fund Directors for Inadequate Valuation Oversight

On December 10, 2012, the SEC charged eight former directors of five registered investment companies with securities laws violations for their role in valuing the companies' securities. For a further discussion of the SEC's charges against the directors and the implications for registered fund directors, please see the December 17, 2012 Davis Polk Client Newsflash, ***SEC Charges Mutual Fund Directors for Inadequate Valuation Oversight***. The SEC noted in its press release announcing the charges that the SEC Enforcement Division's Asset Management Unit has continued to prioritize asset valuation investigations.

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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