Investment Management Regulatory Update

November 27, 2012

SEC Rules and Regulations

SEC Proposes Extension of Temporary Rule 206(3)-3T Regarding Principal Transactions with Certain Advisory Clients

On October 9, 2012, the Securities and Exchange Commission (the "**SEC**") proposed to extend the date on which Rule 206(3)-3T (the "**Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**") will expire from December 31, 2012 to December 31, 2014. The Rule is a temporary rule that establishes an alternative means for registered investment advisers that are also registered with the SEC as broker-dealers ("**Dual Registrants**") to comply with Section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their non-discretionary advisory clients.

If the proposed extension is adopted, this will mark the third extension of the sunset date of the Rule. The Rule was initially adopted in September 2007 on an interim final basis and was supposed to expire on December 31, 2009, but that date was subsequently extended to December 31, 2010. The sunset date was again extended by two years to December 31, 2012 in order for the SEC to complete a study required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") and for the SEC to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.

As previously reported in the ***September 13, 2010 Investment Management Regulatory Update*** and the ***October 2007 Investment Management Regulatory Update***, the Rule generally allows Dual Registrants to trade on a principal basis with certain non-discretionary advisory accounts if, among other things: (i) the adviser discloses conflicts of interest associated with principal transactions and the manner in which such adviser addresses those conflicts, (ii) the client executes a blanket consent prospectively authorizing principal transactions, (iii) before the execution of each principal transaction, the adviser informs the client of the capacity in which it may act with respect to such transaction and obtains the client's consent (either written or orally), (iv) at or before completion of each such transaction, the adviser sends the client written confirmation of the principal transaction and (v) at least annually, the adviser provides the client reports of principal transactions executed in reliance on the Rule.

If the Rule is allowed to expire on December 31, 2012, then, after that date, Dual Registrants will need to comply with Section 206(3)'s transaction-by-transaction written disclosure and consent requirements for all of their advisory accounts. This could, according to the SEC, limit the access of non-discretionary advisory clients of Dual Registrants to certain securities and require firms to make substantial changes to disclosure documents, client agreements, procedures and systems.

The SEC has requested comments by November 13, 2012 on a list of questions set forth in the proposed rule release.

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

Industry Update

SEC Announces Presence Exams of Newly Registered Investment Advisers

On October 9, 2012, the SEC's Office of Compliance Inspections and Examinations ("OCIE") sent a letter to newly registered investment advisers (i.e., investment advisers to private funds that registered with the SEC as a result of the Dodd-Frank Act) introducing its new National Exam Program ("NEP") initiative. According to the letter, the NEP will be conducting focused, risk-based "presence exams" of newly registered investment advisers over the next two years to protect investors and maintain market integrity. For more information on the impact of the Dodd-Frank Act on the registration of investment advisers, please see the June 29, 2011 Davis Polk Client Memorandum, ***SEC Issues Final Rules Implementing Dodd-Frank Amendments to the Investment Advisers Act of 1940***.

The NEP's "presence exams" initiative has three primary phases: (i) engagement, (ii) examination and (iii) reporting. In the ongoing engagement phase, the NEP staff is engaging in a nationwide outreach to inform newly registered investment advisers about their obligations under the Advisers Act and related rules, the presence exams initiative and OCIE's practice of engaging directly with investment adviser's senior management. As part of this phase, the NEP staff has published various compliance materials on the SEC's website.

In the examination phase, the NEP staff will review one or more of the following "higher-risk" areas of the business and operations of an investment adviser that is selected for examination:

- Marketing: The investment adviser's marketing materials and the manner in which it solicits investors for private funds (including the use of placement agents).
- Portfolio Management: The investment adviser's portfolio decision-making practices, including decisions with respect to investment allocations and whether the practices are consistent with disclosures provided to investors.
- Conflicts of Interest: The investment adviser's procedures and controls to identify, mitigate and manage certain conflicts of interest, including investment allocations, allocations of fees and expenses, sources of revenue, payments made by private funds to the investment adviser and its related persons, outside business activities, personal securities trading and transactions by the investment adviser with affiliated parties.

- Safety of Client Assets: The investment adviser's compliance with the custody rule under the Advisers Act and, if available, independent audits of the investment adviser's private funds for consistency with the custody rule.
- Valuation: The investment adviser's valuation policies and procedures, including its methodology for fair valuing illiquid or difficult to value investments and its procedures for calculating management and performance fees and allocating expenses to private funds.

The letter reminds newly registered investment advisers that, as part of the examination process, they will be required to provide the NEP staff with access to all requested advisory records (including the records and reports of any private funds that receive advice from the investment adviser), subject to attorney-client privilege under certain circumstances. In addition, similar to traditional SEC examinations, the NEP staff may issue a deficiency letter to the investment adviser and, if serious deficiencies are found, may refer the matter to the SEC's Division of Enforcement or to a self-regulatory organization, state regulatory agency or other regulator for possible action.

Finally, in the reporting phase, the NEP staff will report its observations to the SEC and the public, including common practices identified in the higher-risk focus areas, industry trends and significant issues.

The NEP staff will contact investment advisers separately if their firm is selected for examination.

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

Additional Guidance Extends FATCA Deadlines and Expands the Scope of "Grandfathered" Obligations

On October 24, 2012, the Internal Revenue Service (the "**IRS**") and the United States Treasury Department released Announcement 2012-42, which provides additional guidance on the provisions of the Internal Revenue Code (the "**Code**") commonly referred to as "**FATCA**." The announcement (i) extends certain timelines for withholding agents and foreign financial institutions (including foreign investment entities such as hedge funds and private equity funds) ("**FFIs**") to complete the due diligence required under FATCA, (ii) delays the date by which a participating FFI must file its first information report under FATCA, (iii) delays the start of FATCA withholding on gross proceeds and (iv) expands the scope of "grandfathered" obligations that will not be subject to withholding under FATCA if outstanding as of a specified date. Proposed FATCA regulations, which will be modified to conform with the announcement, were released in February 2012. For a detailed summary of the proposed FATCA regulations, please see the March 7, 2012 Davis Polk Client Memorandum, ***Summary of the Proposed FATCA Regulations***.

Timelines. In order to avoid being subject to FATCA withholding, an FFI must either qualify for an exemption or become a "participating FFI" by entering into an FFI agreement with the IRS pursuant to which it agrees to perform certain due diligence, reporting and withholding functions. The announcement provides that the earliest effective date of an FFI agreement will be January 1, 2014. The announcement also generally extends the timelines within which U.S. withholding agents and participating FFIs must implement new account opening procedures and complete due diligence on pre-existing accounts. The new schedule matches the corresponding deadlines applicable to FFIs in countries that have intergovernmental agreements with the United States for the implementation of FATCA. The announcement contains a summary table of the dates by which each type of person must implement new account opening procedures and complete its review of pre-existing accounts. The announcement also delays the date by which a participating FFI must begin to file its information reports with respect to U.S. accounts to March 31, 2015 (from September 30, 2014).

Gross Proceeds Withholding. Under FATCA, the payment of gross proceeds from a disposition of any property of a type that can produce U.S.-source interest or dividends is a "withholdable payment" that may be subject to FATCA withholding. The announcement delays the date on which FATCA withholding will begin to apply to gross proceeds to January 1, 2017 (from January 1, 2015).

Grandfathered Obligations. The proposed FATCA regulations provide that payments made under an obligation that is outstanding on January 1, 2013 will not constitute withholdable payments and will therefore not be subject to FATCA withholding. The announcement provides that there will be three additional categories of obligations that are grandfathered:

- Any obligation that produces or could produce a foreign passthru payment and that cannot produce a withholdable payment (*e.g.*, a debt security issued by a participating FFI) and is outstanding as of the date that is six months after the date on which final regulations defining the term "foreign passthru payment" are released. Notably, this additional category of grandfathered obligations does not, as written, include equity securities that could produce foreign passthru payments.
- Any obligation to make a payment with respect to, or to repay, collateral posted to secure obligations under a notional principal contract that is a grandfathered obligation. The proposed FATCA regulations provide that a derivatives transaction under an ISDA master agreement will be a grandfathered obligation if the transaction is evidenced by a confirmation executed before January 1, 2013. Many market participants believed that payments with respect to collateral for these contracts were grandfathered under this general rule. The announcement's inclusion of this new category of grandfathered obligations implies that payments with respect to collateral posted to secure grandfathered derivatives transactions other than notional principal contracts (e.g., securities loans) may not be covered by the grandfathering rule.
- Any instrument that gives rise to a withholdable payment solely because it gives rise to a dividend equivalent pursuant to Section 871(m) of the Code if such instrument is outstanding six months after the date on which instruments of its type first become subject to the provisions of Section 871(m). Absent a change in law, certain instruments will be grandfathered under this provision if they are outstanding on *January 1, 2013*, while other instruments (covered by proposed regulations under Section 871(m)) will be grandfathered if they are outstanding on *July 1, 2014*. For a summary of the proposed regulations under Section 871(m), please see the January 20, 2012 Davis Polk Client Newsflash, ***New Regulations Address Withholding on "Dividend Equivalents***."[1]

  ► **See a copy of Announcement 2012-42**

Investor Advisory Committee Submits Recommendations to the SEC on the SEC's Proposal to Eliminate the General Solicitation Ban

On October 15, 2012, the Investor Advisory Committee (the "**IAC**"), which was established by the Dodd-Frank Act to advise the SEC on various regulatory and policy issues, submitted recommendations to the SEC on the SEC's proposed rule to permit general solicitation and general advertising in private offerings made in reliance on Rule 506 of Regulation D of the Securities Act of 1933 (the "**Securities Act**"). The SEC's proposed rule to eliminate the general solicitation ban is mandated by Section 201(a) of the Jumpstart Our Business Startups Act (the "**JOBS Act**"). For a discussion of the SEC's proposed rule, including implications for investment advisers, please see the September 4, 2012 Davis Polk Client Newsflash, ***SEC Issues Proposal to Eliminate General Solicitation Ban as Mandated by the JOBS Act***.

[1] Note that recent guidance provides the proposed regulations will apply to payments made beginning on January 1, 2014.

The IAC's submission to the SEC included the following seven recommendations:

- As a precondition to claiming the new general solicitation exemption, issuers should be required to file either a new "Form GS" or a revised version of Form D that would include, among other things, information about the issuer's control persons, the issuer's business and intended use of proceeds, the issuer's counsel, auditors and accountants (if any) and a description of the issuer's plans to use general solicitation.
- Issuers should be required to submit to the SEC, prior to or promptly after first use, all materials used in a general solicitation for a Rule 506 offering, including any print, audio or video content. The IAC also recommended that such material be made available to the public so that the public may inform the SEC of potential instances of fraud by issuers.
- The SEC should adopt a safe harbor establishing "clear and enforceable standards" for issuers to verify accredited investor status in Rule 506 offerings using general solicitation, including standards relating to verification by reliable third parties such as a broker-dealer, bank or licensed accountant. Under the SEC's proposed rule, an issuer using general solicitation in a Rule 506 offering must take "reasonable steps" based on the "facts and circumstances" of the transaction to verify that the purchasers of the issuer's securities are accredited investors, but the proposed rule does not provide specific measures that an issuer must take to verify a purchaser's accredited investor status or otherwise provide a bright line test for determining what constitutes "reasonable steps."
- The SEC should make the filing of a Form D a condition for relying on the Regulation D exemption in order to encourage "broad compliance" with the filing requirement, but should consider "not impos[ing] undue penalties for inadvertent violations by small, unsophisticated issuers." Currently, the filing of a Form D is required, but it is not a condition for relying on the Regulation D exemption.
- The SEC should take steps to ensure that any performance claims in materials used in general solicitations are based on a "clear, well-defined, and auditable standard."
- The SEC should amend the accredited investor definition as it relates to natural persons to better reflect a person's financial sophistication. The current definition for natural persons relies exclusively on net worth and income tests that, according to the IAC, do not adequately address an investor's actual investment sophistication. While the IAC acknowledged that the net worth component of the accredited investor definition cannot be amended until 2014 (pursuant to the Dodd-Frank Act), the IAC indicated that the SEC has the authority to otherwise amend the definition.
- The SEC should promptly adopt the "bad actor" rule that it proposed in May 2011 that would disqualify securities offerings involving certain felons and other bad actors from relying on the exemption provided by Rule 506 of Regulation D. For further details on the SEC's proposed "bad actor" rule, please see the ***June 10, 2011 Investment Management Regulatory Update***.

Notably, a number of state securities regulators and industry associations have submitted comment letters also requesting that the SEC establish a safe harbor for verifying accredited investor status in lieu of the proposed "facts and circumstances" regime.

We will continue to monitor developments.

► **See a copy of the IAC's recommendations**

SEC Staff Issues Report on Authority to Enforce the Anti-Evasion Rule Under Section 12(g) of the Exchange Act

On October 15, 2012, the SEC staff submitted to Congress the report (the "**Report**") required by Section 504 of the JOBS Act on the SEC's authority to enforce Rule 12g5-1(b)(3) under the Securities Exchange Act of 1934 (the "**Exchange Act**"). Section 504 of the JOBS Act required that the SEC examine its enforcement authority and determine whether new enforcement tools were needed to enforce the anti-evasion provision contained in Rule 12g5-1(b)(3). The Report concluded that the enforcement tools available to the SEC were adequate, and the staff did not make legislative recommendations for any additional tools.

Section 12(g) of the Exchange Act, as amended by the JOBS Act on April 5, 2012, requires an issuer[2] to register its securities with the SEC and file periodic and current reports if it has total assets exceeding $10 million and a class of equity securities (other than an exempted security) that is "held of record" by either (i) 2,000 persons or (ii) 500 persons who are not "accredited investors."[3] Prior to the enactment of the JOBS Act, an issuer with more than 499 record holders was subject to the Exchange Act's registration and reporting requirements. Rule 12g5-1(b)(3) of the Exchange Act, which is intended to prevent evasion of Section 12(g), requires an issuer to count beneficial owners as record holders if the issuer knows or has reason to know that a form of holding securities is being used primarily to circumvent Section 12(g).

According to the Report, the increased record holder threshold has raised concerns that special purpose vehicles ("**SPVs**") established to pool investor funds and purchase interests in unregistered companies may be used to facilitate evasion of the Exchange Act's registration and reporting requirements. Specifically, an issuer would have significantly fewer record holders if it were to count an SPV (rather than each investor in such SPV) as a single record holder for purposes of Section 12(g). The Report noted, however, that the increased record holder threshold may actually reduce circumvention concerns in respect of Section 12(g), although it acknowledged that the limit of 500 non-accredited investors could "prove to be a new area for possible circumvention efforts using special purpose vehicles." The Report ultimately concluded that since the changes to the threshold were recently enacted, more time was needed before the impact (including the impact on possible circumvention efforts) could be assessed and, therefore, did not suggest any particular legislative recommendations regarding enforcement at this time.

Notably, despite coming to the conclusion that the SEC's enforcement tools were sufficient, the Report discussed a number of challenges that make detecting and pursuing violations based on Rule 12g5-1(b)(3) difficult. For example, according to the Report, it may be difficult to determine that an SPV was formed "primarily" to circumvent registration as there may be other reasons for holding securities through an SPV, including "to avoid triggering rights of first refusal or other contractual transfer restrictions common in private companies, to earn fees, to provide a service to clients, for tax or liability structuring or for some other purpose other than to circumvent Section 12(g)." In such situations, according to the Report, the SEC would need to prove that circumvention is a primary purpose rather than an ancillary effect of such form of holding. The Report also noted that it would be reasonable to assume that the "primarily" element of the rule would not ordinarily be met in situations where the issuer and its insiders and controlling stockholders were not involved in setting up such form of holding. Similarly, the Report

[2] Private funds that rely on the exemption from registration under Section 3(c)(1) of the Investment Company Act of 1940 (the "**Investment Company Act**") typically do not have to contend with Section 12(g)'s record holder limit, as such funds are limited to 100 beneficial owners under Section 3(c)(1). However, private funds that rely on the exemption from registration under Section 3(c)(7) of the Investment Company Act are impacted by the record holder limit.

[3] Banks and bank holding companies are, as a result of the JOBS Act, subject to a different threshold requirement and must register with the SEC if they have more than $10 million in assets and a class of equity securities (other than an exempted security) that is held of record by 2,000 persons, regardless of "accredited investor" status.

observed that there are evidentiary challenges relating to the "knows or has reason to know" element of Rule 12g5-1(b)(3). The SEC staff noted that this would also turn, in part, on how involved the issuer was in creating or administering the SPV and that, absent any involvement by the issuer, it would be much harder to prove this element of the rule.

The Report also noted that Rule 12g5-1(b)(3) has rarely been invoked by the SEC or in private litigation.

For further discussion of the implications of the JOBS Act for private funds, please see the March 23, 2012 Davis Polk Client Newsflash, ***Senate Passes Legislation To Raise the 500 Shareholder Threshold for SEC Registration and To Relax General Solicitation Prohibition in Reg D Offerings***.

- **See a copy of the Report**

NFA Waives Series 3 Proficiency Exam Requirement for Associated Persons of Certain Registered CPOs and CTAs

On October 3, 2012, the National Futures Association (the "**NFA**") released a notice announcing that it had amended NFA Registration Rules 401 and 402 to exempt from the Series 3 proficiency exam requirement "associated persons" of commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**") whose activities subject to Commodity Futures Trading Commission ("**CFTC**") jurisdiction are limited to swaps. Such amendments were effective immediately.

Rules 401 and 402 require that an associated person of a registered CPO or CTA pass the Series 3 exam unless the person can rely on an exemption to, or obtain a waiver from, this requirement. Absent the relief provided by the NFA's amendments to these rules, associated persons of CPOs and CTAs that are required to register with the CFTC solely as a result of their swap activities would have been required to pass the Series 3 exam. For further details on the registration of such CPOs and CTAs, please see the ***October 17, 2012 Investment Management Regulatory Update***.

As a result of the NFA's amendments, an associated person of a registered CPO or CTA whose activities are solely limited to swaps and who has answered "yes" to the questions regarding swap activities on his or her Form 8-R is automatically exempt from the Series 3 exam requirement. In addition, an associated person of a registered CPO that "but for the trading of swaps" would be exempt from CPO registration under CFTC Rule 4.13(a)(3) or excluded from the definition of CPO under CFTC Rule 4.5(c)(2)(iii)(A) or (B) may seek a waiver from the Series 3 exam requirement by sending a signed request to the NFA. The NFA's notice provides additional details on the process for obtaining a waiver and completing the associated person's Form 8-R. These new exemptions also apply to an associated person whose activities are limited to supervising other associated persons who are exempt from the Series 3 exam requirement.

In addition, as a result of the NFA's amendment to Rule 402, any CPO that obtains a waiver on behalf of its associated persons and subsequently becomes ineligible for the waiver must notify the NFA in writing of such ineligibility.

- **See a copy of the NFA's notice**
- **See a copy of amended NFA Registration Rule 401**
- **See a copy of amended NFA Registration Rule 402**

Speech by SEC Chairman on New Technology Initiatives to Detect Suspicious Trading

On October 11, 2012, in a speech at the 2012 New England Securities Conference, SEC Chairman Mary Schapiro discussed the new technology initiatives being employed by the SEC's Enforcement Division to bolster its capabilities to investigate suspicious trading. According to Schapiro, "[u]pgraded technology makes it possible to wade through literally millions of documents and thousands of hours of conversations to find the proverbial needle in a haystack that lets us sew up a case."

During the speech, Schapiro discussed a number of the SEC's new initiatives, including its recently instituted Automated Bluesheet Analysis Project. According to Schapiro, this initiative adds "another dimension" to the SEC's investigative capabilities, with the SEC enforcement staff using newly developed analytics to identify suspicious trading patterns and relationships among multiple traders and across multiple securities to generate enforcement leads. Schapiro stated that this new initiative has already generated significant insider trading enforcement actions, including its high-profile case against Matthew Kluger, a corporate attorney, and Garrett Bauer, a trader, who ran a lucrative insider trading scheme spanning two decades by communicating through a middleman using public telephones and prepaid mobile phones. Schapiro said that the SEC was initially unaware of Bauer's or the middleman's relationship with Kluger, but that parallel analysis of the bluesheet trading data enabled the SEC to successfully identify the middleman and uncover his relationship with Bauer.

Schapiro also discussed the SEC's new Aberrational Performance Inquiry team, which is an initiative by the SEC Enforcement Division's Asset Management Unit that uses proprietary risk analytics to review investment performance data to identify hedge fund firms that may be engaging in fraudulent practices "before a tip is received or a routine examination discovers the questionable behavior." She noted that this initiative has also already led to fraud enforcement actions (including the action against Yorkville Advisors LLC and two of its executives that is discussed in more detail elsewhere in this Investment Management Regulatory Update) and to the SEC having brought suspicious behavior to the attention of regulators in 17 countries.

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

Litigation

SEC Charges Hedge Fund Adviser and Two Executives in Continuing Probe of Suspicious Fund Performance

On October 17, 2012, the SEC charged a hedge fund advisory firm and two of its executives with fraudulently reporting false and inflated values for certain assets under management in order to conceal losses and collect higher fees from investors. In its complaint, the SEC alleges that Yorkville Advisors LLC ("**Yorkville**"), Mark Angelo, Yorkville's founder and president, and Edward Schinik, Yorkville's chief financial officer, used these inflated investment returns to collect excessive fees from Yorkville's funds (the "**Funds**"), to solicit investors to make additional investments in the Funds and to entice investors who wanted to redeem their investments in the Funds to instead participate in a special redemption fund.

According to the SEC, in connection with this scheme, the defendants created and provided false and misleading documents to, and withheld adverse information about the Funds' investments from, its auditors. In addition, the SEC's complaint asserts that the defendants made "materially false and misleading statements to [Yorkville's] investors and potential investors about: (1) the value of certain investments in the Funds; (2) [Yorkville's] valuation policies generally; (3) the collateral underlying the investments; (4) the liquidity of the Funds, and (5) Yorkville's use of third-party valuation consultants." The SEC also claims that the defendants portrayed Yorkville as employing "robust" valuation procedures when, in fact, the methodologies used to value the Funds' investments did not comport with Yorkville's valuation policies. According to the SEC, as a result of these fraudulent statements, Yorkville was able to solicit over $280 million in investments from pension funds and funds of funds and received at least $10 million in excess fees based on the inflated value of Yorkville's assets under management. The SEC's complaint charges the defendants with violating various sections of the Securities Act, the Exchange Act and the Advisers Act.

According to the SEC's press release, this is the seventh case arising from the SEC's Aberrational Performance Inquiry, an initiative by the SEC Enforcement Division's Asset Management Unit that uses proprietary risk analytics to identify hedge funds with suspicious returns (for example, if a fund's performance is inconsistent with its investment strategy or other benchmarks). In discussing this initiative, Bruce Karpati, Chief of the SEC Enforcement Division's Asset Management Unit, said "[t]he analytics put Yorkville front and center on our radar screen."

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

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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