Investment Management Regulatory Update

February 24, 2014

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SEC Rules and Regulations

SEC Issues Guidance on Rule 506(c) Exemption

On January 23, 2014, the Division of Corporate Finance of the Securities and Exchange Commission (the "**SEC**") issued additional Compliance and Disclosure Interpretations ("**C&DIs**") regarding Rule 506(c) under the Securities Act of 1933.

Section 201(a) of the Jumpstart Our Business Startups Act mandated private offering reforms and the SEC responded on July 10, 2013 by adopting final rules to permit advertising and other forms of "general solicitation" in private offerings made in reliance on Rule 506 of Regulation D of the Securities Act on the condition that all purchasers in the offering are accredited investors. Please see the July 10, 2013 Davis Polk Client Newsflash, ***SEC Adopts Private Offering Reforms Mandated by JOBS Act***, as well as the ***July 18, 2013 Investment Management Regulatory Update*** for further discussion of the proposed and final Rule 506 amendments.

The additional C&DIs provided guidance on Rule 506 offerings that commenced prior to Rule 506(c)'s effectiveness on September 23, 2013:

Requirement to Take "Reasonable Steps to Verify." The C&DIs clarified that if an issuer commenced an offering in reliance on Rule 506 before September 23, 2013, and the issuer continues such offering in accordance with Rule 506(c) after that date, the issuer would only be required to take reasonable steps to verify the accredited investor status of the investors who purchase securities in the offering *after* the issuer begins to make offers and sales in reliance on Rule 506(c). According to the C&DIs, the issuer would be required to amend any previously filed Form D to indicate its reliance on the Rule 506(c) exemption for its offering.

Securities Sold to Non-Accredited Investors Prior to Relying on the Rule 506(c) Exemption. The C&DIs explained that, in the case of an offering commenced before September 23, 2013, even if the issuer had already sold securities to non-accredited investors in reliance on the exemption that became Rule 506(b), it may continue the offering in reliance on Rule 506(c) as long as all sales of securities in the offering after the issuer begins to rely on the Rule 506(c) exemption are limited to accredited investors and the issuer takes reasonable steps to verify the accredited investor status of those purchasers.

- See a copy of the C&DIs

SEC Issues No-Action Guidance Regarding Definition of "Knowledgeable Employee" Under the Investment Company Act

On February 6, 2014, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") that provided guidance as to who may qualify as a "knowledgeable employee" under the Investment Company Act. Rule 3c-5 under the Investment Company Act of 1940 permits a "knowledgeable employee" of a private fund or a "knowledgeable employee" of an affiliated person that manages the investment activities of the private fund (an "**Affiliated Management Person**") to invest in such fund without being counted for purposes of the 100-person limit in Section 3(c)(1) or regardless of whether the knowledgeable employee is a "qualified purchaser" for purposes of Section 3(c)(7).

The SEC provided guidance on the following aspects of the definition of "knowledgeable employee":

- **Principal Business Unit**. Rule 3c-5(a)(4)(i) includes any natural person who is an "Executive Officer" of a private fund or an Affiliated Management Person in the definition of knowledgeable employee. Rule 3c-5(a)(3) then defines "Executive Officer" as the "president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions" for a private fund or for its Affiliated Management Person. The Letter clarifies that (i) the principal status of a unit, division or function depends on the relevant facts and circumstances of a particular investment manager's business operations, (ii) several business units, divisions or functions within an investment manager may each be considered a principal unit, division or function and (iii) the unit, division or function need not be part of the investment activities of a private fund to be considered a principal unit, division or function. The Letter then discussed how, in certain circumstances, the information technology or investor relations groups of an investment management firm could be considered principal business units.
- **Employees Who Make Policy**. The Letter further clarified that persons who perform "a policy-making function" for a private fund or Affiliated Management Person are not required to have a specific title and consist of all employees who have the power to make, and do make, policy on behalf of the investment manager, private fund or the Affiliated Management Person. The Letter also stated that employees serving as active members of a group or committee that develop and adopt an investment manager's policies, such as the valuation committee, could be executive officers under Rule 3c-5.
- **Employees Who Participate in the Investment Activities of a Private Fund**. Rule 3c-5(a)(4)(ii) defines the second category of knowledgeable employee as any employee of a private fund or Affiliated Management Person who, in connection with his or her regular function or duties, participates in the investment activities of such private fund, or other private funds, or investment companies the investment activities of which are managed by such Affiliated Management Person, provided that such employee has been performing such functions and duties for or on behalf of the private fund or the Affiliated Management Person, or substantially similar functions or duties for or on behalf of another company for at least 12 months (a "**Participating Employee**").

- **Employees Who Participate in Investment Activities**. The SEC staff clarified that a research analyst who researches only a portion of the portfolio of a private fund and provides analysis or advice to the portfolio manager with respect to such portion of the private fund's portfolio is participating in the investment activities of the private fund, and thus could be considered a knowledgeable employee for purposes of Rule 3c-5. In the Letter, the staff also stated that Participating Employees are not limited to individuals charged with overall responsibility for the investment activity of a private fund, and that non-executive employees (such as employees who form part of analytical or risk teams, tax professionals or attorneys) whose analysis or advice is material to an investment adviser's investment decisions and who regularly participate in the management of a private fund's investments, or a portion thereof, may all be considered to be Participating Employees depending on the facts and circumstances.
- **Treatment of Separate Accounts**. Rule 3c-5(a)(4)(ii) includes as Participating Employees not only employees who participate in the investment activities of the private fund at which they are employed but also those who participate in the investment activities of other private funds or investment companies managed by an Affiliated Management Person. In the Letter, the SEC staff clarified that Participating Employees also include employees of an Affiliated Management Person who participate in the investment activities of separate accounts (or a portfolio, or portion thereof, of a separate account) for clients who are "qualified clients" within the meaning of the Investment Advisers Act of 1940 and are otherwise able to invest in the private funds advised by the Affiliated Management Person and whose accounts pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds.
- **Employees of Related Advisers in Control Relationships**. The SEC staff stated that a knowledgeable employee of a filing adviser or any of its affiliated relying advisers may be deemed a knowledgeable employee with respect to any private fund managed by the filing adviser or its affiliated relying advisers, provided that the relevant adviser entities are permitted to report on a single Form ADV in accordance with no-action letter granted to the American Bar Association Section of Business Law on January 18, 2012 (the "**ABA Letter**"). For a discussion of the ABA Letter, please see the ***February 21, 2012 Investment Management Regulatory Update***.

The SEC staff further advised investment managers to maintain a written record of employees the investment manager has permitted to invest in a private fund as knowledgeable employees.

- See a copy of the Letter

IM Guidance Update Urges Risk Management in Changing Fixed Income Market Conditions

In January 2014, the SEC's Division of Investment Management issued an IM Guidance Update to suggest steps fund advisors may consider with respect to risk management and disclosure matters relating to changing fixed income market conditions.

The IM Guidance Update discusses various trends in the fixed income market, including an increase in the net assets of bond mutual funds and exchange traded funds ("**ETFs**") to $3.6 trillion. According to the IM Guidance Update, while assets in bond mutual funds and ETFs have grown rapidly in recent years, primary dealer capacity is at similar levels to 2001 and primary dealer inventories of corporate bonds appear to be at an all-time low, relative to the market size. The IM Guidance Update notes that to the extent the apparent reduction in market-making capacity is a result of broader structural changes, such as fewer proprietary trading desks at broker dealers and increased capital requirements at the holding company level, the change may be persistent and could potentially decrease liquidity and increase volatility in the fixed income markets.

In light of the potential fixed income market volatility, the IM Guidance Update suggests that fund advisers may consider taking the following steps:

- **Assess and Stress Test Liquidity**. The IM Guidance Update urges fund advisers to consider assessing overall fund liquidity needs during both normal and stressed environments, including assessing their sources of liquidity. The IM Guidance Update states that these assessments may include needs and sources of fund liquidity over 1 day, 5 days, 30 days, and potentially longer periods.
- **Conduct More General Stress-Tests/Scenario Analyses**. The IM Guidance Update also suggests that fund advisers consider the impact of various stress-tests beyond just liquidity, such as stress-tests involving interest rate hikes, widening spreads, price shocks to fixed income products, increased volatility and reduced liquidity.
- **Risk Management Evaluation**. The IM Guidance further suggests that fund advisers consider using the outcomes of any assessments to evaluate what risk management strategies and actions are most appropriate in response to changing fixed income market conditions at a fund and/or the complex level. The IM Guidance Update states that these strategies and actions might include decisions around portfolio composition, concentrations, diversification and liquidity.
- **Communication with Fund Boards**. The IM Guidance Update recommends that fund advisers consider what information they need to provide to both fund directors so that they are informed of the risk exposures and liquidity position of the fund and the fund's ability to manage through charging interest rate conditions and potentially increased fixed income market volatility.
- **Shareholder Communications**. The IM Guidance Update also suggests that funds assess the adequacy of their disclosures to shareholders in light of any additional risks due to recent events in the fixed income markets and the potential impact of tapering quantitative easing and/or rising interest rates, including the potential for periods of volatility and increased redemptions.

► See a copy of the IM Guidance Update

Industry Update

SEC Issues Risk Alert Focusing on Due Diligence Processes of Investment Advisers

On January 28, 2014, the staff of the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") issued a National Examination Risk Alert focused on the due diligence processes that investment advisers use when they recommend or place clients' assets in alternative investments such as hedge funds, private equity funds or funds of private funds.

According to the Alert, an adviser that exercises discretion to purchase alternative investments on behalf of its clients, or that, in performing due diligence, relies on a manager of the alternative investments the adviser recommends, must determine whether such investments both meet the clients' investment objectives and are consistent with the investment principles and strategies that were disclosed by the manager to the adviser. The OCIE staff noted the following emerging industry trends regarding advisers' due diligence processes:

Advisers Are Seeking More Information and Data Directly from Managers. The staff has noticed increased requests from advisers for position-level information about the alternative investments to enable advisers to (i) adjust analyses of market sector exposures, (ii) determine position concentrations across the client's portfolio and (iii) identify individual positions that may present risks that were inconsistent with managers' disclosed investment strategies. The staff also noted that some advisers recommended that each client's assets be managed within a separate account (as opposed to being managed in a pooled fund) to (i) provide transparency and greater control to clients over how their assets are invested, (ii) allow for better oversight of the portfolio's liquidity and valuation and (iii) better prevent the manager from being able to misappropriate client assets or charge unauthorized fees or expenses.

Advisers Are Engaging Third Parties to Supplement Due Diligence Processes. According to the Alert, the staff has noticed that advisers have increased their use of "portfolio information aggregators:" third-party service providers that aggregate portfolio-level information they receive from funds and pass that information on to the advisers. The staff has also observed that advisers have independently verified that alternative investment funds' assets were serviced and held, as applicable, with certain key third-party service providers, such as administrators, custodians and auditors. In addition, according to the Alert, certain advisers would condition a recommendation for an investment in an alternative investment fund on that fund utilizing an independent third-party administrator. The staff also observed that many advisers have started receiving "transparency reports" containing information about an investment's net asset value and the level of involvement in third-party administrators directly from third-party administrators. Furthermore, the staff noted that most advisers engaged third-party firms to conduct background checks on the managers and key personnel and utilized FINRA BrokerCheck to research the backgrounds of FINRA registered brokerage firms and individual broker-dealer registered representatives.

Advisers Are Executing Additional Quantitative Analyses on the Alternative Investments and Their Managers. According to the Alert, the staff observed that advisers were increasing the use of quantitative analysis to attempt to both detect aberrations in investment returns and to enhance investment-level due diligence processes.

Advisers Are Intensifying Their Due Diligence Processes and Focus Areas. The staff further observed that some advisers have increased their focus on operational due diligence, including by having dedicated operational teams with the power to reject alternative investment manager candidates that did not prove acceptable. The staff also noted that most advisers included a review of legal documents, an expanded review of audited financial statements and onsite visits to the managers as part of their due diligence process. Furthermore, the staff observed that advisers' due diligence teams tended to concentrate on liquidity issues to identify any significant mismatches in liquidity.

The Alert stated that the due diligence methods employed by advisers identified certain risk indicators which led advisers to perform additional due diligence, request that the manager make appropriate changes or reject the manager or the alternative investment. The following describes certain of the risk indicators identified in the Alert by category:

- **Investment Due Diligence**. The Alert pinpointed risk indicators arising in the investment due diligence phase, including managers that were unwilling to provide the requisite transparency regarding portfolio holdings to the adviser and a lack of clear research and investment processes carried out by the adviser.
- **Risk Management Due Diligence**. The Alert also identified several risk indicators relating to risk management due diligence, including alternative investment portfolio holdings that showed a high concentration in a single investment position, or a heavy concentration in a single sector, for a purportedly diversified strategy and investments that, as described by the manager, appear to be overly complex or opaque.
- **Operational Due Diligence**. The Alert mentioned several risk indicators relating to operational matters. These operational risk indicators include a lack of a third-party administrator or an unknown or unqualified administrator, multiple changes in key service providers and identification of undisclosed potential conflicts of interests, such as compensation arrangements or business activities with affiliates.

The Alert also highlighted the following observations by the OCIE staff during examinations relating to advisers' compliance:

- **Deficiencies Relating to Advisers' Compliance Programs**. The Alert identified three areas where the OCIE staff had observed material weaknesses or control deficiencies relating to the adviser's compliance program: (1) annual review, (2) disclosures made to clients and (3) marketing claims. With respect to the annual review requirement, the staff observed that some advisers did not cover their due diligence policies and procedures for alternative investments in their annual review. With respect to disclosures made to clients, the staff observed that advisers' disclosure procedures sometimes differed from actual practices and that advisers failed to report any notable exceptions made to the advisers' typical due diligence processes. With respect to marketing claims, the staff noted that some advisers' marketing materials contained potentially misleading information about the breadth and depth of the due diligence process or statements that appeared to be unsubstantiated. The staff further observed that advisers with due diligence policies and procedures that were written, detailed and required documentation were more likely to have consistently applied due diligence processes. The staff also observed that advisers that delegated certain responsibilities to third-party service providers and did not conduct periodic reviews of such service providers were more likely to have deficiencies in meeting those responsibilities.

- **Deficiencies Relating to Advisers' Codes of Ethics**. The staff observed cases where advisers recommended a limited offering to their clients, while also permitting certain employees of the adviser to purchase an interest in that offering on more favorable investment terms than those offered to the advisory clients. According to the Alert, such arrangements create a conflict of interest between the adviser and the client, since the advisory employees receiving the preferential terms may be incentivized by their own financial interests rather than the best interest of their advisory clients.

- See a copy of the Alert

FINRA Loosens Private Fund Anti-Spinning Compliance Regulations for Private Fund Managers and Proposes Rule to Grant Exemptions from Such Regulations Without SEC Approval

On February 3, 2014, the Financial Industry Regulatory Authority ("**FINRA**") amendment to Rule 5131 providing a limited exception from compliance with its anti-spinning prohibitions went into effect. This rule change enables private fund managers to rely on written anti-spinning representations from certain unaffiliated private fund of funds. "Spinning" refers to the practice of securities firms allocating valuable initial public offering shares to directors or executives of their investment banking clients in exchange for investment banking business. Rule 5131(b) is designed to prevent such abuse by prohibiting certain allocations of new issues. Please see the ***June 10, 2011 Investment Management Regulatory Update*** for further discussion of FINRA rule 5131. In addition, on February 14, 2014, FINRA filed a proposed rule change with the SEC in order to provide FINRA with general exemptive authority under the rule.

FINRA amended Rule 5131 to address concerns raised by its members regarding the difficulty of tracking down information from accounts regarding indirect beneficial owners, including participants in a fund of funds, for use in determining an account's eligibility to receive a new issue allocation. The amendment will permit FINRA members selling IPO shares to rely upon a written representation from a person authorized to represent an account (such as a manager of a hedge fund) obtained within the prior 12 months with respect to an investor in the account that is an unaffiliated private fund (the "investing fund"), provided that the investing fund (i) is a "private fund" as defined in the Advisers Act; (ii) is managed by an investment adviser; (iii) has assets in excess of $50 million; (iv) owns less than 25% of the account and is not a fund in which a single investor has a beneficial interest of 25% or more; (v) does not have a beneficial owner that also is a control person of the investing fund's investment adviser; (vi) is "unaffiliated" with the account in that the investing fund's investment adviser does not have a control person in common with the account's investment adviser; and (vii) was not formed for the specific purpose of investment in the account. If the investing fund does have a beneficial owner that is a control person of its investment adviser, the manager of the account must look through to such beneficial owner of the investing fund.

The proposed rule change would enable FINRA to, “in exceptional and unusual circumstances,” exempt a person from any or all provisions of Rule 5131 that it deems appropriate.

- See a copy of the SEC Order approving the amended rule
- See a copy of the proposed rule change

Litigation

SEC Sanctions Investment Adviser for Defrauding Clients

On January 27, 2014, the SEC issued two orders instituting settled administrative and cease-and-desist proceedings against Western Asset Management Company (“**WAM**”), a California-based investment adviser and subsidiary of Legg Mason, Inc., for concealing investor losses stemming from a coding error and engaging in illegal cross trading that favored some clients over others in violation of certain provisions of and rules under the Advisers Act and the Investment Company Act.

Under Section 206(2) of the Advisers Act, investment advisers are prohibited from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. According to the SEC, WAM breached its fiduciary duty by failing to disclose and correct a coding error that caused a restricted private investment to be improperly allocated to the accounts of nearly 100 plans subject to the Employee Retirement Income Security Act (“**ERISA**”). The SEC order stated that WAM failed to notify the affected ERISA clients until two years after WAM became aware of the error, and also failed to reimburse the affected ERISA clients for their losses (as WAM was obligated to do under its error correction policy). In addition, Rule 206(4)-7 under the Advisers Act requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. According to the SEC, because WAM’s compliance policies and procedures allowed for it to refrain from notifying ERISA clients about the coding error, WAM violated Rule 206(4)-7 by failing to ensure such errors are promptly corrected and disclosed.

The SEC also charged WAM with violating Section 206(2) of the Advisers Act and Section 17(a) of the Investment Company Act by engaging in illegal cross trading. According to the order, during the financial crisis, WAM arranged for certain broker-dealers to purchase mortgage-backed securities and similar assets from WAM clients and sell them back to different WAM clients in sale-and-repurchase cross trades. According to the SEC, by selling the securities through pre-arranged trades at the bid price, rather than an average between the bid and ask price, WAM favored the buying clients over the selling clients and denied the selling clients approximately $6.2 million in savings, thereby violating Section 206(2). Additionally, according to the SEC, WAM violated Section 17(a) of the Investment Company Act—which prohibits cross trades between registered investment companies (“**RICs**”) and their affiliates—by arranging cross trades between RIC client accounts and between RIC and RIC-affiliated client accounts.

Without admitting or denying the findings in the SEC’s orders, WAM settled the proceedings. For the disclosure violations related to the coding error, WAM must distribute more than $10 million to harmed clients and pay a civil penalty of $1 million in the SEC settlement and a $1 million penalty in a Labor Department settlement. For the cross trading violations, WAM must distribute more than $7.4 million to harmed clients and pay a $1 million civil penalty in the SEC settlement and a $607,717 penalty in the Labor Department settlement. WAM also must retain a compliance consultant to internally address both sets of violations.

- See a copy of the SEC Order (Disclosure Violations)
- See a copy of the SEC Order (Cross Trading Violations)

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SEC Sanctions Investment Adviser for Advisers Act Violations

On December 24, 2013, the SEC issued an order instituting settled administrative cease-and-desist proceedings (the "**Order**") against Jim Poe and Associates, Inc. ("**JPA**"), a registered investment adviser, and James Emory Poe ("**Poe**"), JPA's founder and principal, for violating certain provisions of and rules under the Advisers Act.

Under Section 205(a)(1) of the Advisers Act, registered investment advisers are generally prohibited from entering into advisory contracts or providing advisory services under contracts that provide for compensation based on a share of capital gain or upon capital appreciation of the assets or any portion of the assets of a client (a "**Performance Fee**"). However, Rule 205-3 under the Advisers Act provides that Section 205(a)(1) does not apply if the client entering the contract is a "qualified client."

According to the SEC, when JPA established advisory contracts for three of its funds, it failed to determine whether any investors were "qualified clients." As a result, JPA charged all investors in its funds, including those who were non-qualified clients, a Performance Fee. According to the Order, JPA received $610,762 in performance fees in violation of Section 205(a)(1). The SEC alleged that JPA willfully violated, and Poe willfully aided, abetted and caused JPA's violations of, Section 205(a) of the Advisers Act. Without admitting or denying the findings in the SEC's Order, JPA and Poe settled the proceedings. JPA and Poe agreed to a censure, and to cease and desist from committing or causing violations of Section 205(a) of the Advisers Act. JPA and Poe also agreed to pay, jointly and severally, civil penalties of $35,000 to settle the charges.

- See a copy of the SEC Order

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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