Investment Management Legal + Regulatory Update

Regulatory Updates

SEC and CFTC Finalize Rules and Interpretations on Key Terms for Regulating Derivatives

On July 6 and July 10, 2012, the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") approved joint final rules and interpretations for key definitions of certain derivative products. The rules and interpretations address which products will be considered a "swap," "security-based swap" or "mixed swap." Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") provides that the SEC will regulate "security-based swaps," while the CFTC will regulate "swaps"; the two agencies will jointly regulate "mixed swaps."

The SEC and the CFTC clarified that certain insurance products, consumer and commercial agreements, and loan participations are not swaps or security-based swaps, and thus not subject to regulation by those agencies. On the other hand, swaps or security-based swaps include: foreign exchange forwards, foreign exchange swaps, foreign currency options (other than those traded on a national securities exchange), currency and cross-currency swaps, and forward rate agreements. The interpretations also offer guidelines on the classification of credit default swaps and total return swaps.

The CFTC adopted a related anti-evasion rule to prevent the structuring of transactions to avoid the regulatory framework created by Title VII of the Dodd-Frank Act governing the regulation of swaps.

The new definitions under the Securities Exchange Act of 1934 (the "Exchange Act") and the Commodity Exchange Act will become effective 60 days after the publication of the rules in the *Federal Register*. The publication of the final rules in the Federal Register will also trigger compliance obligations under a number of other CFTC rules under Title VII of the Dodd-Frank Act.

The new rules allow anyone to request a joint interpretation from the SEC and the CFTC as to whether a particular agreement, contract, or transaction (or class thereof) is a swap, security-based swap or mixed swap.

SEC Approves Rules and Interpretations on Key Terms for Regulating Derivatives, SEC Press Release No. 2012-130 (July 9, 2012), available at http://www.sec.gov/news/press/2012/2012-130.htm; CFTC Fact Sheet (July 10, 2012), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd_factsheet_final.pdf.

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SEC Names Norm Champ as Director of Division of Investment Management

The SEC announced on July 5, 2012 that Norm Champ would succeed Eileen Rominger as the Director of the Division of Investment Management effective July 9th. Ms. Rominger is retiring. Mr. Champ served as Deputy Director of the SEC's Office of Compliance Inspections and Examinations (OCIE) since June 2010.

Mr. Champ served as acting head of the broker-dealer, investment adviser/investment company and credit rating agency examination programs, in addition to acting as chief counsel for OCIE. Prior to joining the SEC staff in January 2010 as Associate Regional Director for Investment Adviser/Investment Company Examinations in the SEC's New York Regional Office, Mr. Champ had been general counsel of Chilton Investment Company, a multi-national adviser to private funds and managed accounts, for 10 years. He had previously been an attorney with the law firm Davis Polk & Wardwell, and served as a law clerk for the Honorable Charles S. Haight, Jr., of the U.S. District Court for the Southern District of New York.

SEC Names Norm Champ as Director of Division of Investment Management, SEC Press Release No. 2012-129 (July 5, 2012), available at http://www.sec.gov/news/press/2012/2012-129.htm.

Advisers with $5 Billion AUM in Hedge Fund Assets to File First Form PFs by End of August

Many advisers with at least $5 billion in assets under management attributable to hedge funds must file their first Form PFs by the end of August.

Form PF Requirements.

In October 2011, pursuant to Sections 404 and 406 of the Dodd-Frank Act, the SEC and the CFTC issued final rules defining the systemic risk reporting obligations of private fund advisers on Form PF.

Rule 204(b)-1 under the Investment Advisers Act of 1940 (the "Investment Advisers Act") provides that registered investment advisers managing $150 million or more in "regulatory assets under management" ("RAUM") attributable to private funds must file Section 1 of Form PF with the SEC.

In addition, certain large private fund advisers are required to provide more detailed information in Sections 2, 3 and/or 4 of Form PF, and in some cases are required to file Form PF more frequently than smaller advisers. These large private fund advisers include:

- *Large Private Equity Fund Advisers*: any adviser having at least $2 billion in RAUM attributable to private equity funds as of the last day of the adviser's most recently completed fiscal year;
- *Large Hedge Fund Advisers*: any adviser having at least $1.5 billion in RAUM attributable to hedge funds as of the end of any month in the prior fiscal quarter; and
- *Large Liquidity Fund Advisers*: any adviser managing a liquidity fund and having at least $1 billion in combined RAUM attributable to liquidity funds and registered money market funds as of the end of any month in the prior fiscal quarter.

Filing Deadlines.

Large Private Equity Fund Advisers and smaller private fund advisers must file Form PF within 120 days of the end of such adviser's fiscal year. However, Large Hedge Fund Advisers and Large Liquidity Fund Advisers must file Form PF quarterly, and must file within 60 days and 15 days, respectively, of the end of each such adviser's fiscal quarter.

The Commission is in the first stage of a two-stage phase-in period for compliance with Form PF requirements.

In Stage 1, advisers with $5 billion in RAUM attributable to hedge funds, private equity funds or liquidity funds and money market funds must begin filing Form PF following the end of their first fiscal year or fiscal quarter, as applicable, to end on or after June 15, 2012. As a result, large hedge fund advisers with at least $5 billion RAUM attributable to hedge funds as of the fiscal quarter ended June 30, 2012, must file Form PF within 60 days of that date, i.e., August 29, 2012. Similarly, if a large private equity fund adviser has a June 30 fiscal year and at least $5 billion in RAUM attributable to private equity funds as of June 30, 2012, such adviser would be required to file its first Form PF within 120 days following June 30, 2012, that is, October 28, 2012.

In Stage 2, all other private fund advisers will be required to file their first Form PF following the end of their first fiscal year or fiscal quarter, as applicable, to end on or after December 15, 2012.

Calculation of RAUM.

Form PF, SEC Frequently Asked Questions, and Form ADV provide guidance on how to calculate RAUM for purposes of Form PF. Advisers must calculate RAUM on a gross basis, without deducting outstanding indebtedness or other accrued but unpaid liabilities. In addition, a sub-adviser to a private fund would include in RAUM only that portion of the value of the portfolio for which it provides continuous and regular supervisory or management services.

The Advisers Act uses the term "assets under management" in the context of whether a person falls within the definition of an investment adviser. The rules define "regulatory assets under management" in the context of whether an adviser meets the statutory thresholds to register with the SEC or file reports. The definitions are not the same.

For purposes of determining whether an adviser meets Form PF reporting thresholds, the adviser must aggregate, among other things, assets of managed accounts advised by the firm that pursue substantially the same investment objective and strategy, and invest in substantially the same positions as private funds advised by the firm ("parallel managed accounts"), unless the value of these accounts exceeds the value of the private funds with which they are managed.

Advisers are not required to file Form PF with respect to any period prior to the effective date of their registrations.

SEC Publishes Responses to Frequently Asked Questions about Reporting by Advisers to Private Funds, available at http://www.mofo.com/files/Uploads/Images/120621-SEC-FAQ-Private-Funds.pdf; Form PF: Systemic Risk Reporting for Private Fund Advisers, available at http://www.mofo.com/files/Uploads/Images/111115-Form-PF.pdf.

Enforcement + Litigation

SEC Sues Fund Adviser for Illusory Services

The SEC sued a Malaysian investment adviser, alleging that for more than a decade, it charged a U.S. registered investment company for sub-advisory services that AMC did not in fact provide. The SEC alleged that by doing so, the adviser breached its fiduciary duty with respect to receipt of compensation for advisory services under the Investment Company Act.

The adviser, AMMB Consultant Sendirian Berhad (AMC) served as sub-adviser to The Malaysia Fund, Inc., a closed-end fund that invests in Malaysian companies, whose principal investment adviser is Morgan Stanley Investment Management, Inc. (MSIM). The SEC alleged that AMC misrepresented its services during the fund's annual 15(c) advisory agreement review process for each year from 1996 through 2007, and that AMC collected fees for advisory services it did not provide.

AMC agreed to pay $1.55 million to settle the SEC's charges, without admitting or denying the allegations. MSIM had settled a related action in November 2011 by agreeing to pay $3.3 million without admitting or denying the allegations.

According to the SEC, AMC submitted a report to the Malaysia Fund's board of directors each year that falsely claimed that AMC was providing specific research, intelligence and advice to MSIM for the benefit of the fund. However, the SEC alleged that AMC's services were limited to providing two monthly reports based upon publicly available information that MSIM did not request nor use. In addition, the SEC alleged that AMC failed, contrary to certifications provided to the fund directors in 2006 and 2007, to adopt and implement adequate policies, procedures and controls over its advisory business.

The specific allegations alleged breach of fiduciary duty under Section 36(b) of the Investment Company Act, as well as violations of Section 15(c) of the Investment Company Act and Sections 206(2) and 206(4) under the Investment Advisers Act and Rule 206(4)-7 thereunder. AMC consented to a judgment that bars it from violating these provisions in the future. AMC's subadvisory agreement was terminated in 2008 after the SEC staff inquired about the services AMC was purportedly providing to the fund.

SEC Sues Fund Adviser for Fees Charged in Breach of Duty Under the Investment Company Act, SEC Press Release No. 2012-120 (June 26, 2012), available at http://www.sec.gov/news/press/2012/2012-120.htm; *see also SEC Charges Morgan Stanley Investment Management for Improper Fee Arrangement*, SEC Press Release No. 2011-244 (Nov. 16, 2011), available at http://www.sec.gov/news/press/2011/2011-244.htm.

Philip A. Falcone and Harbinger Charged with Securities Fraud

On June 27, 2012, the SEC charged hedge fund adviser Philip A. Falcone and his advisory firm, Harbinger Capital Partners LLC, for alleged misappropriation of client assets and market manipulation, among other things. The SEC also charged the former Chief Operating Officer, Peter A. Jensen, for aiding and abetting the misappropriation scheme. In addition, the SEC reached a settlement with Harbinger for unlawful trading activities.

In a separate, settled action, the SEC charged Harbert Management Corporation, whose affiliates served as the managing members of two Harbinger-related entities, as a controlling person in the market manipulation.

The SEC alleges that Falcone used fund assets to pay his taxes, conducted an illegal "short squeeze" to manipulate bond prices, secretly favored certain customers at the expense of other customers, and that Harbinger unlawfully bought equity securities in a public offering after having sold short the same security during a restricted period.

In particular, the SEC alleges that the respondents:

- Fraudulently obtained a loan in the amount of $113.2 million from a hedge fund he advised and used the proceeds to pay his personal tax obligations.
- Manipulated the price and availability of a series of distressed high-yield bonds by engaging in an illegal "short squeeze."
- Offered and granted favorable redemption and liquidity rights to certain strategically important investors in exchange for those investors' consent to restrict redemption rights of other fund investors, and concealed the arrangement from the fund's directors and investors. This restriction on most investors' ability to redeem their investments served to temporarily stabilize a decline in Harbinger's assets.
- Engaged in illegal trading in connection with selling stocks short during a restricted period, and then buying them back in three public offerings. Harbinger agreed to pay

$1.4 million and consented to a cease-and-desist order without admitting or denying these allegations.

The SEC filed a separate complaint against Harbert and two related investment entities, HMC-New York Inc. and HMC Investors, LLC, which served as the managing members of two limited liability companies that served as general partners of funds advised by Falcone. The SEC alleged that as controlling persons, they were aware of Falcone's trading described immediately above, but did not take appropriate steps to address Falcone's manipulative conduct. Without admitting or denying the allegations, these defendants agreed to pay a $1 million penalty, and agreed to an injunction prohibiting further violations.

Philip A. Falcone and Harbinger Charged with Securities Fraud, SEC Press Release No. 2012-122 (June 27, 2012), available at http://www.sec.gov/news/press/2012/2012-122.htm.

Mutual Funds Settle SEC Charges Alleging Misleading Disclosure Regarding Derivative Exposure to Mortgage-Backed Securities

On June 5, 2012, the Securities and Exchange Commission charged OppenheimerFunds Inc. and its sales distribution arm with making misleading statements about two of its mutual funds in late 2008. While neither admitting nor denying the SEC's findings, OppenheimerFunds agreed to pay a penalty of $24 million, disgorgement of $9,879,706, and prejudgment interest of $1,487,190, to be deposited into a fund for the benefit of investors.

The SEC found that Oppenheimer used total return swaps to increase the amount of commercial mortgage-backed securities exposure in a high-yield bond fund (the Oppenheimer Champion Income Fund) and an intermediate-term, investment grade fund (the Oppenheimer Core Bond Fund). According to the SEC, the Champion Fund's 2008 prospectus was materially misleading because it described the fund's "main" investments in high-yield bonds without adequately disclosing the fund's practice of assuming substantial leverage on top of these investments. Oppenheimer also allegedly advanced misleading messages to financial advisers and fund shareholders when responding to questions in the midst of the financial crisis. For example, Oppenheimer allegedly stated that the funds suffered from paper losses only and that their holdings and strategies remained intact.

The SEC's order states that OppenheimerFunds violated Section 34(b) of the Investment Company Act, Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (the "Securities Act"), and Section 206(4) of the Investment Advisers Act and Rule 206(4)-8. Additionally the order finds that OppenheimerFunds Distributor violated Sections 17(a)(2) and 17(a)(3) of the Securities Act.

OppenheimerFunds to Pay $35 Million to Settle SEC Charges for Misleading Statements During Financial Crisis, SEC Press Release No. 2012-110 (June 6, 2012), available at http://www.sec.gov/news/press/2012/2012-110.htm.

Court Approves SEC Settlement with Hedge Fund Managers

On June 18, 2012, the U.S. District Court for the Eastern District of New York approved Commission settlements with two former Bear Stearns Asset Management portfolio managers, Ralph R. Cioffi and Matthew M. Tannin. The Court ordered Cioffi and Tannin to pay a total of $1.05 million in disgorgement and civil penalties and enjoined them from federal securities law violations in the future.

The Commission's original complaint, filed June 19, 2008, alleged that the Bear Stearns funds run by Cioffi and Tannin collapsed after taking highly leveraged positions in structured securities based largely on subprime mortgage-backed securities. The complaint also alleged, among other things, that Cioffi and Tannin made various misrepresentations to investors in the funds, including the extent of the funds' investments in subprime mortgage-backed securities, the level of investor redemption requests, and Cioffi's redemption of a portion of his personal investment in the Enhanced Leverage Fund used to invest in a third fund for which he acted as portfolio manager.

Cioffi and Tannin settled the charges, without admitting or denying the allegations, and consented to the entry of district court judgments that permanently enjoin them from violating Section 17(a)(2) of the Securities Act. In connection with the settlement, on June 27, 2012, the Commission issued orders instituting administrative proceedings that bar Cioffi and Tannin from industries regulated by the SEC for periods of three years and two years, respectively.

SEC v. Ralph R. Cioffi and Matthew M. Tannin, SEC Litigation Release No. 22398 (June 25, 2012), Civil Action No. 08 2457, available at http://www.sec.gov/litigation/litreleases/2012/lr22398.htm.

SEC Charges Investment Adviser with Fraud for Failure to Disclose Conflicts

On May 30, 2012, the SEC charged Walter J. Clarke, through his role with Oxford Investment Partners LLC, with violating Sections 206(1), 206(2) and 206(4) of the Investment Advisers Act and Rule 205(4)-8 thereunder.

According to the SEC's order, in late 2007 and early 2008, Clarke convinced three clients to fund more than $300,000 in loans originated by a company co-owned by Clarke. Clarke did not inform his clients that he was a co-owner and therefore personally profiting from these loans. In addition, during November 2008, Clarke convinced four clients to invest $40,000 in a privately-held company co-owned by paid consultants of Oxford. In each case, investors lost their investments.

The SEC alleges that Clarke fraudulently sold a client 7.5% of his ownership interest in Oxford in March of 2008.
The SEC alleges that Clarke fraudulently valued Oxford at $10 million by first applying an excessive and baseless multiple to Oxford's 2007 revenue; second, by calculating the 2007 revenue by

quadrupling revenue in the fourth quarter of 2007 and ignoring the lower revenue of the previous three quarters; and thirdly, by adding a baseless $1 million "premium" to Oxford's valuation. The client paid $750,000 for Clarke's ownership interest.

SEC Charges Phoenix-Based Investment Adviser and Firm With Fraud, SEC Press Release No. 2012-105 (May 30, 2012), available at http://www.sec.gov/news/press/2012/2012-105.htm.

SEC Imposes Preliminary Injunction Against Fraudulent Investment Scheme by New York-Based Fund Manager

On May 25, 2012, the SEC charged an investment adviser and his two firms with violating the antifraud provisions of the Exchange Act. Without admitting or denying the allegations, the adviser and the firms consented to the entry of an order freezing their assets, obtained May 24 in a federal court in Manhattan.

The SEC claims that since at least November 2011, the adviser and the firms raised about $11 million by selling limited partnership interests, which the adviser claimed had $220 million in trading capital. The SEC alleged that instead of using the investors' funds for trading purposes, the adviser siphoned off approximately $2 million to pay earlier investors, as well as personal and business expenses.

SEC Halts Fraudulent Investment Scheme by New York-Based Fund Manager, SEC Press Release No. 2012-103 (May 25, 2012), available at http://www.sec.gov/news/press/2012/2012-103.htm.

SEC Charges Hedge Fund Adviser for Misleading Investors About "Skin in the Game" and Related-Party Deals

An investigation by the SEC claimed that investment adviser executives deceived investors about whether executives had personally invested in a $1 billion private fund they managed.

The SEC charged that from 2006 to 2008, the executives misrepresented to investors that they had "skin in the game" on due diligence questionnaires and in side letter agreements. In 2006 and 2007, the fund allegedly made undocumented loans to affiliates of the executives. The SEC claimed that the executives recreated the loans after the fact, but that the documents failed to correctly state key terms of the loans. The SEC also alleged that the executives provided this falsified loan information to the fund's investors.

The executives agreed to pay more than $3.1 million in total disgorgement and penalties to settle the charges.

Miami Hedge Fund Adviser Charged for Misleading Investors About "Skin in the Game" and Related-Party Deals, SEC Press Release No. 2012-104 (May 29, 2012), available at http://www.sec.gov/news/press/2012/2012-104.htm.

SEC Issues Wells Notices to Funds and Their Advisers

A public filing disclosed that the SEC issued a Wells notice to Northern Lights Fund Trust and certain members of its current and former trustees, as well as an unnamed chief compliance officer, on May 30, 2012. According to the disclosure, the Wells notice relates primarily to the process by which certain investment advisory agreements between the Trust and their advisers were approved, and the disclosures regarding the same. The Trust disclosed to its shareholders that the Wells notice alleges separate books, records, and compliance violations. According to the Trust, the specific funds are no longer offered for sale by the Trust.

Guggenheim Investments disclosed that the SEC issued Wells Notices to Guggenheim Funds Investment Advisors, a current employee, and a former employee in April 2012. According to Guggenheim, the Notice is related to inadequate disclosure of certain investments within a currently liquidated closed-end fund.

Northern Lights Fund Trust Prospectus Supplement (June 8, 2012), available at http://www.sec.gov/Archives/edgar/data/1314414/000091047212001769/nlftwellsnoticesticker6812.htm; Guggenheim Investments Fiduciary/Claymore MLP Opportunity Fund Semiannual Report (May 31, 2012), available at http://www.guggenheimfunds.com/libraries/literature_en/fmo_semiannual_report_5-31-12.pdf.

SEC Charges Mutual Fund Adviser with Failing to Turn Over Records to SEC Examiners

On August 10, 2012, the SEC charged an investment advisory firm with failing to provide various document requested during the course of an SEC examination. The examination staff had requested records from the adviser in 2010 while examining their advisory business and the operations of a mutual fund represented by the adviser, but did not receive any documents from the adviser despite its numerous requests.

Simultaneously with the SEC's examination in 2010, the fund's board requested information from the adviser. The adviser requested additional time to respond to the board, but thereafter failed to provide copies of the requested documents. The board subsequently terminated the firm's advisory agreement and liquidated the fund by returning the money to investors.

Under the relevant rules, the SEC could seek to permanently bar the adviser's principals from association with SEC registered investment advisers or broker dealers.

SEC Charges Mutual Fund Adviser With Failing to Turn Over Records to SEC Examiners, SEC Press Release No. 2012-154 (August 10, 2012), available at http://www.sec.gov/news/press/2012/2012-154.htm.

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