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HEDGE FUND TRADING-AND INVESTOR-RELATED COMPLIANCE ISSUES AND REGULATORY DEVELOPMENTS

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The following is a summary of certain trading-related compliance issues for hedge funds and their managers in light of recent Securities and Exchange Commission ("SEC" or "Commission") final and proposed rulemakings and other actions.

I. ADOPTION OF A SHORT SALE-RELATED CIRCUIT BREAKER

A. Overview of Rule 201

On February 24, 2010, the SEC voted to amend Regulation SHO by adopting amendments to Rule 201 and Rule 200(g) (together the "Alternative Uptick Rule").[1] The Commission adopted the short sale-related circuit breaker solution to prevent short selling, including potentially abusive or manipulative short selling, from being used to exacerbate a decline in a security's price and to address the concerns that such downward price pressure can undermine investor confidence in the markets.

Generally, Rule 201 prohibits short sales at or below the national best bid price for the remainder of the day and the following trading day of any covered security that declines 10% or more from the prior day's closing price.

B. Summary of the Rule's Amendments

1. Rule 201 Circuit Breaker

The Alternative Uptick Rule prohibits a trading center[2] from executing or displaying any short sale order of a "covered security",[3] absent an exception, at a price that is equal to or below the current national best bid if the price of that security declines

1. *Amendments to Regulation SHO*, Exchange Release No. 61595 (Feb. 26, 2010), 75 Fed. Reg. 11232 (Mar. 10, 2010), available at http://www.sec.gov/rules/final/2010/34-61595fr.pdf.
2. A "trading center" is defined in Rule 600(b)(78) of Regulation NMS as "a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent."
3. A "covered security" is defined in Rule 201 as any NMS stock. As a result, Rule 201 generally applies to all securities, except options, that are listed on a national securities exchange, whether traded on an exchange or in the over-the-counter market.

intra-day by 10% or more from the security's closing price as determined by the covered security's listing market as of the end of the prior day's regular trading hours.[4]

2. Rule 200(g) Sell Order Marking Requirements

In addition to Rule 201, the SEC amended Rule 200(g) to require broker-dealers to mark all sell orders as "long", "short" or, if the sell order meets the requirements or exceptions found in Rule 201, "short exempt".

a. "Short Exempt" Marking Requirements

A broker-dealer is permitted to mark a sale "short exempt" if the broker-dealer identifies the order as being at a price above the current national best bid at the time of submission of the order to a trading center and the broker-dealer maintains and enforcement written policies and procedures reasonably designed to prevent the incorrect identification of orders, regularly surveils to ascertain the effectiveness of its policies and procedures and takes prompt action to remedy any deficiencies.

b. "Short Exempt" Marking Exceptions

Subject to certain conditions, broker-dealers may also mark orders as "short exempt" in relation to:

- The delay in delivery of a security that the broker has a reasonable basis to believe that the seller owns and will deliver as soon as the restrictions are lifted;
- Odd-lot transactions if the broker-dealer has a reasonable basis to believe that the short sale order is by a market maker to offset a customer odd-lot order or to liquidate an odd-lot position that changes such broker-dealer's position by no more than a unit of trading;

4. SEC Division of Trading and Markets, Short Sale Price Test Restrictions: A Small Entity Compliance Guide (Apr. 16, 2010), available at http://www.sec.gov/rules/final/2010/34-61595-secg.htm.

- Certain *bona fide* domestic and international arbitrage transactions for which there is a corresponding offer in a foreign securities market;[5]
- Short sales in connection with an over-allotment by underwriters or syndicate members participating in a distribution, and short sales for purposes of lay-off sales by such persons in connection with a distribution of securities through a rights or standby underwriting commitment;
- Riskless principal transactions by broker-dealers; and
- Transactions executed on a volume weighted average price ("VWAP") basis that meet the following conditions: (1) the VWAP for the covered security is calculated by: determining the values for every regular way reported trade for the security during the regular trading session, by multiplying each such price by the total number of shares traded at that price; compiling an aggregate sum of all values; and dividing the aggregate sum by the total number of reported shares for that day in the security; (2) a VWAP trade modifier is used to report the transactions; (3) the VWAP matched security is an "actively-traded security" under Regulation M, or if a listed security is not an "actively-traded security," the proposed short sale transaction is conducted as part of a basket transaction of 20 or more securities in which the subject security does not comprise more than 5% of the value of the basket traded; (4) the sale is not effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security; and

5. To qualify for the "bona fide" domestic arbitrage exception, the broker-dealer must have a reasonable belief that the short sale is being executed "for the good faith account of a person who then owns another security by virtue of which he is, or presently will be, entitled to acquire an equivalent number of securities of the same class as the securities sold; provided such sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such securities of the issuer." Rule 201(d)(3) of Regulation SHO.

(5) a broker-dealer will act as principal on the contra-side to fill customer short sale orders only if the broker-dealer's position in the covered security, as committed by the broker-dealer during the pre-opening period of a trading.

One key difference between the Alternative Uptick Rule and the former uptick rule, Rule 10a-1 under the Securities Exchange Act of 1934 (the "Exchange Act"), is the absence of a general exception for market makers, including option market makers.

3. Effective Date and Compliance Date

The effective date for the Alternative Uptick Rule was May 10, 2010. However, all market participants have until November 10, 2010 to fully comply with the requirements of Rule 201 and 200(g).

4. Compliance Considerations

Although trading centers and broker-dealers will have primary responsibility for complying with the Alternative Uptick Rule, hedge funds and other managers that employ short selling strategies should still:

- Analyze the impact of the new restrictions and "short exempt" exceptions on trading strategies; and
- Coordinate with their broker-dealers to clarify any new compliance or informational requirements.

II. COMPLIANCE WITH RULE 105 OF REGULATION M WHEN TRADING ACROSS MULTIPLE ACCOUNTS

A. Overview of Rule 105 of Regulation M

Rule 105 of Regulation M under the Exchange Act prohibits short sales of equity securities that are the subject of a firm commitment cash offering pursuant to a registration statement or a notification pursuant to Securities Act of 1933 (the "Securities Act") Regulation A or Regulation E (the "Offered Securities") by any person who purchases the Offered Securities from an underwriter or broker-dealer participating in the offering.[6] The Rule 105 restriction on short sales (the "Restricted Period") applies during the shorter of the period beginning (1) five business days before the pricing of the Offered Securities and ending with the pricing, or (2) with the initial filing of the registration statement or notification and ending with the pricing. Unlike other rules under Regulation M, Rule 105 does not apply to reference securities.

B. Excepted Activity

In August 2007, the SEC adopted amendments to Rule 105, which, among other things, excluded three categories of transactions from the rule's prohibitions.[7] (The release publishing these amendments is referred to herein as the "2007 Adopting Release.")

1. Bona Fide Purchases

Paragraph (b)(1) of Rule 105 permits purchases of Offered Securities in an offering even if the purchaser sold the security short during the Restricted Period. To be eligible for this exception, the following conditions must be met:

- The purchases of Offered Securities must be at least equivalent in quantity to the entire amount of short sales of Offered Securities during the Restricted Period. This exception is not available if there are only partial purchases.
- The purchase must also be *bona fide*. In other words, even if the purchaser is in technical compliance with this exception, the purchase must, among other things, be subject to the economic risks associated with a purchase for value.
- The purchase(s) must be reported pursuant to an effective transaction reporting plan, and effected during regular trading

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6. "Short sale" for purposes of Rule 105 has the same meaning as in Regulation SHO under the Exchange Act. Rule 200(a) of Regulation SHO defines a "short sale" as "any security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."
7. *Short Selling in Connection with a Public Offering*, Exchange Release No. 56206 (Aug. 6, 2007),72 Fed Reg. 45094 (Aug. 10, 2007), available at http://www.sec.gov/rules/final/2007/34-56206fr.pdf.

hours such that they occur no later than the end of the regular trading session on the business day prior to the day of pricing.

- The sequence of the transactions is critical in order to claim the exception. The purchases must take place after the last short sale in the Offered Securities during the Restricted Period.
- The person seeking to claim the exception may not effect a reported short sale within the 30 minutes prior to the close of regular trading on the business day prior to the day of pricing.

2. *Separate Accounts*

Paragraph (b)(2) of Rule 105 permits short sales in separate accounts to be disregarded for purposes of determining eligibility to purchase Offered Securities in an offering. The SEC has provided guidance that the term "account" can include "portions of a particular fund", a "unit", a "department" or an "identifiable division".[8] For the exception to apply, however, decisions regarding securities transactions for each "account" must be made separately and without any coordination of trading or cooperation among or between accounts.

Although the Commission stated in the August 2007 Adopting Release that the availability of the separate accounts exception is a facts and circumstances determination, it also provided guidance on when accounts will be viewed as separate and operating without coordination of trading or cooperation among or between accounts:

- Each account must have separate and distinct investment and trading strategies and objectives;
- Personnel must be separately assigned to each account and may not coordinate trading among or between the accounts;
- There must be information barriers separating the accounts, and information about securities positions or investment decisions may not be shared between accounts;

8. *Id*. at 45098 fn 64.

- Each account must maintain a separate profit and loss statement;[9]
- There can be no allocation of securities between or among accounts;
- Senior supervisory personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities cannot execute or have the authority to execute trades in individual securities in the accounts, and cannot pre-approve or have the authority to pre-approve trading decisions for the accounts; and
- Account owners of multiple accounts cannot execute or have the authority to execute trades in individual securities in the accounts, and cannot pre-approve or have the authority to pre-approve trading decisions for the accounts.[10]

With respect to "funds of funds", the SEC noted that a fund that invests in multiple unaffiliated funds and owns shares of each fund, rather than shares of each fund's underlying investments, will likely not need to rely on this exception, assuming there is no coordinated trading activity. Under those scenarios, the shares of each fund are viewed as different securities from the underlying securities.[11]

3. *Investment Companies*

Paragraph (b)(3) of Rule 105 permits purchases of Offered Securities in an offering by an investment company, or series of such investment company, registered under Section 8 of the Investment Company Act of 1940 (the "1940 Act") without regard to short sales by an affiliated investment company or series of such a company, or a separate series of the investment company.

In adopting this exception, the SEC noted that 1940 Act Section 17(d) and Rule 17d-1 thereunder generally prohibit any arrangement or concerted action between affiliated persons of registered investment companies. Accordingly, an arrangement

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9. The SEC did not require that accounts have separate legal identities or separate taxpayer identification numbers to be considered separate. *Id*. at 45099.
10. *Id*. at 45098.
11. *Id*. at 45099.

between principals of affiliated funds to coordinate short sales by one fund and purchases by another fund would generally be the type of joint enterprise that is prohibited by the 1940 Act.

C. Excepted Offerings Best Efforts Offerings

Paragraph (c) of Rule 105 states that the rule's proscription apply only to firm commitment offerings. Accordingly, short sales in advance of a best efforts offering are not subject to Rule 105.

D. Recent SEC Enforcement Actions

On January 26, 2010, the SEC announced separate settled enforcement actions against two California investment advisory firms. The SEC noted that these were the first cases it had filed following the 2007 amendments to Rule 105.

In its case against AGB Partners and its principals, the SEC found that the state registered investment adviser and its two principals netted thousands of dollars in illegal profits by violating Rule 105.[12] According to the SEC's order, the Commission found that, among other things, subsequent to the 2007 amendments, the respondents used two accounts such that they sold short through one account that was used solely to manage the two principals' personal funds, and purchased securities in a follow-on offering through a second private fund that managed monies for outside clients.

Although the two accounts were held at different prime brokers, had separate trading strategies and separate profit and loss statements, the SEC noted in its order that the accounts were not managed separately. For example, on one occasion, shares were allocated from one account to cover a short position in the other account, and both principals had authority to place trades in both accounts. The SEC also noted the absence of information barriers to separate the accounts or prevent the sharing of information about securities positions and investment decisions, and that trading ideas were often discussed and shared.[13]

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12. *In re AGB Partners LLC, Gregory A. Bied, and Andrew J. Goldberger*, Exchange Act Release No. 61422, Advisers Act Release No. 2977, Administrative Proceeding File No. 3-13764 (Jan. 26, 2010), available at www.sec.gov/litigation/admin/2010/34-61422.pdf.
13. *Id*.

In settling the SEC's charges without admitting or denying the Commission's findings, AGB Partners, and its two principals consented to be censured and were required to disgorge $38,444 in profit and to pay prejudgment interest of $2,921, together with a civil penalty of $20,000.

Similarly, in its action against Palmyra Capital Advisors LLC, the SEC found that the adviser violated Rule 105 and improperly profited by selling Offered Securities for three of its managed hedge funds, and purchasing the Offered Securities in a secondary offering.[14]

Palmyra Capital consented to be censured, and was required to disgorge $225,000 out of its own funds, which represented the profits earned by the three funds, and to pay prejudgment interest of nearly $11,000, plus a civil money penalty of $105,000.

E. Compliance Considerations

The SEC's recent enforcement cases are a reminder to review policies and procedures relating to Rule 105 compliance. Potential controls might include one or more of the following:

- Reviewing current trading authority, trading practices, and organizational structure for availability of the separation account exception.
- Reviewing and updating policies and procedures that document and implement information barriers and segregate trading activities and non-public order and trading information.
- Periodically updating and documenting each "account's" investment and trading strategy and authorized trading personnel.
- Prohibiting or implementing appropriate controls and approval processes relating to any journaling of positions between accounts.
- Providing appropriate training on Rule 105's current requirements, including the application of the Restricted Period to shelf offerings, the trade sequence requirements of the *bona fide* purchase exception, and controls to demonstrate the separation of accounts.

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14. *See In re Palmyra Capital Advisors*, Exchange Act Release No. 61421 Advisers Act Release No. 2976, Administrative Proceeding File No. 3-13763 (Jan. 26, 2010), (Jan. 26, 2010), available at http://www.sec.gov/litigation/admin/2010/34-61421.pdf.

- Implementing and documenting restrictions on personnel with management or oversight responsibility with respect to (1) executing or pre-approving trades in multiple accounts that rely on the separate account exception and (2) approving the journaling of trades or allocation of securities between or among separate accounts.
- Reviewing tools to generate alerts regarding short sales and potential participation in offerings of equity securities to help reduce inadvertently triggering Rule 105 restrictions.
- Conducting periodic reviews of the controls, including reviewing for signs of coordination or cooperation between accounts and for trading activity that appears to be inconsistent with the stated strategy or objectives of the account. Appropriately document any such reviews.

III. IN FLIGHT ORDERS

A. SEC Guidance

According to the SEC's Division of Trading and Markets (the "Division"), if a seller is net long 1,000 shares and simultaneously enters multiple sell orders of 1,000 shares each, Rule 200(g)(1) of Regulation SHO provides that only one of these sell orders may be marked "long" and any additional orders must be market "short".[15] The Division's view is that after the first order to sell 1,000 shares is entered, it is no longer reasonable to expect that delivery can be made on additional orders to sell the same shares.

B. Compliance Considerations

The Division's guidance is a reminder to periodically review how long and short positions are calculated. Among other things, consider:

- Periodically reviewing and testing order entry and trading systems to confirm the timely input of order and execution information and the accurate decrementation of positions.

15. SEC Division of Trading and Markets, Frequently Asked Questions Concerning Regulation SHO, Question 2.5 (Aug. 28, 2009), available at http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

- Confirming that all required trading and position information is aggregated on a timely basis.
- Reviewing the speed and accuracy with which position information is updated to reflect trading errors and cancelled trades.

IV. PARTIAL LONG SALES

A. SEC Guidance

In the case of a sell order for shares in excess of a long position, the Division has advised that the broker-dealer executing the order is required to mark part of the customer's sell order as "long", and treat (and mark) the additional amount as a separate short sale order.[16]

B. Compliance Considerations

Generally, the key compliance concern is the accuracy of position information.

V. PROPOSED ELIMINATION OF FLASH ORDER EXCEPTION

A. Proposed Amendments

In September 2009, the SEC proposed amending Rules 601 and 602 of Regulation NMS and Rule 301 of Regulation ATS to eliminate certain exceptions that allow for the transmission of flash orders to some market participants by equity and options exchanges and alternative trading systems ("ATSs").[17] Currently, Rule 602 of Regulation NMS requires exchanges to provide their best-priced bids and offers to the consolidated quotation data that is widely disseminated to the public. Quotations that are executed immediately after communication, or cancelled or withdrawn if not executed immediately after communication, are excepted from the public dissemination requirement by paragraph (a)(1)(i)(A) of Rule 602.

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16. SEC Division of Trading and Markets, Frequently Asked Questions Concerning Regulation SHO, Question 2.4 (Aug. 28, 2009), available at http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.
17. *Elimination of Flash Order Exception From Rule 602 of Regulation NMS*, Exchange Act Release No. 60684 (Sept. 18, 2009), 74 Fed. Reg. 48632 (Sept. 23, 2009), available at http://www.sec.gov/rules/proposed/2009/34-60684fr.pdf.

Similarly, Rule 301(b)(3)(ii) of Regulation ATS, requires ATSs that have average daily trading volume of at least 5% of the aggregate average daily share volume of an "NMS stock" during at least four of the preceding six months to provide their best priced orders displayed to more than one person in the consolidated quotation data made available to the public.[18] Under the current version of the rule, flash quotes are not required to be displayed publicly.

If the proposed amendments are adopted, the exception in Rule 602 would be eliminated for flash orders with respect to NMS stocks and listed options, and the public display requirement in Rule 301(b) would be extended to all orders whether immediately executed or withdrawn if not immediately executed without regard to whether the order is characterized by the ATS as an order or an "indication of interest." Accordingly, rather than flashing quotes, exchanges and ATSs would be required to handle marketable orders that they cannot execute at the best displayed prices in accordance with Regulations NMS and ATS, as applicable, *e.g.*, by routing marketable orders away to another exchange or ATS for execution against the best displayed quotations on those market centers. The restrictions on locking or crossing quotations in Rule 610(d) of Regulation NMS would also be extended to prohibit the practice of displaying marketable flash orders.

On July 2, 2010, the SEC published a release reopening the public comment period until August 9, 2010 for the portion of the September 2009 Proposal related to the elimination of the flash order exception with respect to listed options.[19] Additional comments were requested regarding the effect of a proposed cap on access fees for listed options, and on the execution quality that flash orders receive in the options markets. The SEC is particularly interested in the extent to which flash orders, if they fail to receive an execution in the flash process, "miss the market" by either receiving an inferior

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18. An "NMS stock" is defined in Rule 600(b)(47) of Regulation NMS as an "NMS security" other than an option. Rule 600(b)(44) of Regulation NMS defines "NMS security" as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options."
19. *Elimination of Flash Order Exception From Rule 602 of Regulation NMS*, Exchange Act Release No. 62445 (July 2, 2010), 75 Fed. Reg. 39626 (July 9, 2010), available at http://www.sec.gov/rules/proposed/2010/34-62445fr.pdf.

price through an execution against a displayed quotation or no execution at all.

B. Compliance Considerations

Until the Commission publishes final rules, compliance obligations and concerns cannot be fully assessed. However, based on the proposals, it appears that exchanges, ATSs, and other broker-dealers will have primary responsibility for complying with requirements related to flash orders.

VI. PROPOSED LARGE TRADER REPORTING SYSTEM

A. Large Trader Obligations

On April 14, 2010, the SEC proposed new Rule 13h-1 under the Exchange Act to establish a large trader reporting system.[20] Proposed Rule 13h-1 would require "large traders" to identify themselves to the SEC by filing proposed Form 13H. Paragraph (a)(1) of the proposed rule defines a "large trader" as "any person that directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level."[21] The rule would apply to firms trading 2 million shares or $20 million a day, or 20 million shares or $200 million a month.[22]

Each large trader would be assigned a unique identification number which would allow the SEC to efficiently identify and analyze trading activity conducted by the large trader. Large traders would provide this number to their broker-dealers, who would be required to maintain transaction records for each large trader and report that information to the SEC upon request. Under Rule 13h-1, broker-dealers would be required to change their trading systems to include large trader identifying numbers in their trading records and

20. *Large Trader Reporting System*, Exchange Release No. 61908 (Apr. 14, 2010), 75 Fed. Reg. 21456 (Apr. 23, 2010), available at http://www.sec.gov/rules/proposed/2010/34-61908.pdf.
21. *Id*. at 21460.
22. *Id*. at 21463.

to monitor customer trades to determine if those customers should be filing as large traders.[23]

Paragraph (b)(3)(i) of the proposed rule provides that a large trader would not be required to separately comply with the requirements of paragraph (b) of Rule 13h-1 if a person who *controls* the large trader complies with all of the requirements under paragraphs (b)(1), (b)(2) and (b)(4) applicable to such large trader with respect to all of its accounts.[24] The Commission stated that the intent of this proposed provision is to push the identification requirement up the corporate hierarchy to the parent entity to identify the primary institutions that conduct a large trading business. Conversely, paragraph (b)(3)(ii) of the proposed rule would apply the same principle on a "top down" basis, providing that a large trader would not be required to comply with the requirements of paragraph (b) if one or more persons *controlled by* such large trader collectively comply with all of the requirements under paragraphs (b)(1), (b)(2), and (b)(4) applicable to such large trader with respect to all of its accounts. A controlling person of one or more large traders would be required to comply with all of the requirements of paragraph (b) unless the entities that it controls discharge all of the responsibilities of the controlling person under paragraph (b).

The comment period for the proposed rule expired on June 22, 2010.

B. Compliance Considerations

While a full assessment of compliance concerns cannot be completed until the Commission discusses and publishes final rules, a few preliminary concerns for hedge funds raised by the proposed rule include:

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23. The Commission also proposed new Exchange Act Rule 613, which would establish a consolidated audit trail for equities and options that would collect and consolidate detailed information about orders entered and trades executed on any exchange or in the over-the-counter market. The large trader reporting system is designed to address in the near term the Commission's need for access to more information about large traders and their activities. Id. at 21459 fn. 32.
24. Paragraphs (b)(1), (b)(2) and (b)(4) of the proposed rule set forth the large trader's obligation to file Form 13H, disclose its large trader status to broker-dealers and provide any additional descriptive or clarifying information that would allow the Commission to further identify the large trader and all accounts through which the large trader effects transactions.

- Determining which entity or entities within a large hedge fund complex would have "control" for purposes of self identifying as large traders may be a complicated undertaking.
- Confidentiality of proprietary and sensitive information, including concerns about reverse engineering of trading strategies.

VII. RISK MANAGEMENT CONTROLS FOR BROKERS OR DEALERS WITH MARKET ACCESS

A. Overview

On January 19, 2010 the SEC proposed a new risk management rule, Rule 15c3-5 under the Exchange Act, that would require broker-dealers with access to trading directly on an exchange or ATS to establish (and periodically evaluate) a system of controls intended to limit potential financial exposure and to ensure compliance with relevant regulatory requirements.[25]

The proposed rule seeks to address risks associated with "direct market access" and "sponsored market access" arrangements. "Direct market access" refers to a customer securities order that flows through a broker dealer's systems before entering the markets. "Sponsored market access" involves an arrangement in which a broker-dealer allows a customer to use its market participant identifier ("MPID") to electronically access an exchange or ATS. The SEC is particularly concerned about the lack of broker-dealer risk controls in "unfiltered" or "naked" access arrangements in which the broker-dealer may be unaware of the trading activity occurring under its MPID and have no mechanism to control it.[26]

B. Proposed Rule 15c3-5

Proposed Rule 15c3-5 would require broker-dealers with trading access to exchanges and ATSs to establish, document, maintain and evaluate annually a system of risk management controls and supervisory procedures that are reasonably designed to (1) systematically limit

25. *Risk Management Controls for Brokers or Dealers with Market Access*, Exchange Act Release No. 61379 (Jan. 19, 2010), 75 Fed. Reg. 4007 (Jan. 26, 2010), available at http://www.sec.gov/rules/proposed/2010/34-61379.pdf.

26. *Id*. at 4008.

the broker-dealer's financial exposure from market access and (2) ensure compliance with all regulatory requirements applicable in connection with market access.

The Commission also included the following guidance for the risk management controls and supervisory procedures in its proposal:

- The controls should prevent the entry of orders that exceed pre-set credit or capital thresholds, or that appear to be erroneous.
- Each broker would be required to set appropriate credit limits for each customer (on an aggregate and on a sector- or security-specific basis) and appropriate capital thresholds for its own proprietary trading.
- The controls should prevent failures to comply with pre-trade regulatory requirements (*e.g.*, special order types, trading halts, Regulation SHO and Regulation NMS), prevent entry of orders whose trading is restricted, restrict market access technology and systems to authorized persons, and assure that surveillance personnel are given immediate post-trade reports.
- The procedures should be applied on an automated, pre-trade basis, which would effectively prohibit "naked" or unfiltered access.
- The risk controls should be under the direct and exclusive control of the broker or dealer with market access. Each broker or dealer would also be required to annually review its business activity to ensure the overall effectiveness of the risk management controls and supervisory procedures and document the results of each review.[27]

The comment period for the proposed rule expired on March 29, 2010.

VIII. AMENDMENTS TO THE "CUSTODY" RULE

A. Overview Act Rule 206(4)-2

On December 16, 2009, the SEC voted to approve amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act

27. *Id*. at 4011-4012.

of 1940 (the "Advisers Act").[28] The Commission's action was directed at strengthening controls over client assets held by registered investment advisers and their related persons, and deterring fraudulent conduct with respect to those client assets.[29]

Generally, Rule 206(4)-2 requires SEC-registered investment advisers to maintain client funds in accounts that are restricted to client assets and are held by a qualified custodian.[30] If the registered investment adviser holds client securities, they must be identified and segregated as client securities and held in a reasonably safe place. Even though registered investment advisers themselves rarely maintain physical custody of client assets, they can be deemed to have custody if the client assets are maintained with an affiliate of the adviser, or if the adviser has access to the assets.[31]

B. Summary of the Rule's Amendments

1. Surprise Examinations

Absent an exception, registered investment advisers that have custody of client assets, directly or through a related person, are required to engage an independent public accountant to conduct an annual surprise examination to verify the existence of client assets

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28. *Id*.
29. A "related person" is defined in Rule 206(4)-2(d)(7) as "any person, directly or indirectly, controlling or controlled by [a registered investment adviser] and any person under common control with [the investment adviser]".
30. Generally, a "qualified custodian" is defined in Rule 206(4)-2(d)(6) as a bank, as defined in Section 202(a)(2) of the Advisers Act; a saving association; a broker-dealer registered with the SEC and holding the advisory client assets in customer accounts; a futures commission merchant registered with the Commodity Futures Trading Commission and holding the advisory client assets in customer accounts, if the client assets are funds, security futures, or other securities incidental to transactions in futures or options on futures; and a foreign financial institution that customarily holds financial assets for its customers and holds the advisory clients' assets in customer accounts segregated from its proprietary assets.
31. An adviser can be deemed to have custody of client assets through a variety of relationships, including a power of attorney, acting as trustee, or a general partnership relationship. *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Release No. 2968 (Dec. 30, 2009), 75 Fed. Reg. 1456, 1471 (Jan. 11, 2010), available at http://www.sec.gov/rules/final/2009/ia-2968fr.pdf.

and to confirm that the investment adviser's books and records are consistent with those of the custodian.[32]

In addition to verifying client funds and securities for which the adviser has custody and that are maintained at a qualified custodian, the independent public accountant is required to verify securities that the adviser is not required to maintain with a qualified custodian, such as certain privately offered securities and mutual fund shares.[33]

Within one day of the discovery of any material discrepancy or missing assets, the accountant must report such findings to the Director of the SEC's Office of Compliance Inspections and Examinations. The accountant also must notify the SEC if it resigns or is dismissed by the investment adviser. Accountants' termination statements will be made public and are required to include an explanation of any problem, although not the reason for the resignation or dismissal.

2. *Exceptions to the Surprise Exam Requirement*

a. Custody Arising Solely from Fee Deductions

Registered investment advisers who are deemed to have custody solely because they have the authority to deduct advisory fees are not subject to the surprise exam requirement.

b. Pooled Investment Vehicles

A pooled investment vehicle whose securities are not sold in a public offering of securities is not subject to the surprise audit requirements if it obtains annual audits of its financial statements and distributes those audited financials to its investors. The annual audit must be performed by an auditor registered with the Public Company Accounting Oversight Board (the "PCAOB").

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32. The SEC also issued interpretive guidance about the responsibilities of accountants in performing surprise examinations and preparing internal control reports. *See Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940*, Advisers Act Release 2969 (Dec. 30, 2009), 75 Fed. Reg. 1492 (Jan. 11, 2010), available at http://www.sec.gov/rules/interp/2009/ia-2969fr.pdf.
33. *Id*. at 1450 fn. 36.

c. Affiliated Custodians

Investment advisers are permitted to use related persons as custodians; however, unless the related person is "operationally independent", the adviser is subject to the annual surprise examination requirement. To be deemed "operationally independent", (i) the related person must not be subject to the claims of the adviser's creditors, (ii) the adviser's personnel cannot have custody or possession of, or direct or indirect access to client assets that the related person custodies, the power to control the disposition of such assets, or the opportunity to misappropriate such assets; (iii) there can be no common supervision or management of the personnel of the adviser and the custodian, and (iv) advisory personnel cannot hold any position with the related person, or share the same premises.[34]

3. Internal Control Reports

If an adviser or a related person is a qualified custodian, the custodian is required to have an annual review of its internal controls, even if the custodian is deemed to be operationally independent. This review must be conducted by an independent accountant registered with the PCAOB, and may be the same accountant that conducts the surprise exam.

Among other things, the Commission stated that the internal control report should address control objectives and associated controls related to the areas of:

- client account setup and maintenance,
- authorization and processing of client transactions,
- security maintenance and setup,
- processing of income and corporate action transactions,
- reconciliation of funds and securities to depositories and other unaffiliated custodians, and
- client reporting.[35]

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34. *See* Rule 206(4)-2(d)(5).
35. Advisers Act Release 2969, 75 Fed. Reg. at 1493-1494.

The internal control report requirement does not apply to the custody of privately offered securities.[36]

4. *Delivery of Account Statements*

Under the amended rule, registered investment advisers are not allowed to deliver quarterly account statements to their clients.[37] Rather, investment advisers are required to have a reasonable belief, after "due inquiry", that the custodian delivered the account statements directly to the adviser's clients. The SEC did not define "due inquiry", however, a potential way to satisfy this requirement might be to receive from the custodian duplicate copies of each account statement sent to clients.

An adviser may send its own account statements to clients in addition to those sent by the custodian. If the adviser elects to do so, it must include a legend directing clients to compare the account statements they receive from the adviser with those they receive from the custodian.

5. *Amendments to Form ADV*

In connection with the amendments to the custody rule, the SEC adopted several amendments to Form ADV including, among others, a requirement that registered investment advisers report all related persons who are broker-dealers on Item 7 and Section 7.A. of Form ADV's Schedule D, and identify those that act as custodian for the funds or securities of the adviser's clients. The SEC also is requiring that advisers who have, or whose related persons have, custody of client assets provide additional information about their custodial practices. Advisers are allowed to answer "no" on Item 9.A. if they have custody solely because they are authorized to deduct fees from client accounts, or an operationally independent related person is a qualified custodian.[38]

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36. Advisers Act Release No. 2968, 75 Fed. Reg. at 1461 fn. 65.
37. Adviser Act Release No. 2969, 75 Fed. Reg. at 1474 fn. 225. The SEC retained the exception from the account statement delivery requirement for certain advisers to pooled investment vehicles.
38. *Id*. at 1468 fn. 154.

6. *Effective Date and Compliance Dates*

The effective date for the Custody Rule's amendments was March 12, 2010. Investment advisers who are subject to the surprise examination requirement must be examined by an independent public accountant by December 31, 2010.[39]

Investment advisers who are required to obtain an internal control report because they or a related person maintains client assets must do so within six months of becoming subject to the requirements. If required, investment advisers must reflect updated information in their first annual Form ADV amendment after January 1, 2011.

7. *Dodd-Frank Act*

Section 411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") adds a new Section 223 to the Advisers Act, which requires registered investment advisers to safeguard client assets over which the adviser has custody, including verification of client assets by independent public accountants, as may be prescribed by SEC rule. The SEC has not yet provided guidance as to the interplay of the new statutory provision and Rule 206(4)-7.[40]

8. *Compliance Considerations*

Advisers Act Rule 206(4)-7 requires a registered investment adviser to adopt polices and procedures that are reasonably designed to prevent violations of the Advisers Act and its rules. In the case of Rule 206(4)-2, this includes adopting controls that are reasonably designed to prevent misappropriation or misuse of client assets, developing systems and procedures to assure prompt detection of any misuse of client assets, and taking appropriate action if any misuse does occur. Among other things, the SEC directed investment advisers with custody of client assets to consider including in the policies and procedures:

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39. Investment advisers who become subject to the rule after the effective date must obtain a surprise examination within six months. *Id*. at 1469.
40. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

- Conducting background and credit checks to determine whether employees should have access (or could acquire access) to client assets.
- Requiring the authorization by more than one employee before assets can be moved within client accounts, withdrawals or transfers can be made from client account, and changes can be made to account ownership information.
- Restricting the number of employees who are permitted to interact with custodians regarding client assets and rotating personnel on a periodic basis.
- If the adviser is a qualified custodian for client assets, segregating the duties of its advisory and custodial personnel to make it easier to detect the misuse of client assets.
- Periodic testing of client account balances on the books of the adviser with the transactions and holdings reflected on the records of the custodian.
- Comparing client addresses used by the custodian with those on the records of the adviser to look for inconsistencies or patterns that could suggest misappropriation of client assets by advisory personnel.
- Including in policies and procedures the requirement that problems be brought to the attention of management. Reminding personnel not to go it alone.
- Prohibiting employees from undertaking activities that could deem them individually to have custody of client assets, such as by becoming a trustee for client assets or obtaining individual powers of attorney for clients. Alternatively, requiring that any such activities be subject to the adviser's policies and procedures and capable of being supervised for compliance by the adviser.
- Adopting procedures to ensure the accurate calculation of fees deducted from client accounts.

IX. OUTSOURCING TRADE CONFIRMATION RETENTION

A. Letter to Omgeo LLC

On August 14, 2009, the SEC's Division of Investment Management issued a no-action letter to Omgeo LLC ("Omgeo"),[41] stating that it would not recommend enforcement action under Advisers Act Rule 204-2 against investment advisers ("Adviser Participants") that outsource the maintenance and preservation of trade confirmations to Omgeo, a third-party service provider of post-trade applications through its TradeSuite and Central Trade Manager services.[42] Absent such relief, Rule 204-2 generally requires that investment advisers make and keep originals of all trade confirmations.

B. Conditions of No-Action Relief

The SEC staff conditioned its no-action relief as follows:

- Omgeo will store at least two electronic copies of all confirmations sent to Adviser Participants for not less than five years from the end of the fiscal year during which the last entry was made on the confirmation;
- At least one copy of each document will be stored in a secure facility separate from the facility used to store the other copies;
- During the retention periods specified in the Advisers Act recordkeeping rules, Adviser Participants will be able, at any time, to access confirmations sent by Omgeo and available through computers located at the Adviser Participant's office, but are not required to download and print the confirmations in order to comply with Advisers Act Rules 204-2(a)(7) and 204-2(b)(3);

41. Letter to Omgeo LLC, SEC Staff No-Action Letter (Aug. 14, 2009), available at http://www.sec.gov/divisions/investment/noaction/2009/omgeo081409.htm.
42. Pursuant to prior no-action letters, investment advisers may treat confirmations available through Omgeo as original communications for purposes of Advisers Act Rule 204-2(a)(7) and to satisfy the requirements of Advisers Act Rule 204-2(b)(3), which requires investment advisers to make and keep copies of confirmations of all transactions effected by or for the account of a client. *See* Letters to The Depository Trust Company, SEC Staff No-Action Letters (Sept. 4, 1992) and (Apr. 17, 2001).

- For at least five years from the end of the fiscal year during which the last entry was made on a confirmation, Omgeo will provide former Adviser Participants with requested documents within 24 hours of the time of a written request;
- In the event that an Adviser Participant ceases operations without making adequate provision for its continued compliance with its recordkeeping obligations under Rule 204-2(f), Omgeo will provide the SEC within 24 hours of the time of the request, without charge to the SEC, an electronic copy of any record that the Adviser Participant received through Omgeo for not less than five years after the end of the fiscal year during which the last entry was made on the confirmation;
- In the event that Omgeo ceases operations, it will make arrangements reasonably acceptable to the SEC or its staff to ensure the continued availability of documents for regulatory purposes during the remainder of the applicable recordkeeping period; and
- Omgeo's internal systems for making and keeping confirmations on behalf of Adviser Participants are required to meet all of the requirements of Rule 204-2(g) under the Advisers Act.

X. ADJUSTMENTS TO THE ACCREDITED INVESTOR STANDARD

A. Overview

Section 413 of the Dodd-Frank Act revised the "accredited investor" definition in Rules 215 and 502 under the Securities Act to exclude a natural person's primary residence from the calculation of net worth.[43]

In late July, the SEC's Division of Corporation Finance issued informal guidance clarifying that, when determining net worth for purposes of Rules 215 and 501(a)(5), the related amount of indebtedness secured by a person's primary residence up to its fair market value may also be excluded. Indebtedness secured by the

43. *See* Dodd-Frank Act *supra* note 29.

residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth.[44]

The SEC is also authorized to review the definition of "accredited investor" as applied to natural persons, and to promulgate rules adjusting the provisions of the definition that do not relate to the net worth test. Beginning on the fourth anniversary of the enactment of the Dodd-Frank Act, and not less than once every four years thereafter, the SEC is required to review the definition of "accredited investor" as applied to natural persons, and may make such adjustments, by notice and comment of rulemaking, as it deems appropriate for the protection of investors, in the public interest, and in light of the economy.

B. Compliance Considerations

Hedge funds should update their investor questionnaires to reflect the new definition. Relevant personnel should receive training on the new definition of "accredited investor," and policies and procedures should be updated.

XI. QUALIFIED CLIENT STANDARD

Similarly, Section 418 of the Dodd-Frank Act amended Section 205(e) of the Advisers Act to require the SEC by July 21, 2011, to adjust for inflation, in increments of $100,000, the dollar thresholds for "qualified client" status. This means that the scope of the exception in Advisers Action Rule 205-3 that allows investment advisers to charge performance fees to qualified clients may be narrowed. Following the required SEC rulemaking, it may be necessary for some private funds to amend their investment terms either to exclude non-qualified clients or to apply a different fee structure to such clients.

XII. "BAD BOY" DISQUALIFICATION FROM RELIANCE ON RULE 506 OF REGULATION D

By July 21, 2011, Section 926 of the Dodd-Frank Act requires the SEC to issue rules disqualifying from reliance on the private offering safe

44. *See* SEC Division of Corporation Finance Compliance and Disclosure Interpretations, Question 179.01.

harbor of Rule 506 of Regulation D any issuers that have been, or that have officers, directors, affiliates or placement agents that have been, the subject of certain civil, criminal or administrative proceedings under federal and state laws.