Investment Management Regulatory Update
February 27, 2013

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SEC Rules and Regulations

SEC Issues Guidance on New Iran Disclosure Requirements

The Iran Threat Reduction and Syria Human Rights Act of 2012 (the “ITR Act”) adds new reporting obligations for companies that are required to file periodic reports with the Securities and Exchange Commission (the “SEC”). New Section 13(r) of the Securities Exchange Act of 1934 (the “Exchange Act”) requires an SEC reporting company to disclose in its quarterly and annual reports if, during the relevant reporting period, it or any of its affiliates knowingly engaged in certain Iran-related activities—particularly investments or transactions relating to the Iranian petroleum, petrochemical or marine transport sectors—or transactions with persons designated under certain executive orders relating to the prevention of terrorism and the proliferation of weapons of mass destruction.

On December 4, 2012, the SEC published Compliance and Disclosure Interpretations (“CDIs”) related to the new disclosure requirements contained in the ITR Act. The new CDIs confirm, among other things, that:

 The new disclosure requirements apply to all quarterly and annual Exchange Act reports due after February 6, 2013.
 The term “affiliate” as used in Section 13(r) has the meaning in Exchange Act Rule 12b-2, which provides that an affiliate is “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.” This confirmation has potentially broad implications for reporting companies, as a reporting company may be required to report the activities of certain “affiliates” for which it does not exercise sufficient control as a practical matter to require their cooperation in the collection of the relevant information. For example, a reporting company controlled by a private investment fund may be required to disclose not only its own covered activities, but also any such activities engaged in by other portfolio companies controlled by the same private investment fund. An
analysis of what disclosure is required is highly fact-specific, and the SEC has not issued any formal guidance about how issuers should ensure proper disclosure in circumstances involving portfolio companies controlled by private investment funds.

For more information on the new disclosure requirements in the ITR Act and the ITR Act generally, please see the September 5, 2012 Davis Polk Client Memorandum, *New Law Requires Issuers to Disclose Certain Iran-Related Transactions* and the September 12, 2012 Davis Polk Client Memorandum, *United States Enacts Further Sanctions on Iran and Syria: the Iran Treat Reduction and Syria Human Rights Act of 2012*. In addition, for more information on the CDIs, please see the December 5, 2012 Davis Polk Client Newsflash, *SEC Issues Guidance on New Iran Disclosure Requirements*.

► See a copy of the updated CDIs (numbers 147.01 through 147.07)

**SEC Extends No-Action Relief to Broker-Dealers Who Rely on Registered Investment Advisers to Perform Customer Identification Program Obligations**

On January 11, 2013, the SEC’s Division of Trading and Markets extended previously granted no-action relief that allows broker-dealers, subject to certain conditions, to rely on registered investment advisers to perform some or all of their customer identification program (“CIP”) obligations for their shared customers.

**Background.** The CIP rule, adopted in 2003 pursuant to the USA PATRIOT Act of 2001, requires broker-dealers to adopt written programs, including risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable, as part of the broker-dealer’s anti-money laundering compliance program. Under this rule, broker-dealers may rely on certain financial institutions to perform CIP obligations for their shared customers if, among other things, the financial institution is subject to an anti-money laundering program rule (“AML program rule”) under Section 5318(h) of the Bank Secrecy Act and is federally regulated. Because the Department of Treasury’s Financial Crimes Enforcement Network (“FinCEN”) has not yet adopted an AML program rule for investment advisers, broker-dealers technically would not be permitted to rely on registered investment advisers to perform CIP obligations absent no-action relief. Accordingly, in 2004, the SEC issued a no-action letter stating that it would not recommend enforcement action under Rule 17a-8 of the Exchange Act if a broker-dealer were to treat a registered investment adviser as if it were subject to an AML program rule. At the request of the Securities Industry and Financial Markets Association (“SIFMA”), the SEC subsequently extended this no-action relief in 2005, 2006, 2008, 2010 and, subject to certain additional conditions, in 2011.

**2013 No-Action Relief.** As the SEC no-action relief granted in 2011 was set to expire on January 11, 2013, SIFMA again requested that the SEC extend the no-action relief, noting that broker-dealers rely on registered advisers to perform some or all of their CIP obligations with respect to shared customers. In response to this request, the SEC has extended the no-action relief granted in 2011 until January 11, 2015. Accordingly, the SEC will not recommend enforcement action if a broker-dealer treats an investment adviser as if it were subject to an AML program rule as long as the other conditions of the CIP rule are met and (i) the broker-dealer’s reliance on the investment adviser is reasonable under the circumstances, (ii) the investment adviser is a U.S. investment adviser registered with the SEC under the Investment Advisers Act of 1940 (the “Advisers Act”) and (iii) the investment adviser enters into a contract with the broker-dealer in which the investment adviser agrees (among other matters specified in the no-action letter) that it has implemented an anti-money laundering program that is consistent with the

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1 As discussed in the *June 2003 Investment Management Regulatory Update*, FinCEN initially proposed AML program rules under the USA PATRIOT Act for investment advisers in May 2003. The proposed rules were never implemented and, as discussed in the *December 3, 2008 Investment Management Regulatory Update*, FinCEN withdrew them in October 2008.
requirements of Section 5318(h), that it will update such program as necessary to implement changes in applicable laws and guidance and that it will disclose promptly to the broker-dealer potentially suspicious or unusual activity.

The SEC noted in the no-action letter that broker-dealers seeking to rely on this no-action position will undertake “appropriate due diligence on the investment adviser that is commensurate with the broker-dealer’s assessment of the money laundering risk presented by the investment adviser and the investment adviser’s customer base.” The SEC also indicated that such due diligence should be undertaken both at the outset of the relationship with the investment adviser and during the course of the relationship, as appropriate. In addition, the SEC noted that it expects that a broker-dealer’s assessment of the money laundering risk presented by an investment adviser and the investment adviser’s customer base would depend on the particular facts and circumstances.

► See a copy of the SEC’s 2013 no-action letter

Industry Update

**European Commission Adopts AIFMD Level 2 Regulations**

On December 19, 2012, the European Commission published the AIFMD Delegated Regulations (the “Level 2 Regulations”), which supplement the Directive on Alternative Investment Fund Managers (the “Directive”). See the **December 17, 2010 Investment Management Regulatory Update** for a detailed discussion on the Directive. In short, the Directive established a new regulatory framework for the authorization and supervision of alternative investment fund managers (“AIF Managers”) that conduct business in the European Union (the “EU”). The Directive allows AIF Managers to manage alternative investment funds (“AIFs”), including private equity funds and hedge funds, in the EU and market AIFs in the EU to “professional investors,” subject to compliance with the conditions set forth in the Directive.

The Level 2 Regulations are an extensive set of implementing measures that provide details on the framework established by the Directive. As with the Directive, the Level 2 Regulations may apply to EU AIF Managers and non-EU AIF Managers that manage or market one or more AIFs in the EU. The Level 2 Regulations are subject to a three-month scrutiny period by the European Parliament and Council and, absent any objections from these two bodies, will take effect on July 22, 2013. As of the effective date of the Level 2 Regulations, a non-EU AIF Manager cannot market AIFs in the EU unless a cooperation agreement is in place between the regulatory authorities of the relevant EU member state and the regulatory authority of a non-EU AIF Manager’s home country.

The Level 2 Regulations address, among other things, delegation, the calculation of assets under management, leverage, reporting and disclosure obligations, conflicts of interest, risk and liquidity management, the safeguarding of assets by depositaries and cooperation agreements. Additional details regarding three key aspects of the Level 2 Regulations follow—delegation, calculation of assets under management and leverage.

**Delegation**

Under the Directive, an AIF may have only one AIF Manager. An AIF Manager may, in turn, delegate certain of its functions to a third party with the requisite resources and expertise, provided that the AIF

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2 Under the Directive, all investment funds in the EU fall into one of two categories: (i) UCITS (undertakings for collective investment in transferrable securities) and (ii) AIFs. UCITS funds are governed by the UCITS Directive (2009/65/EC), are authorized for sale to the retail market and are not governed by the Directive.
Manager complies with a number of conditions (including that it notifies the relevant regulatory authorities and provides objective reasons for the delegation structure). The Directive also provides that an AIF Manager will no longer be considered the manager of an AIF if it becomes a “letter-box entity” as a result of excessive delegation of its management functions, in which case the delegate may instead be treated as the AIF Manager for purposes of the Directive. The Level 2 Regulations sets forth four examples in which an AIF Manager will be considered a letter-box entity:

- the AIF Manager no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation;
- the AIF Manager no longer has the power to carry out certain senior management functions;
- the AIF Manager loses (or cannot exercise) its contractual rights to inquire, inspect, have access to or instruct its delegates; or
- the AIF Manager delegates the performance of investment management functions to an extent that exceeds by a “substantial margin” the investment management functions performed by the AIF Manager itself. Investment management functions includes both portfolio management and risk management.

In assessing the extent of delegation, the Level 2 Regulations direct the relevant regulators to assess the entire delegation structure, taking into account the assets managed under delegation as well as certain specified qualitative criteria such as the importance of the assets managed under delegation for the risk and return profile of the AIF, the geographical and sector spread of the AIF’s investments, the AIF’s investment strategies, the AIF’s risk profile, the types of tasks delegated in relation to those retained and whether the delegate is an affiliate of the delegating AIF Manager.

The European Commission must review the application of the delegation provisions established under the Level 2 Regulations after two years and, if necessary, provide further clarity on the conditions under which an AIF Manager would be deemed a letter-box entity.

**Calculation of Assets Under Management**

The Directive includes a partial exemption for AIF Managers that directly or indirectly manage portfolios of AIFs with assets under management (“AUM”) of (i) EUR 100 million or less (including any assets acquired through the use of leverage) or (ii) EUR 500 million or less when the portfolios of the AIFs consist of other AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF. These AIF Managers are only required to register with regulators rather than comply with the full set of rules under the Directive.

The Level 2 Regulations provide guidance on how to calculate AUM for purposes of this exemption. They clarify, among other things, that AUM should be calculated by aggregating the value of all assets of the AIFs managed by the AIF Manager, including the assets of AIFs where the AIF Manager has delegated management functions to another manager but excluding assets where the AIF Manager is managing under delegation. The Level 2 Regulations do not require assets to be “double-counted” in a “master-feeder” structure, and they also exclude from the AUM calculation the assets of UCITS managed by an AIF Manager. In addition, the Level 2 Regulations explain that the value of derivative positions should be calculated by reference to the underlying assets.

Under the Level 2 Regulations, AIF Managers seeking exemption from authorization must monitor AUM on an ongoing basis and calculate AUM at least annually. If an AIF Manager exceeds the applicable exemption threshold and determines that this is not a temporary situation (i.e., the AUM is likely to remain above the applicable threshold for more than three months), then the AIF Manager must seek authorization under the Directive within 30 days.
**Leverage**

The Directive requires that an AIF Manager set a maximum level of leverage that it can employ on behalf of each AIF it manages and periodically make disclosures about its use of leverage to investors and the relevant regulatory authorities. In addition, the Directive authorizes the relevant regulatory authorities to impose limits on the level of leverage that an AIF Manager may employ. The Level 2 Regulations confirm, among other things, that an AIF’s exposure to leverage must be calculated in accordance with two methods: (i) the gross method, which is intended to capture an AIF’s overall exposure to leverage and (ii) the commitment method, which is intended to account for an AIF Manager’s hedging and netting techniques. The Level 2 Regulations also confirm that AIF Managers that employ leverage on a substantial basis, which is defined as three times the net asset value of an AIF based on the commitment method, will be subject to additional reporting obligations to regulators.

- See a copy of the Level 2 Regulations
- See a copy of the Directive

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**FinCEN Extends FBAR Filing Deadline for Certain Employees and Officers**

Federal law generally requires U.S. persons with a financial interest in, or signature authority over, a foreign financial account to file Form TD F 90-22.1, the Report of Foreign Bank and Financial Accounts (the “FBAR”) on an annual basis. On December 26, 2012, FinCEN released FinCEN Notice 2012-2, which extends the deadline to June 30, 2014 for (i) employees and officers to file an FBAR to report signature authority over foreign financial accounts of affiliates of their employers under certain circumstances and (ii) employees and officers of registered investment advisers to file FBARs to report signature authority over certain accounts in the course of their employment. This deadline had previously been extended by FinCEN Notices 2011-1, 2011-2 and 2012-1. This extension does not affect the requirement that individuals report that they have a financial interest in, or signature authority over, a foreign financial account on Schedule B to IRS Form 1040.

- See a copy of FinCEN’s notice

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**SEC Official Discusses Enforcement Priorities in the Private Fund Space**

Bruce Karpati, Chief of the SEC’s Asset Management Unit (“AMU”), discussed his views on the AMU’s current hedge fund and private equity fund enforcement priorities in two recent public appearances. The AMU, created in 2010, is a specialized unit within the SEC’s Division of Enforcement that focuses on investigating securities law violations in the asset management industry.

**Hedge Fund Enforcement Priorities.** In a speech on December 18, 2012 before the Regulatory Compliance Association, Karpati discussed the AMU’s oversight of the hedge fund industry. According to Karpati, the industry needs vigilant enforcement oversight because of certain trends and practices in the industry. In particular, he noted that there are a growing number of retail investors who are directly or indirectly exposed to hedge funds via pension plans, endowments, foundations and other retirement plans. He also noted that, looking ahead, the elimination of the prohibition on general solicitation as a result of the Jumpstart Our Business Startups Act may make it easier for unsophisticated investors to invest directly in hedge funds.

In addition, Karpati expressed concern that many hedge funds are vulnerable to fraud because their operating models create a “misalignment of incentives” between the adviser and its investors. He provided several concrete examples of this, including that (i) payment of management fees and performance fees to advisers creates an incentive to overvalue assets in order to boost compensation, (ii) advisers are under pressure to show consistently positive performance in order to attract new investors and retain existing investors, (iii) where a hedge fund’s investment strategy may benefit from an informational edge in the market, the fund’s adviser may seek this information through insider trading or
other illicit means, (iv) because some advisers control all aspects of their business, severe conflicts of interest may arise (such as improper related-party transactions or misappropriation of money) and (v) advisers may be under pressure to give preferential redemptions or side letters to certain investors.

Karpati noted that, since 2010, the SEC’s Division of Enforcement has brought over 100 cases against hedge fund managers, a significant majority of which involved valuation, conflicts of interest, performance and compliance and controls. Hedge fund advisers can expect these areas to continue to be a focus for the AMU.

**Private Equity Enforcement Priorities.** In a question and answer session on January 23, 2013 at the Private Equity International Conference, Karpati discussed the AMU’s oversight of the private equity industry and noted that it is “not unreasonable to think that the number of cases involving private equity will increase.” Karpati noted that the private equity industry has certain unique characteristics that make it susceptible to fraud. He identified a difficult fundraising environment and capital overhang as current “industry stressors” that are leading to extra pressure on returns and incentivizing advisers to engage in inappropriate marketing activity and other misconduct. In addition, he cited the following as areas of concern: (i) lack of transparency, especially with respect to the valuation of illiquid assets and the operations of portfolio companies (for example, he noted that some managers may write up assets during a fund raising period to attract potential investors and then write them down after the fund raising period closes) and (ii) conflicts of interest, which according to Karpati can lead to misappropriation, cherry picking and other misconduct. He highlighted several recent enforcement actions against private equity advisers that involved misconduct such as usurpation of investment opportunities, misallocation of expenses, misstatements to investors about performance, insider trading and inflated valuations.

Karpati also spoke about the ways in which private equity chief compliance officers (“CCOs”), chief financial officers (“CFOs”) and chief operating officers (“COOs”) can reduce the risk of SEC examinations. He noted that because these individuals are responsible for overseeing the adviser’s business, they are in the best position to detect and correct conduct that is inconsistent with the adviser’s fiduciary duties. He recommended that private equity firms integrate compliance risk into their overall risk management process and ensure that the CCOs, CFOs, COOs and other risk managers are able to proactively spot and correct situations where conflicts of interest may arise. In addition, according to Karpati, CCOs, CFOs and COOs should act as “investor advocates” and should be a part of the adviser’s important decision-making processes. For example, he noted that such officers could sit on the adviser’s investment committee in order to ensure that the firm executes transactions at arm’s length. Lastly, he recommended that private equity firms use their limited partner advisory committees to meet fiduciary responsibilities. He noted that many firms have these committees but do not use them to resolve conflicts of interest.

**Risk Analytic Initiatives.** Karpati noted that the AMU has been able to bring many of its recent cases against advisers in part because of its new risk-based investigative initiatives. These initiatives utilize data analysis and quantitative models to proactively detect misconduct. He mentioned two current initiatives: (i) the Aberrational Performance Inquiry, which focuses on suspicious hedge fund returns and (ii) the Private Equity Initiative, which seeks to identify private equity fund advisers that are at higher risk for certain fraudulent behavior. According to Karpati, managers of “zombie funds” (i.e., funds that allegedly delay liquidity of their holdings because the income derived from such holdings is their only source of revenue) will likely be targeted as part of the Private Equity Initiative.

**Best Practices.** Karpati emphasized in both public appearances that an adviser’s fiduciary duty under the Advisers Act is the lens through which the AMU looks at many of the issues it investigates. Karpati highlighted a number of “best practices” that private fund advisers should follow in order to help fulfill their fiduciary duties, including that advisers should (i) create a culture of compliance by ensuring that there is robust supervision of employees and sufficient internal controls, (ii) adopt and implement a compliance program and controls tailored to the risks and investment strategy of the particular firm, (iii) periodically review and test their compliance procedures and update them as necessary, (iv) check and monitor
traders and (v) be prepared for SEC exam inquiries, cooperate with exam staff during the examination process and correct any deficiencies or violations identified during the examination.

► See a copy of Karpati’s December 2012 speech
► See a copy of Karpati’s January 2013 Q&A remarks

SEC Expected to Move Forward with Uniform Fiduciary Standard

On January 16, 2013, Kenneth E. Bentsen Jr., executive vice president of public policy and advocacy for SIFMA, said that he expects the SEC to issue by March 31, 2013 a request for information or concept release regarding a uniform fiduciary standard for investment advisers and broker-dealers that provide personalized investment advice to retail investors. The SEC had previously indicated in its Fiscal Year 2012 Agency Financial Report that it planned to move forward with recommendations from a staff report to consider such a uniform fiduciary standard and that it would “continue assessing ways to better harmonize the regulatory requirements of investment advisers and broker-dealers when they are providing the same or substantially similar services to retail investors.”

On January 21, 2011, the SEC released its study, mandated by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), on the effectiveness of the standards of care required of broker-dealers and investment advisers providing personalized investment advice about securities to retail customers (the “Study”). As required by Section 913 of the Dodd-Frank Act, the Study also considered whether there are any regulatory gaps, shortcomings or overlaps that should be addressed by rulemaking. The Study recommended that the SEC establish a uniform fiduciary standard for broker-dealers and investment advisers that provide personalized investment advice about securities to retail customers no less stringent than currently applied under Sections 206(1) and (2) of the Advisers Act. The SEC, however, is not required to impose a uniform fiduciary standard.

For further information regarding the Study’s recommendations, see the January 24, 2011 Davis Polk Client Memorandum, SEC Study on the Fiduciary Duty of Investment Advisers and Broker-Dealers and the February 14, 2011 Investment Management Regulatory Update.

► See a copy of the Fiscal Year 2012 Agency Financial Report
► See a copy of the January 2011 SEC study

Litigation

First Circuit Considers Current and Prospective Business Relationships When Evaluating Independence of Fund Directors in Shareholder Derivative Cases

On January 4, 2013, the U.S. Court of Appeals for the First Circuit overturned a district court’s dismissal of a shareholder derivative action against an investment adviser, applying a stricter independence standard for fund directors. Unión de Empleados de Muelles de Puerto Rico PRSSA Welfare Plan v. UBS Fin. Services Inc. of Puerto Rico, No. 11-1605, 2013 WL 49818 (1st Cir. Jan. 4, 2013). This ruling signals that the current and prospective business relationships of fund directors may be considered when evaluating their independence in shareholder derivative legislation.

The plaintiffs are two Puerto Rican pension plans that owned shares of certain closed-end investment funds (the “Funds”) with identical boards of directors. According to the plaintiffs, in 2008, the Funds’ investment adviser (the “Adviser”) purchased approximately $757 million worth of bonds from a series of issuances being underwritten by an affiliated broker-dealer (the “Broker-Dealer”) and then sold these bonds to the Funds—despite there being minimal global interest in the first issuance of bonds. The bonds lost more than 10% of their value within one year of issuance, resulting in substantial losses for the Funds. The plaintiffs brought a shareholder derivative action in 2010 against the Funds’ directors, the
Adviser and the Broker-Dealer alleging that the institutional defendants had engaged in a scheme of manipulative trading aimed at manufacturing the appearance of market interest in the bonds and driving up the price of the bonds.

In order to assert a proper cause of action in a shareholder derivative suit, a shareholder must allege with particularity either that suitable demand was made on the board of directors to take corrective action or that such a demand would have been futile. The plaintiffs did not demand that the Funds’ directors take action before filing the suit on the grounds that such demand would have been futile given the relationships of a majority of the Funds’ directors with the Adviser and the Broker-Dealer. The district court dismissed the plaintiffs’ derivative claims for failure to properly plead demand futility.

In reviewing the decision of the district court de novo, the court of appeals first determined that the Delaware law demand futility test from *Rales v. Blasband*, 634 A.2d 927 (Del. 1993) was the appropriate test in this case. Under the *Rales* test, a plaintiff must allege facts creating “a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” The court of appeals then determined that, in evaluating the independence and disinterest of the Funds’ directors, the district court had focused too narrowly on whether each director had received a financial benefit from the bond transaction. Rather, according to the court of appeals, the *Rales* test requires an analysis of whether each director has such significant personal, financial or other connections to the defendants that the director could not “impartially consider [demand] without being influenced by improper considerations.”

Applying the *Rales* test to the Funds’ eleven directors, the court of appeals determined that the plaintiffs had established a reasonable doubt as to the independence and disinterest of a majority of the directors. The court concluded that four directors may have lacked the requisite independence because they were employed by the Adviser, the Broker-Dealer or one of their respective affiliates at the time that the plaintiffs’ complaint was filed. More importantly, the court further concluded that two directors, whose principal employer was the largest managed care company in Puerto Rico, also may have lacked the requisite independence. The court reasoned that the directors’ employer had enjoyed a lucrative relationship with the Adviser and the Broker-Dealer in the recent past, including engaging in a similar bond transaction as the one at issue. In addition, this prior business dealing gave the two directors particular reason to discourage scrutiny of similar related-party transactions. The court also noted that the institutional defendants were powerful actors in Puerto Rico that were heavily involved in the directors’ lives as underwriter, investor and “gate-keeper” to Puerto Rico’s capital markets. It reasoned that, in such an environment, maintaining a good relationship with the institutional defendants could yield benefits to the two directors, including assistance in future business ventures. Thus, the court concluded that the prior business dealings between the directors’ employer and the Adviser, the Broker-Dealer and their affiliates, as well as the potential for future business dealings, created a reasonable doubt as to the independence of the directors.

This ruling is notable because in evaluating fund director independence, the court of appeals looked at broader considerations of the business relationship between the fund directors and the fund adviser and how such a relationship could affect current and prospective business opportunities for the directors.

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3 Although the Funds are Puerto Rico corporations, the court of appeals looked to Delaware corporate law because (i) Puerto Rico corporate law does not specifically elaborate on the requirements of demand futility and (ii) Puerto Rico corporate law is modeled on Delaware corporate law.

4 According to the court of appeals’ opinion, the *Rales* test applies when the plaintiff challenges a board’s failure to discharge its oversight duties. The court of appeals determined that this was the appropriate test in this case because the Funds’ directors had delegated their authority to make investment decisions on behalf of the Funds to the Adviser.
While certain facts and circumstances, such as the overwhelming influence of the institutional defendants in the Puerto Rican financial markets, are particular to this case, this decision may nevertheless cause increased scrutiny of the influence that prospective business opportunities have on fund directors.

See a copy of the court’s opinion

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