

Investment Management Regulatory Update

September 2002

Treasury Proposes AML Program Guidelines for Hedge Funds

On September 18, 2002, the Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury issued a proposed rule requiring certain private investment funds not registered with the Securities and Exchange Commission as investment companies to establish an anti-money laundering (AML) program, pursuant to Section 352 of the USA PATRIOT Act. The proposed rule, which would apply to any “unregistered investment company,” would also require such entities to register with FinCEN. The term “unregistered investment company” is defined to include any 3(c)(1) or 3(c)(7) fund, commodity pool or real estate fund that has assets of at least \$1 million and a U.S. sponsor or U.S. investors, and that permits investors to redeem an ownership interest within two years of the purchase. Since most private equity and venture capital funds do not permit redemption at the option of investors, the proposed rule would apply primarily to hedge funds.

The proposed rule, if adopted, would require that each “unregistered investment company” develop and implement a written AML program reasonably designed to prevent the company from being used for money laundering or the financing of terrorist activities. The minimum requirements for the AML programs consist of the following: (1) implementation of AML policies and procedures; (2) provision for independent testing of compliance; (3) designation of an AML compliance officer; and (4) employee training. FinCEN has noted a number of issues in the proposed rule in respect of which it has requested comments, which are due on or before 60 days from publication of the proposed rule in the Federal Register. The proposed rule may be accessed at <http://www.ustreas.gov/press/releases/docs/352investmentcompanies.pdf>.

For more details regarding these proposed requirements, please refer to the Davis Polk memo “Treasury Department Proposed Regulations Regarding Anti-Money Laundering Programs for Unregistered Investment Companies” distributed on September 20, 2002. Please contact us if you would like additional copies of that memo.

SEC Proposes Proxy Voting Disclosure Requirements for Registered Funds and Advisers

The SEC is proposing changes intended to improve proxy voting policies and disclosure. A new rule targets all SEC-registered investment advisers, and new amendments to various forms target registered investment companies. In releases explaining the proposed changes, the SEC expressed concern about the enormous voting power of registered investment advisers and of mutual funds, and about the importance of acting in the best interests of the investor and of influencing corporate governance. For all SEC-registered investment advisers, new Rule 206(4)-6 under the Investment

Advisers Act of 1940 would require: (1) adoption of proxy voting policies, which must address conflict-of-interest situations; (2) disclosure of policies to clients upon request; (3) notification to clients of how to obtain information about the adviser's proxy voting of the client's securities; and (4) maintenance of books and records of proxy voting that can be examined by the SEC during inspections. For registered investment companies, changes to forms under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 would require: (1) adoption and registration statement disclosure of proxy voting policies, including a discussion of voting in situations where there is a conflict of interest between fund shareholders and the investment adviser or its affiliates; (2) detailed disclosure of the fund's proxy voting record, to be filed with the SEC; (3) disclosure in shareholder reports of any proxy votes that are inconsistent with the fund's stated policies; and (4) disclosure of information about the fund's proxy voting via a toll-free number and the fund's web site. Comments are due by December 6, 2002. The releases can be viewed at <<http://www.sec.gov/rules/proposed/ia-2059.htm>> (new investment adviser rule) and <<http://www.sec.gov/rules/proposed/33-8131.htm>> (amendments affecting registered investment companies).

SEC Sanctions Adviser for Failing to Make IPO Trading Disclosures

The SEC has sanctioned Davis Selected Advisers-NY, Inc. (Davis), a registered investment adviser, for failing to make disclosures related to its trading of securities issued in initial public offerings. The Commission alleges that during 1999 and 2000, Davis caused the Davis Growth Opportunity Fund, a series of a registered investment company for which Davis is the sub-adviser and Davis's parent is the adviser, to trade in 182 mainly technology company IPOs. In most cases, the fund held the IPO shares for only a few days. The fund did not, however, provide any specific disclosures regarding its short-term IPO trading, and the impact of that trading on the fund's performance, in its 1999 and 2000 prospectuses and other disclosure documents. According to the Commission, such disclosures were required because that trading had a significant positive effect on the fund's performance, while the fund's documents generally described its investment strategy as one of holding for the long term. The SEC found that Davis's disclosure practices violated Section 34(b) of the Investment Company Act, which makes it unlawful for any person to make materially misleading statements or omissions, and fined Davis \$10,000. The order, *In re Davis Selected Advisers-NY, Inc.*, is available at <<http://www.sec.gov/litigation/admin/ia-2055.htm>>.

FSA Seeks Comment on Hedge Fund Regulation

In a recently issued Discussion Paper, the UK's Financial Services Authority (FSA) has asked for comment from market participants and investors on whether the FSA should liberalize its regulation of hedge funds. The FSA, which regulates the financial services industry in the UK, seeks comment on current controls on the selling and marketing of hedge funds in the UK; the regulation of UK-based fund managers who manage off-shore hedge funds; and the FSA's approach to monitoring the effects of

hedge funds on UK markets. Submissions are due by November 29, 2002. The Discussion Paper may be accessed at <<http://www.fsa.gov.uk/pubs/discussion/dp16.pdf>>.

2002 Report on Registered Investment Advisers

The Investment Counsel Association of America and National Regulatory Services have issued their second annual report profiling SEC-registered investment advisers based on their electronic filings of Form ADV, Part 1. This is the first report on the industry since all investment advisers made the transition to electronic filing. The report found, among other things, that 7,581 advisers registered last year, with discretionary assets under management of \$19.7 trillion. The report also noted that 82% of SEC-registered investment advisers have reported no disciplinary history. The report, *Evolution/Revolution: A profile of the U.S. Investment Advisory Profession*, is available at <http://www.icaa.org/public/evolution-revolution_2002.pdf>.

Sarbanes-Oxley Act of 2002

Davis Polk has previously distributed to recipients of the Investment Management Regulatory Update a series of memos on this major new legislation and related SEC rules regarding topics of corporate governance and new required disclosures and certifications, including a recent memo (dated September 16, 2002) regarding registered funds. Please contact us if you would like additional copies of that memo. We will continue to distribute memos as these issues develop.

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