

A Summary of
Current Investment
Management Regulatory
Developments

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SEC Rules & Regulations

SEC Adopts Proposed Amendments to the Redemption Fee Rule and Extends Deadline for Compliance

On September 26, 2006, the SEC voted to adopt proposed amendments to Rule 22c-2, the redemption fee rule (the “Rule”), under the Investment Company Act of 1940. Originally adopted in 2005, the Rule requires most mutual funds to enter into written shareholder information-sharing agreements with intermediaries (*e.g.*, broker-dealers and retirement plan administrators) that use omnibus accounts to hold shares on behalf of other investors. Under such agreements, the intermediaries must provide certain investor information to the funds upon request, so that the funds can monitor market timing and other abusive transactions. The Rule also requires fund boards to consider whether a redemption fee policy is appropriate for their funds.

As described in greater detail in the [April 2006 Investment Management Regulatory Update](#), in February 2006 the SEC proposed three amendments to the Rule. These sought to (1) narrow the scope of intermediaries required to enter into information-sharing agreements, (2) address the Rule’s application to “chain of intermediaries” situations and (3) clarify the consequences for a fund not entering into information-sharing agreements. In its release of September 27, 2006 (the “Release”), the SEC adopted the amendments largely as proposed and, for several portions of the rule, extended the dates for compliance.

Amendments to Rule 22c-2 under the Investment Company Act are adopted largely as proposed

As originally adopted, the Rule had a compliance date of October 16, 2006. The Release extends the compliance date for the provisions of the Rule relating to information-sharing agreements by six months—*i.e.*, until April 16, 2007. The Release also extends by 12 months—*i.e.*, until October 16, 2007—the date by which funds must be able to obtain shareholder information pursuant to those agreements.

A copy of the Release is available at: <http://www.sec.gov/rules/final/2006/ic-27504.pdf>.

SEC Issues Guidance for Interim Completion of Form ADV In Wake of *Goldstein*

The SEC recently issued guidance (the “Guidance”) on how to complete certain sections of Form ADV for electronic filing with the Investment Adviser Registration Depository (the “IARD”) until the IARD is reprogrammed to reflect changes arising from *Goldstein v. Securities and Exchange Commission*, No. 04-1434, 2006 U.S. App. LEXIS 15760 (D.C. Cir. June 23, 2006), which, as discussed in greater detail in the [September 2006 Investment Management Regulatory Update](#), is viewed by the SEC as vacating not only the controversial client-counting rule, but also other related rules and interpretations promulgated in the same rulemaking, including conforming amendments to Form ADV. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004). Until the reprogramming is completed, Form ADV will continue to display the amendments that the court vacated (mostly involving references to the term “private fund”). Among these vacated rules are amendments to Form ADV Item 7.B. and Section 7.B. of Schedule D of Part IA (the “ADV Amendments”). Registered investment advisers may follow the guidelines set forth in the SEC’s Guidance pending the IARD reprogramming or may instead choose to complete Form ADV as it appears on the IARD.

References on IARD to “private fund” may be ignored in Form ADV Part IA, Item 7.B. and Section 7.B. of Schedule D of Part IA

The changes set forth in the Guidance generally permit advisers to ignore references to “private funds” in the relevant Form ADV sections. For instance, Item 7.B. currently reads: “*Are you or any related person a general partner in an investment-related limited partnership or manager of an investment-related limited liability company, or do you advise any other ‘private fund,’ as defined under SEC rule 203(b)(3)-1?*” According to the Guidance, advisers may ignore the last clause and instead read the question as follows: “*Are you or any related person a general partner in an investment-related limited partnership or manager of an investment-related limited liability company?*”

Similarly, in the first paragraph of Section 7.B. of Schedule D, the phrase “*and each other private fund that you advise*” may be ignored and the instruction read as “*You must complete a separate Schedule D Page 4 for each limited*

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partnership in which you or a related person is a general partner and each limited liability company for which you or a related person is a manager.”

Likewise, in Section 7.B. of Schedule D, advisers may ignore the reference to “private fund,” where the IARD version asks for the name of the “*Limited Partnership, Limited Liability Company, or other Private Fund.*”

In addition, among other changes, the adviser no longer needs to provide the name of the fund’s general partner or manager, but the Guidance notes that the IARD system will not accept a filing if a fund is listed but the name of the general partner or manager is simply left blank. An adviser has to write “not required” in the space provided. Advisers are also no longer required to state whether the fund listed is a “private fund.” In the last four questions in Section 7.B., the phrases “*or other private fund*” and “*or other investor*” may be ignored.

A copy of the Guidance is available at: <http://www.sec.gov/divisions/investment/iard.shtml>.

SEC Interpretations: No-Action Letters

SEC No-Action Letter Grants Relief from Auditor Independence Rules

Certain hedge fund advisers have until June 30, 2007, to comply with the SEC’s independence rules for auditors

On August 28, 2006, the SEC Division of Investment Management issued a no-action letter (the “No-Action Letter”) regarding the applicability of the SEC’s auditor independence rules for purposes of Section 206(4) of the Investment Advisers Act of 1940 (the “Advisers Act”) and Rule 206(4)-2 promulgated thereunder. The No-Action Letter granted no-action relief from the independence rules for the audits of hedge funds advised by advisers that were required to register as a result of the SEC’s controversial Rule 203(b)(3)-2 under the Advisers Act (the “Hedge Fund Rule”). *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004). This rule was vacated by the U.S. Court of Appeals for the District of Columbia Circuit on June 23, 2006, in *Goldstein v. Securities and Exchange Commission*, No. 04-1434, 2006 U.S. App. LEXIS 15760 (D.C. Cir. June 23, 2006), but

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many of the newly registered hedge fund advisers remain registered with the SEC and therefore subject to all of the Advisers Act rules. The No-Action Letter was issued in response to a letter submitted on August 2, 2006, by several auditing firms, including Deloitte & Touche LLP, BDO Seidman LLP and Ernst & Young LLP (the “Request Letter”).

Rule 206(4)-2 requires registered investment advisers, among other things, to send (or have a qualified custodian send) account statements to clients on a quarterly basis. However, Rule 206(4)-2(b)(3) (the “Audit Exception”) carves out an exception to this requirement for hedge fund advisers that arrange for an annual audit of the hedge fund and distribute the audited financial statements to its investors within 120 days of the end of the hedge fund’s fiscal year. However, auditors must be “independent” in accordance with the SEC’s independence rules. Such rules require, *inter alia*, that the auditor not have provided non-audit services to, or had certain relationships with, the hedge fund audit client.

According to the Request Letter, public accounting firms have historically applied the independence standards of the American Institute of Certified Public Accountants (the “AICPA”), which are more liberal than the SEC’s rules. Therefore, according to the Request Letter, many of the advisers that registered as a result of the Hedge Fund Rule have engaged auditors that do not meet the SEC’s independence rules. The Request Letter sought assurances that newly registered hedge fund advisers would be able to rely on the Audit Exception despite their failure to satisfy the SEC’s independence rules.

In its No-Action Letter, the SEC stated that it would not recommend enforcement action against a newly registered hedge fund adviser (or its accountant) if the adviser, for purposes of the Audit Exception:

- (1) relies on an audit of a hedge fund by an accountant that is not independent under the SEC’s standards *provided* that (a) the accountant is independent under the standards applicable to it prior to the adviser’s registration and (b) those services or relationships prohibited under the SEC’s independence rules cease no later than June 30, 2007; and

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- (2) causes the hedge fund to disclose in the footnotes to its financial statements:
 - (a) that the accountant was independent under independence standards applicable to an audit of a hedge fund prior to registration by the adviser;
 - (b) that the accountant was not independent under the SEC's independence rules;
 - (c) the general reasons why the accountant was not independent under the SEC's rules; and
 - (d) a brief description of the SEC's relief and the duration of such relief.

A copy of the No-Action Letter is available at: <http://www.sec.gov/divisions/investment/noaction/2006/deloitte082806.htm>.

SEC Enforcement Actions

SEC Censures Five Mutual Fund Advisers for Charging Excessive Fees

SEC settles charges that five advisers violated Section 205(a) of the Advisers Act

On September 7, 2006, the SEC announced the settlement of charges that five mutual fund advisers charged improper performance-based fees in violation of Section 205(a) of the Investment Advisers Act of 1940 (the "Advisers Act"). The investment advisers are Kensington Investment Group, Inc., Numeric Investors LLC, Putnam Investment Management, LLC, Gartmore Mutual Fund Capital Trust and The Dreyfus Corporation (collectively, the "Respondents").

Section 205(a) of the Advisers Act prohibits an investment adviser from entering into an advisory contract with a registered investment company that provides for performance-based compensation unless the requirements of Section 205(b) are met. Section 205(b) requires that such fees be calculated using the average value of the fund's assets over the same period that is used to measure the fund's performance.

According to the SEC, the Respondents entered into advisory contracts with multiple mutual funds that either did not specify the period over which the

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fund's assets were to be averaged for purposes of calculating the fee, or provided for performance-based fees that were not calculated for the same period over which performance was measured. As a result, the Respondents allegedly overcharged the mutual funds by approximately \$7 million in total over the period from April 1997 through December 2004. Upon notification by the SEC, each of the Respondents ceased charging the excessive fees and reimbursed the funds for the amount overcharged plus interest.

Each of the Respondents agreed to settle the SEC's charges without admitting or denying its findings. The SEC censured all of the Respondents and ordered each to cease and desist from committing future violations of Section 205(a).

Copies of the SEC's orders are available as follows:

Kensington – <http://www.sec.gov/litigation/admin/2006/ia-2545.pdf>;

Numeric – <http://www.sec.gov/litigation/admin/2006/ia-2546.pdf>;

Putnam – <http://www.sec.gov/litigation/admin/2006/ia-2547.pdf>;

Gartmore – <http://www.sec.gov/litigation/admin/2006/ia-2548.pdf>;

Dreyfus – <http://www.sec.gov/litigation/admin/2006/ia-2549.pdf>.

SEC Settles Fraud Charges against Mutual Fund Administrator in Connection with Improper Marketing Arrangements

BISYS Fund Services to pay \$21 million to settle SEC charges that it aided and abetted 27 mutual fund advisers in defrauding fund investors

On September 26, 2006, the SEC announced the settlement of fraud charges against BISYS Fund Services, Inc. ("BISYS"), which allegedly entered into improper marketing arrangements with 27 mutual fund advisers (the "Advisers"). BISYS, which is registered with the SEC as a transfer agent and which administers 50 mutual fund families with net assets totaling \$275 billion, agreed to pay more than \$21 million. BISYS is a wholly owned subsidiary of The BISYS Group Inc., a publicly traded Delaware corporation.

According to the SEC's order of settlement (the "Order"), from July 1999 to June 2004, BISYS entered into improper arrangements with the Advisers, which obligated BISYS to rebate a portion of its administration fee to the Advisers in exchange for the Advisers' continued recommendation of BISYS

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to the funds' boards of trustees. The Advisers, in turn, allegedly used such rebated fees—*i.e.*, fund assets—to pay for marketing expenses incurred by the Advisers in promoting the funds and occasionally for non-marketing expenses, such as check fraud losses, seed capital for new mutual funds and the settlement of disputes with third parties. The Advisers would ordinarily have been required to pay for such expenses with their own assets. According to the Order, pursuant to such side arrangements, which were not disclosed to the respective mutual funds' boards or shareholders (nor included in the funds' Rule 12b-1 plans), BISYS rebated to the Advisers over \$230 million from its administration fees.

Based on such conduct, the SEC found that BISYS willfully aided and abetted and caused the advisers' violations of: (1) Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, which generally prohibit fraudulent conduct by an investment adviser; and (2) Section 34(b) of the Investment Company Act of 1940 (the "40 Act"), which prohibits the making of an untrue statement of material fact in a registration statement. In addition, the SEC found that BISYS willfully aided and abetted and caused the mutual funds' violations of Section 12(b) of the 40 Act and Rule 12b-1(d) thereunder.

In settling the SEC's charges, BISYS neither admitted nor denied the SEC's findings. According to the Order, BISYS agreed to pay: (1) disgorgement of approximately \$9.7 million; (2) prejudgment interest of approximately \$1.7 million; and (3) a civil penalty of \$10 million. These payments will be placed into a distribution fund for the benefit of the harmed mutual funds. In addition, BISYS will retain an independent consultant to review and report on its policies and procedures for the receipt and payment of expenses and to review its disclosures to fund boards.

A copy of the Order is available at: <http://www.sec.gov/litigation/admin/2006/ia-2554.pdf>.

SEC Settles Charges that Fund Administrator Aided and Abetted Violations of Section 19(a) of the 40 Act by Three Closed-End Funds

Delaware Service Company, Inc. allegedly paid distributions to shareholders without providing required Section 19(a) notice

On August 31, 2006, the SEC announced the settlement of charges against Delaware Service Company, Inc. (“DSC”), which provides accounting and administrative services to open- and closed-end registered investment companies in the Delaware Investments complex. In its order (the “Order”), the SEC found that DSC had caused and aided and abetted violations of Sections 19(a) and 34(b) of the Investment Company Act of 1940 (the “40 Act”) by three closed-end funds—Delaware Investments Dividend and Income Fund, Inc., Delaware Investments Global Dividend and Income Fund, Inc. and the Lincoln National Convertible Securities Fund, Inc. (collectively, the “Funds”)—all of which are registered under the 40 Act and administered by DSC. DSC is an affiliate of Delaware Management Business Trust, a registered investment adviser.

Section 19(a) of the 40 Act prohibits a registered investment company from paying a dividend or other similar distribution from a source other than accumulated undistributed net income unless such payment is accompanied by a written statement, which adequately discloses the source of such payment (a “19(a) Notice”). The purpose of this section is to disclose to shareholders the sources from which dividend payments are made so that shareholders will not think that a mutual fund portfolio is generating investment income when, in fact, dividends are being paid from other sources such as return of capital. Rule 19a-1 requires that every 19(a) Notice clearly indicate what portion of the payment is made from: (1) net income (not including capital gains); (2) capital gains; or (3) paid-in surplus or other capital source.

According to the Order, from January 2000 through March 2004, the Funds paid a total of 98 dividends that included a return of shareholders’ capital but none of the payments were accompanied by the required 19(a) Notice. The stated objective of each Fund was to provide a steady stream of high current income and, according to the Funds’ annual reports, regular distributions would be paid at a specified annual rate.

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In March 2002, DSC also allegedly made an untrue statement of material fact when it applied to the SEC on behalf of two of the Funds for permission to distribute long-term capital gains more than once a year. DSC allegedly asserted in its application that the Funds had provided the required 19(a) Notice with each distribution. Based on such conduct, the SEC found that DSC violated Section 34(b) of the 40 Act, which renders it unlawful to make untrue statements of material fact in any application filed with the SEC.

DSC agreed to settle the SEC's charges without admitting or denying its findings. The SEC ordered DSC to: (1) cease and desist from further violations of Sections 34(b) and 19(a) of the 40 Act and Rule 19a-1 promulgated thereunder; and (2) pay a civil penalty of \$425,000.

A copy of the Order is available at: <http://www.sec.gov/litigation/admin/2006/ic-27473.pdf>.

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