July 2006

DAVIS POLK & WARDWELL

Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

Contents

SEC Rules & Regulations

SEC Adopts Three New Fund of Funds Rules and Five Amendments to 40 Act Registration Forms to Provide Greater Transparency of Expenses

On June 20, 2006, the SEC adopted three new rules — Rules 12d1-1, 12d1-2 and 12d1-3 (collectively, the "New Rules") — and amended five registration statement forms — Forms N-1A, N-2, N-3, N-4 and N-6 — (collectively, the "New Amendments") under the Investment Company Act of 1940 ("40 Act") to address fund of funds arrangements. The New Rules become effective on July 31, 2006, and registration statements on Forms N-1A, N-2, N-3, N-4 or N-6, and post-effective amendments that are annual updates to effective registration statements on such forms, must include the new disclosure if filed on or after January 2, 2007.

A "fund of funds" arrangement occurs when one fund invests in the shares of another fund. The New Rules codify, with certain modifications, exemptions that the SEC has issued over the past decade and broaden the ability of a fund to enter into certain fund of funds arrangements.

SEC codifies previously issued exemptions under the 40 Act in new Rules 12d1-1, 12d1-2 and 12d1-3 and amends registration forms to provide more disclosure of fund of fund expenses

Rule 12d1-1 will generally permit a fund to invest in shares of money market funds in excess of the ownership limits of Section 12(d)(1)(a) and (b) of the 40 Act and thereby permit so-called "cash sweep" arrangements in which a fund invests all or some of its cash in a money market fund rather than directly in short-term instruments. Under Rule 12d1-1, a fund (including open-end funds, closed-end funds, unregistered funds and business development companies) may invest an unlimited amount of cash in a money market fund (including certain unregistered money market funds) regardless of whether the money market fund is in the same or in a different fund complex, subject to certain conditions. One condition precludes an acquiring fund from paying a sales load, distribution fee or service fee on acquired money market fund shares, unless the acquiring fund's investment adviser waives a portion of its advisory fee to offset the cost of such loads or fees. Rule 12d1-1 also provides exemptions from the affiliate- and joint-transaction limitations of Section 17(a), Section 57 and Rule 17d-1 in order to permit such cash-sweep arrangements.

Rule 12d1-2 codifies three types of exemptive relief that the SEC has provided with respect to investments by registered open-end funds and unit investment trusts ("UITs") in shares of other registered open-end funds and UITs that are part of the same complex as the acquiring fund, as permitted by Section 12(d)(1)(G) of the 40 Act. First, Rule 12d1-2 will permit an "affiliated fund of funds" — *i.e.*, a registered open-end fund or UIT that acquires shares of other registered open-end funds and UITs that are part of the same fund complex — to acquire securities of funds that are not part of the same fund complex, subject to the ownership limitations of Section 12(d)(1)(A) or 12(d)(1)(F). Second, Rule 12d1-2 will permit an affiliated fund of funds, subject to certain restrictions, to invest directly in stocks, bonds and other types of securities, thereby providing an exemption from the requirement of Section 12(d)(1)(G) that an affiliated fund of funds invest only in affiliated funds, government securities and short-term paper. Third, Rule 12d1-2 will permit an affiliated fund of funds to invest in affiliated or unaffiliated money market funds in reliance on, and subject to the conditions of, Rule 12d1-1, which is described above.

Finally, Rule 12d1-3 will permit a fund that invests small amounts in many unaffiliated funds under Section 12(d)(1)(F) to charge, subject to certain limitations, a sales load greater than the 1.5-percent load allowed by Section 12(d)(1)(F). Specifically, the Rule will allow such a fund to charge a higher sales load provided that the aggregate sales load (*i.e.*, the combined distribution expenses of both the fund of funds and the underlying funds) paid by an investor does not exceed the sales-load cap established by the National Association of Securities Dealers ("NASD") for funds of funds (regardless of whether sales of the fund's shares by broker-dealers would otherwise be subject to the NASD cap).

The New Amendments, in turn, seek to increase the transparency of expenses involved in fund of funds arrangements. Specifically, they amend Forms N-1A and N-2 (applicable to open-end and closed-end funds, respectively) and Forms N-3, N-4 and N-6 (applicable to separate accounts) to require generally that a registered fund which invests any of its assets in another fund disclose as a line item in its fee table its *pro rata* share of the cumulative amount of expenses charged by the funds in which it invests.

A copy of the Release is available at: http://www.sec.gov/rules/final/2006/33-8713.pdf.

SEC Interpretations: No-Action Letters

SEC No-Action Letter Provides Guidance Regarding Principal Trades Under Section 206(3) of the Advisers Act

SEC Staff indicate that Section 206(3) consent requirements are not triggered in cross trades between a client account and an account of which the investment adviser owns 25 percent or less

On June 7, 2006, the SEC Division of Investment Management issued a no-action letter regarding cross trades under Section 206(3) of the Investment Advisers Act of 1940, as amended ("Advisers Act") in response to two letters submitted by Gardner Russo & Gardner ("GRG"), an investment adviser, dated June 6, 2006 and May 3, 2005. In its letters, GRG sought assurances that cross trades between a client account and an account in which the general partner of the adviser had an interest would not be treated as principal trades under Section 206(3), which imposes prior disclosure and consent requirements on any adviser that acts as principal in a transaction with a client. The SEC concluded that, in light of the specific facts presented by GRG, the proposed cross transactions would not be subject to Section 206(3).

The facts presented are as follows. GRG, a general partnership, acts as investment manager to various client accounts, including two private investment funds, Semper Vic Partners, L.P. ("Semper Vic") and Semper Vic Partners (QP), L.P. ("Semper Vic QP" and, together with Semper Vic, the "Private Funds"). A general partner (the "Partner") of GRG is also the sole general partner and portfolio manager of each Private Fund. The Partner has a 6.237-percent ownership interest in Semper Vic and a 1.4405-percent ownership interest in Semper Vic QP. Neither GRG nor any employee of GRG (other than the Partner) has an ownership interest in the Private Funds. Because GRG sometimes disposes of a particular security for one account and then acquires the same security for another account, GRG wants to cross the trades of a Private Fund with another account that it manages (including another Private Fund) without having to comply with the notice and consent requirements of Section 203(6). GRG would not receive additional compensation for effecting these cross trades.

Among other things, Section 206(3) of the Advisers Act renders it unlawful for any investment adviser who is "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." Given the potential for self-dealing when an investment adviser acts as principal in a transaction with its client, Section 206(3) requires transaction-by-transaction disclosure to, and consent by, a client prior to the completion of each principal transaction.

In its no-action letter, the SEC stated that it imputes ownership interests of a controlling person of an adviser to the adviser. Nonetheless, it concluded that Section 206(3) "would not apply to a cross transaction between a client account and an account of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less." (The SEC specifically left open the question of Section 206(3)'s applicability to trades with an account in which non-controlling personnel of the adviser have an interest.) Based on the facts presented and specifically because the Partner's ownership interests in the Private Funds fell below 25 percent and neither GRG nor any GRG employee (other than the Partner) owned an interest in the Private Funds, the SEC found that GRG's proposed cross transactions would not implicate Section 206(3). In so doing, the SEC referred to its Letter to the American Bar Association, dated December 8, 2005, in which it stated that the applicability of Section 206(3) to such cross transactions depends on the facts and circumstances, including the relationship of the personnel to the investment adviser and the extent of the ownership interest of the investment adviser and/or its personnel in the account.

Although concluding that Section 206(3) was inapplicable to the facts presented by GRG, the SEC highlighted that the ownership of interests in an account amounting to 25 percent or less by an investment adviser and/or its controlling persons nevertheless creates the "opportunity for significant conflicts of interest." (In terms of aggregating ownership interests of controlling persons, the SEC noted that, in some cases, it may be necessary to count interests held by family members.) The SEC therefore noted that GRG's cross transactions may be subject to Sections 206(1) and (2) of the Advisers Act, which require an investment adviser to provide full and fair disclosure to its clients. Moreover, despite the 25 percent threshold it articulated, the SEC noted that GRG may choose to impose more stringent standards and "choose to provide written disclosure to its clients, before the completion of the transaction, of the capacity in which GRG is acting and obtain the consent of its clients, even when GRG and/or a controlling person of GRG own(s) 25% or less of that account."

A copy of the no-action letter is available at: http://www.sec.gov/divisions/investment/noaction/gardner060706.htm.

SEC Enforcement Actions

SEC Settles Charges that an Investment Adviser and its Director/Head of Compliance Misrepresented the Results of an SEC Examination to Potential Investors

Investment adviser CapitalWorks is censured and fined for allegedly failing to disclose existence of SEC deficiency letter in RFPs

On June 6, 2006, the SEC announced the settlement of fraud charges brought under the Investment Advisers Act of 1940 ("Advisers Act") against CapitalWorks Investment Partners LLC ("CapitalWorks"), a San Diego-based registered investment adviser, and Mark J. Correnti (together with CapitalWorks, "defendants"), a principal of CapitalWorks' parent company, the Director of Client Service and Marketing at CapitalWorks and, until March 2005, its head of compliance. The charges alleged that CapitalWorks violated the antifraud provisions of the Advisers Act and Rule 206(4)-7 thereunder and that Correnti aided and abetted these violations.

In its order, the SEC found that, between August 2002 and December 2004, CapitalWorks violated Sections 206(2) and (4) of the Advisers Act by making false and misleading statements in responses to requests for proposals ("RFPs") regarding the results of an SEC examination. Section 206(2) prohibits the use of interstate commerce by an investment adviser to operate a fraud or deceit on any client. Section 206(4) prohibits an investment adviser from using interstate commerce to engage in any practice determined by the SEC to be fraudulent, deceptive or manipulative.

According to the SEC's findings, despite a July 2002 examination by the SEC that resulted in a deficiency letter which identified problems relating to CapitalWorks' advertising, marketing and performance, custody of client assets, assignment of advisory contracts and internal controls, CapitalWorks failed to disclose the deficiency letter in 12 responses to RFPs. In 10 such responses, the SEC found, CapitalWorks affirmatively stated that "[t]he SEC did not find any deficiencies and required no follow-up actions" or that "[n]o violations were found." The SEC further found that, as Director of Client Service and Marketing, Correnti approved and was ultimately responsible for these responses. Despite being informed of these false statements during an August 2004 examination by the SEC, Correnti allegedly approved another false response by CapitalWorks after that date. Moreover, the SEC found that CapitalWorks failed to adopt written procedures that would have addressed the SEC's concerns until April 2005 and thus violated Rule 206(4)-7, which required investment advisers to adopt and implement by October 5, 2005 written compliance procedures designed to prevent Advisers Act violations.

The defendants settled the charges without admitting or denying the SEC's findings. In addition to censuring the defendants, the SEC ordered CapitalWorks and Correnti to pay a civil penalty of $40,000 and $25,000, respectively, and to cease and desist from future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder. Moreover, CapitalWorks is required to retain an independent consultant to review quarterly for a two-year period its compliance with written policies and procedures for responding to RFPs. At the end of each quarterly review, the independent consultant must submit to both CapitalWorks and the SEC a report describing the review, its conclusions and any recommendations with which

CapitalWorks must comply. Among other things, CapitalWorks is also required for a period of 12 months to provide a copy of the SEC's order to all prospective investment advisory clients not less than 48 hours prior to entering into any oral or written investment advisory contract.

The SEC's order is available at: http://www.sec.gov/litigation/admin/2006/ia-2520.pdf.

Industry Update

Update on the D.C. Circuit's Decision Vacating the Hedge Fund Rule

Democrats in the House of Representatives seek to reverse the court's decision

As reported in the Client Newsflash, *IMG Bulletin: Controversial SEC Hedge Fund Adviser Registration Rule is Vacated*, on June 23, 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the rule regarding the registration of hedge fund advisers ("Hedge Fund Rule"), Rule 203(b)(3)-2 promulgated under the Investment Advisers Act of 1940 ("Advisers Act"). *Goldstein v. SEC*, No. 04-1434 (D.C. Cir. 2006). The court held that it was arbitrary for the SEC to deem an adviser's "client" to include investors in a hedge fund managed by the adviser as well as the hedge fund itself.

Consistent with the applicable rules of appellate procedure, the court entered judgment against the SEC but stayed the issuance of its mandate until seven days after the disposition of any timely petition for a rehearing or a rehearing *en banc*. (Upon issuance of the mandate, the court's judgment will become final and the parties' obligations thereunder fixed.) To be timely, the SEC must seek a rehearing (or a rehearing *en banc*) within 45 days of entry of the judgment or seek an extension of this time period. If the SEC does file a timely petition for rehearing, the mandate would be stayed until the court has disposed of the petition. Similarly, under the applicable appellate rules, the SEC could move for a stay (for example, in order to permit it time to seek review by the Supreme Court), in which case the mandate would be stayed until the court had disposed of the motion. If the SEC does not move for a further stay and does not petition for rehearing, then, under applicable appellate rules, the mandate will issue seven days after the period in which to make such a petition expires. Thus, barring affirmative action by the SEC (or further action by the court), the court's mandate will issue automatically 52 days after entry of judgment — *i.e.*, on August 14, 2006.

Separately, on June 29, 2006, Democrats in the House of Representatives introduced a bill designed to reverse the court's decision in *SEC v. Goldstein*. Specifically, the bill would give the SEC the authority to require that "certain shareholders, partners, and beneficial owners of, or investors in, clients of the adviser . . . also be counted as clients themselves for purposes of [registration], as the Commission determines necessary in the public interest or for the protection of investors." According to Rep. Barney Frank (D., Mass.), "[g]iven the increasing size of hedge funds and the growing role they are playing in the economy, it would be a grave error to allow the court decision denying any authority by the SEC to stand."

A copy of the bill is available at: http://www.house.gov/banking_democrats/HR5712hedgefundbill.pdf. A copy of the statement announcing the bill is available at: http://www.house.gov/banking_democrats/pr06282006.html.

Senate Judiciary Committee Holds Hearing on "Hedge Funds and Independent Analysts: How Independent are Their Relationships?"

Testimony calls for increased hedge fund oversight and regulation

On June 28, 2006, the Senate Committee on the Judiciary met to examine the relationship between hedge funds and independent analysts. The Judiciary Committee focused on whether certain independent analysts and hedge fund principals are improperly colluding to reap profits from the hedge funds' short selling activities. Judiciary Committee Chairman Arlen Specter (R., Pa.) was joined by Ranking Member Patrick Leahy (D., Vt.), Sen. Orrin Hatch (R., Utah) and Sen. Charles Schumer (D., N.Y.), among other committee members. Three current or former government and seven private sector witnesses testified.

The Judiciary Committee hearing focused on the testimony of several "whistle-blowers," who had previously claimed or investigated alleged hedge fund improprieties. Former SEC investigator Gary Aguirre allegedly had conducted an SEC investigation of suspected insider trading and market manipulation by one of the nation's largest hedge funds, Pequot Capital Management. According to Aguirre, he was fired when his investigation led him to a former senior Wall Street executive. Pequot has vigorously denied any wrongdoing and Aguirre's allegations have not been proven.

Demetrios Anifantis, the former client relationship manager at Camelback Research Alliance, Inc., alleged that he was fired for asking questions about practices at Camelback, an independent research firm (now known as Gradient Analytics, Inc.). He testified that Camelback management produced misleading and biased research reports for payment in the interest of improving the short positions of the hedge fund clients paying for such reports. Once again, these allegations have not been proven.

Kim Blickenstaff, the chairman and chief executive officer of Biosite, Inc., testified that Biosite investors were harmed by several false and misleading research reports. In Blickenstaff's view, "the unregulated activities of independent research firms and their possible links to hedge funds merits [sic] further investigation."

The Judiciary Committee also heard testimony calling for greater transparency and stronger government oversight of the hedge fund industry, especially following the D.C. Circuit Court of Appeals' decision in *Goldstein v. SEC* on June 23 vacating the SEC's hedge fund adviser registration rule. Connecticut Attorney General Richard Blumenthal testified that, "after the court of appeals' decision . . . hedge funds are a regulatory black hole — lacking even minimal disclosure and accountability required of mutual funds and other similar institutions."

Sen. Specter focused on the rapidly growing influence of hedge funds as market participants and indicated that the potential market impact of fraud in this arena warranted further inquiry. The meeting was adjourned without an indication of further action.

A copy of the testimony of each hearing participant is available at: http://judiciary.senate.gov/hearing.cfm?id=1972.

SEC Files Status Report and Issues Request for Additional Comment on Mutual Fund Governance Rules

SEC seeks comment on controversial mutual fund governance rules that were vacated by the D.C. Circuit in April for violations of the APA

On June 13, 2006, another chapter in the tortuous history of the SEC's mutual fund governance rules unfolded. The SEC issued a request for additional comment on the rules (the "Request") and separately filed a status report with the U.S. Court of Appeals for the District of Columbia Circuit. As discussed in the *April 2006 Investment Management Regulatory Update*, on April 7, 2006, the court vacated two controversial provisions of the mutual fund governance rules promulgated by the SEC, which the U.S. Chamber of Commerce (the "Chamber") has twice challenged since their July 2004 adoption. The provisions at issue would impose two conditions on investment companies relying on certain exemptive rules under the Investment Company Act of 1940 — namely, (i) at least 75 percent of the directors on such mutual fund's board must be independent and (ii) the board of such fund must have an independent chair.

In its April 7 ruling, the court found that the SEC's process on remand from a June 2005 ruling again violated the Administrative Procedure Act ("APA"). Rather than re-opening the public record to determine the costs of the two provisions and to consider alternatives, the SEC used information that was already in the record and that was publicly available to estimate the costs of compliance. Based on this review, the SEC then decided not to modify the two provisions. The court found the SEC's procedure on remand to be inadequate and therefore vacated the provisions. However, the court gave the SEC 90 days within which to reopen the record for public comment on the costs of compliance and within which it had to file a status report with the court.

According to an SEC release (the "Release") also issued on June 13, the status report, which was filed 23 days ahead of schedule, states that the SEC is soliciting comment on costs as well as "any issue related to the underlying purpose of the independence requirements, which is the protection of funds and fund shareholders."

In its Request, the SEC asks for "comment on the costs associated with the two conditions, and suggestions for additional provisions designed to achieve the underlying purpose of the amendments." Specifically, the SEC seeks comment on (i) the accuracy of cost estimates previously used by the SEC, (ii) "current cost data, including such items as implementation data for funds that have voluntarily complied with either or both of the conditions," (iii) "any other costs that funds may incur, in coming into compliance with the two conditions, that were not identified" previously and (iv) "costs incurred by small fund groups," in particular. With respect to the 75-percent provision, the SEC requests comment on the costs of hiring and recruiting independent directors and the need for additional resources to support the independent directors. With respect to the independent chair provision, the SEC asks for information regarding the costs of hiring and compensating an independent chair and of additional staff and legal services. Comment is sought as to monetary and non-monetary, industry-wide and individual fund costs. Finally, the Request solicits comment on any issue related to whether the rules "promote efficiency, competition, and capital formation."

In its Request, the SEC instructs that comments should be sent by one of the following methods — Internet comment form (http://www.sec.gov/rules/proposed.shtml), e-mail to rule-comments@sec.gov, use of the Federal eRulemaking Portal (http://www.regulations.gov) or paper comments sent in triplicate to the SEC Secretary. The deadline for comments is August 21, 2006.

A copy of the Request is available at: http://www.sec.gov/rules/proposed/2006/ic-27395.pdf. A copy of the Release is available at: http://www.sec.gov/news/press/2006-95.htm.

Senior OCIE Official Identifies Primary Concerns During Mutual Fund Examinations: Costs, Conflicts & Compliance

SEC Associate Director Gene Gohlke discusses problems with costs, conflicts and compliance found during last year's mutual fund examinations

On June 7, 2006, in comments made to mutual fund directors and chief compliance officers during the Mutual Fund Trading Practices and Best Execution Workshop in Chicago, Gene Gohlke, associate director in the SEC's Office of Compliance Inspection and Examinations ("OCIE"), identified costs, conflicts of interest and compliance as the primary areas of concern in mutual fund examinations. The workshop was sponsored by the Mutual Fund Directors

Forum and hosted by the Northwestern University School of Law.

According to Gohlke, OCIE examiners generally seek assurances that (i) investor assets are protected from excessive trading fees, (ii) no relationships exist that would compromise the fund's integrity or performance and (iii) effective compliance systems are in place. With respect to costs, Gohlke said that the OCIE wants to see funds using assets prudently and reporting costs fairly and transparently.

Regarding conflicts, Gohlke acknowledged the significant potential for conflicts in the current environment and highlighted those involving "soft dollar arrangements" — *i.e.*, arrangements in which an adviser receives certain products or services (other than execution of securities transactions) from a broker-dealer in exchange for directing brokerage to such broker-dealer. According to Gohlke, OCIE examiners also focus on conflicts that arise from transactions linked to affiliated entities.

Regarding compliance matters, Gohlke stressed the importance of examination targets and effective compliance programs that are consistent with SEC guidelines.

Gohlke added that the OCIE found deficiencies in each of the three areas of interest — costs, conflicts and compliance — during last year's examinations. Of the 500 mutual fund groups examined (*i.e.*, approximately half of the fund universe), Gohlke said that 75 funds, or approximately 14 percent, had problems with "brokerage arrangements, execution and trading practices." Of these, a large number had questionable relationships that affected trading and approximately half had deficient control environments. In addition, according to Gohlke, the OCIE found a significant number of inappropriate affiliated entity transactions and several undisclosed conflicts of interest.

A copy of Gohlke's comments was not available at press time.

Contacts

If you have questions about the foregoing, please contact the following:

Marlene Alva
212-450-4467
marlene.alva@dpw.com

Nora Jordan
212-450-4684
nora.jordan@dpw.com

Yukako Kawata
212-450-4896
yukako.kawata@dpw.com

Leor Landa
212-450-6160
leor.landa@dpw.com

Danforth Townley
212-450-4240
danforth.townley@dpw.com

Caroline Adams
212-450-4061
caroline.adams@dpw.com

Gregory Rowland
212-450-4930
gregory.rowland@dpw.com