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DAVIS POLK & WARDWELL

Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

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SEC Rules & Regulations

SEC Adopts Investment Company Act Rules For Business Development Companies and Reproposes Additional Rule

On October 25, 2006, the SEC adopted Rule 2a-46 and Rule 55a-1 (the "New Rules") under the Investment Company Act of 1940 (the "40 Act") to expand the definition of "eligible portfolio company" and thus give business development companies ("BDCs") greater flexibility in making investments. The New Rules take effect on November 30, 2006.

BDCs were created by the Small Business Investment Initiative Act of 1980 to provide capital to small, developing and financially troubled companies and are a type of closed-end investment company. Section 55(a) of the 40 Act generally requires BDCs to invest at least 70% of their assets in securities of certain issuers, including eligible portfolio companies. Section 2(a)(46) of the 40 Act defines an eligible portfolio company to include any U.S. operating issuer that "does not have any class of securities with respect to which a member of a national securities exchange, broker, or dealer may extend or maintain credit to or for a customer pursuant to rules or regulations adopted by the Board of Governors of the Federal Reserve System under Section 7 of the Securities Exchange Act of 1934 [*i.e.*, a margin security]." However, as the Federal Reserve Board has expanded the definition of margin security, the definition of eligible portfolio company and, with it, the investment opportunities for BDCs, have narrowed significantly.

> SEC adopts Rule 2a-46 and Rule 55a-1, which expand the definition of "eligible portfolio company"

Originally proposed in November 2004 as described in greater detail in the *December 2004 Investment Management Regulatory Update*, the New Rules are intended to align more closely the permissible investment activities of BDCs with Congress's original purpose in creating them. Originally proposed as Rule 2a-46(a), Rule 2a-46 re-defines "eligible portfolio company" to include "all private companies and public companies whose securities are not listed on a [national securities exchange]." The SEC estimates that 61.4% of all public domestic operating companies qualify as eligible portfolio companies under this New Rule and therefore is of the view that Rule 2a-46 meets the stated purpose of promoting the flow of capital through BDCs.

As adopted, Rule 55a-1 allows a BDC, in certain circumstances, to include in its 70% allotment follow-on investments in a company which qualified as an eligible portfolio company under Rule 2a-46 at the time of the BDC's initial investment, but which does not meet that definition at the time of the follow-on investment.

In addition to adopting the New Rules, the SEC revised and re-proposed Rule 2a-46(b) for additional comment. The SEC is seeking comment on different alternatives for Rule 2a-46(b), which would further expand the definition of eligible portfolio company to include certain companies with securities listed on a national securities exchange. The alternatives are:

(1) companies whose public float is less than $75 million; and

(2) companies whose market capitalization is less than either $150 million or $250 million.

Comments should be received on or before January 2, 2007.

A copy of the release adopting the New Rules is available at: http://www.sec.gov/rules/final/2006/ic-27538.pdf. A copy of the re-proposal release is available at: http://www.sec.gov/rules/proposed/2006/ic-27539.pdf.

SEC Enforcement Actions

SEC Settles Charges that Investment Advisers Failed to Disclose Adequately Possible Conflicts of Interest Over Revenue Sharing Practices

On September 28, 2006, the SEC announced the settlement of charges that Deutsche Investment Management Americas, Inc. ("DIMA"), Deutsche Asset Management, Inc. ("DAMI") and Scudder Distributors Inc. ("SDI" and, collectively, the "Respondents") failed to disclose adequately certain material facts, including potential conflicts of interest arising from SDI's revenue sharing arrangements. DIMA and DAMI serve as investment advisers, both of which are registered with the SEC, to the Deutsche/Scudder Family of Funds Complex (the "Funds"). SDI, a registered broker-dealer, serves as principal underwriter to, and distributor of the shares of, most of the U.S.-registered Funds.

Deutsche Investment Management Americas, Inc., Deutsche Asset Management, Inc. and Scudder Distributors Inc. agree to pay over $19.3 million

According to the SEC's order (the "Order"), between January 1, 2001, and October 2003, SDI entered into revenue sharing agreements (also known as "shelf space" agreements) with broker-dealers to gain additional exposure for the Funds. These agreements provided for placement on preferred fund lists, increased access to broker-dealers' registered representatives and placement on websites, among other things. SDI agreed to pay cash for these arrangements but entered into oral agreements with 18 broker-dealers to direct brokerage commissions on transactions that DIMA and DAMI placed for the Funds to particular broker-dealers and, in exchange, the broker-dealers agreed to reduce the Respondents' revenue sharing obligations to the broker-dealers.

According to the SEC, broker-dealers often required SDI to direct more in brokerage commission dollars than it otherwise would have been required to pay in cash. By using directed brokerage, which is a Fund asset, the Respondents avoided having to pay their revenue sharing obligations with their own assets. Therefore, according to the SEC, such arrangements created conflicts of interest which DIMA and DAMI, as fiduciaries, had a duty to disclose to the Funds' boards and shareholders. DIMA and DAMI allegedly failed to communicate such conflicts adequately.

Based on such conduct, the SEC found that DIMA and DAMI violated, and SDI aided and abetted violations of, Section 206(2) of the Investment Advisers Act of 1940 (the "Advisers Act"), which prohibits investment advisers from perpetrating fraud on any client. In addition, the SEC concluded that DIMA and DAMI violated Section 34(b) of the Investment Company Act of 1940 (the "40 Act") by making untrue or materially misleading statements in a registration statement.

In addition, the SEC found that the Respondents failed to ensure that the brokerage commissions used to satisfy their revenue sharing obligations came from the same Funds that were promoted in connection with the revenue sharing agreements. Thus, the SEC found that the Respondents willfully violated Section 17(d) of the 40 Act, which prohibits joint profit-sharing plans in certain circumstances.

The Respondents neither admitted nor denied the SEC's findings. The SEC censured the Respondents and ordered them to cease and desist from future violations of Section 206(2) of the Advisers Act and Section 17(d) of the 40 Act and Rule 17d-1 thereunder. DIMA and DAMI were also ordered to cease and desist from violations of Section 34(b) of the 40 Act. The SEC ordered the Respondents to pay, jointly and severally, disgorgement of $14,223,493, prejudgment interest of $2,106,236 and a civil penalty of $3,000,000, as well as to comply with certain remedial undertakings.

A copy of the SEC's Order is available at: http://www.sec.gov/litigation/admin/2006/34-54529.pdf.

Other Enforcement Actions

NASD Settles Improper Market-Timing Charges Against Individual Hedge Fund Manager and Registered Broker

Hedge fund manager to pay $2.25 million, the NASD's largest market-timing fine ever levied against an individual

On October 24, 2006, the National Association of Securities Dealers (the "NASD") announced that Paul Saunders, a registered broker and hedge fund adviser, agreed to pay $2.25 million to settle charges that he engaged in improper market timing in the trading of mutual funds through the use of variable annuity sub-accounts. Saunders is the chairman, chief executive officer and majority owner of James River Capital Corp. ("James River"), which is the general partner of Jazzman, a hedge fund that was allegedly created to engage in market timing. The NASD found that Saunders, by acting in a manner inconsistent with high standards of commercial honor and just and equitable principles of trade, violated NASD Rule 2110.

According to the NASD's Letter of Acceptance, Waiver and Consent (the "LOA"), Saunders directed James River to create 19 limited partnerships under

Jazzman (the "Jazzman LPs") in order to engage in market-timing activities undetected and, from October 2001 through September 2003, Jazzman executed approximately 1,000 trades in variable annuity transactions. Despite having distinct names and tax identification numbers, the Jazzman LPs were, in fact, all under Saunders' ownership and control, according to the NASD. By concealing the common ownership and control of these entities from the insurance companies that offered the variable annuities and using various deceptive practices, Saunders was allegedly able to circumvent the market-timing restrictions set forth in the insurance companies' prospectuses. Among the allegedly deceptive practices was Saunders' practice of obtaining multiple contracts in the same variable annuity but using different annuitants, which were always employees of entities that Saunders controlled.

Without admitting or denying the charges, Saunders agreed to be suspended for 60 days and to pay a $2,250,000 fine, including $750,000 of disgorgement.

A copy of the NASD's LOA is available at: http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_017688.pdf.

Industry Update

U.K.'s Alternative Investment Management Association Issues Guidance on Disclosure of Hedge Fund Side Letters

On September 27, 2006, the U.K.'s Alternative Investment Management Association (the "AIMA") issued an Industry Guidance Note (the "Guidance Note") concerning the disclosure of hedge fund side letter arrangements. On October 24, 2006, after consulting with the U.K. Financial Services Authority ("FSA"), AIMA issued Supplement No. 1 to the Guidance Note (the "Supplement"). AIMA is a U.K.-based trade association, not a regulatory body, and, as such, its guidance is not binding and does not provide a safe harbor from FSA rules. However, the Guidance Note addresses some of the same concerns previously expressed by the FSA (for example, in its Feedback Statement

06/2, issued in March 2006) about the failure to disclose the existence of certain side letters. In addition, according to the Guidance Note, the FSA has confirmed that it will take AIMA's guidance into account in its rulemaking.

The Guidance Note requires disclosure of the existence of side letters that contain "material terms" via a brief description of such terms. The Guidance Note defines a "material term" as:

AIMA Guidance Note states that side letters containing "material terms" must be disclosed to hedge fund investors

> "[a]ny term the effect of which might reasonably be expected to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investor's ability either (i) to redeem shares or interests of that class or (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage in connection with the exercise of their redemption rights."

According to the Guidance Note, material terms include preferential redemption rights and "key man" provisions, while non-material terms include fee rebates and "most favored nation" clauses. AIMA's focus on preferential redemption and information rights echoes concerns recently expressed by the SEC, as discussed in greater detail in the *August 2006 Investment Management Regulatory Update*. In this way, the Guidance Note and the clarifying Supplement may provide some indication of where the SEC is headed in its approach to side letters.

According to the Supplement, the disclosure requirement applies only to firms which are both:

> "(1) FSA-regulated discretionary investment managers which employ hedge fund techniques; and
> (2) authoritative sources of information for fund investors on the investment strategy, risk profile, and related matters affecting the relevant fund."

A discretionary investment manager will be considered an "authoritative source of information" only if it is "primarily responsible for generating the substance of such information." The disclosure requirement applies to discretionary investment managers regardless of whether they publish such information to fund investors directly or indirectly via third parties.

According to the Supplement, the disclosure requirement does not apply to managers of funds of hedge funds or managers who do not exercise investment discretion over fund assets. The Supplement also clarifies that a firm does not need to disclose merely because it is a party to a side letter if it is not itself an "authoritative source of information" — in other words, no disclosure would be required by a firm where its affiliated investment manager (*e.g.*, a U.S. or other non-U.K. affiliate) is actually the authoritative source of information.

The Supplement also sets out several "grey areas" regarding which AIMA intends to continue its dialogue with the FSA. These grey areas include:

> "(1) where a firm (a) is not a party to certain side letters but is aware that a fund of which an affiliated entity is the investment manager is a party to them, (b) is an authoritative source of information [*i.e.*, information for fund investors on the investment strategy, risk profile and related matters affecting the relevant fund] but (c) has no or limited contact with investors and prospective investors because all or most of such contact is the responsibility of a non-UK affiliated manager (such as a US affiliated manager) and
>
> (2) where a firm has responsibility for generating only part of such information in conjunction with a non-UK affiliated manager which also generates part thereof."

According to the Supplement, the FSA will not insist on disclosure with respect to such grey areas until AIMA publishes further supplements to its Guidance Note.

The Guidance Note sets October 31, 2006, as the deadline for compliance, although the Supplement indicates that the FSA will consider firms to be compliant if they make the required disclosure in investor reports and newsletters that are sent out in early November 2006. Disclosure should be made to both existing and prospective investors.

A copy of the Guidance Note and the Supplement is available at: http://www.aima.org/uploads/IndustryGuidanceNoteSideLettersPublic.pdf.

Director of SEC's Division of Investment Management Gives Keynote Address at Compliance Conference

Andrew J. Donohue discusses compliance initiatives and best execution practices

On September 25, 2006, in comments made at the IA Week's 6th Annual Fall Compliance Conference, Andrew J. Donohue, director of the SEC's Division of Investment Management, discussed, among other things, compliance initiatives at the SEC and best execution practices. Donohue also discussed the staff's consideration of a new antifraud rule in connection with hedge funds.

Donohue highlighted three initiatives currently being undertaken by the Division of Investment Management: (1) an Investment Adviser/Broker-Dealer Study to enable the SEC to evaluate better broker-dealer and investment adviser regulatory schemes; (2) a comprehensive review of the books and records requirements for investment advisers with a view to modernization; and (3) amendments to Form ADV, Part II.

On the topic of soft dollar practices, Donohue indicated that the staff is currently working to provide additional guidance as a follow-up to its July 2006 release, which is discussed in greater detail in the *August 2006 Investment Management Regulatory Update*. Donohue stressed that, in his view, "advisers and their clients should not consider soft dollars in isolation, but should instead focus on how soft dollar arrangements influence the overall practice of how an adviser places trades and whether that adviser is meeting its best execution obligations." He went on to say that compliance professionals should not limit their inquiry to commissions on equity trades. Rather, "[t]here are best execution challenges in other asset classes as well, including fixed income. In addition, best execution inquiries should be made across all accounts and products, each of which, including separately managed accounts, may have its own best execution issues and challenges."

In addition to speaking generally about compliance duties, Donohue referred to Chairman Christopher Cox's testimony before the Senate Banking Committee regarding the promulgation of a new antifraud rule under the Investment Advisers Act of 1940 (the "Advisers Act"), which is also discussed in the *August 2006 Investment Management Regulatory Update*. Such a rule would reverse the effect of the D.C. Circuit's decision in *Goldstein v. SEC*, No. 04-1434, 2006 U.S. App. LEXIS 15760 (D.C. Cir. June 23, 2006), to vacate Rule 203(b)(3)-2 under the Advisers Act. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004). The new rule would have the effect of looking through a hedge fund to apply the antifraud provisions of the Advisers Act to its investors.

The full text of Donohue's speech is available at: http://www.sec.gov/news/speech/2006/spch092506ajd.htm.

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