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DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

Contents

SEC Enforcement Actions 1
Litigation 2
Industry Update 3

SEC Enforcement Actions

SEC Settles Charges of Insider Trading on Information from PIPE Offerings against a Hedge Fund Adviser and Portfolio Manager

On May 2, 2006, the SEC announced the settlement of insider trading charges against hedge fund adviser Deephaven Capital Management, LLC ("Deephaven") and its former portfolio manager Bruce Lieberman. The SEC alleged violations of Section 17(a) of the Securities Act of 1933 (the "Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder.

According to the SEC's complaint, from August 2001 to March 2004, Deephaven and Lieberman traded on the information that 19 private investment in public equity ("PIPE") stock offerings were about to be publicly announced. In such offerings, a publicly traded company raises money by selling primary shares to investors in private placements. By increasing the number of shares that are outstanding in the market and discounting the price, PIPE offerings often depress an issuer's share price.

> Deephaven Capital Management, LLC and Bruce Lieberman agree to pay civil penalties for allegedly shorting the stock of PIPE issuers based on inside information

In each of the 19 PIPE offerings cited by the SEC, the defendants allegedly learned material nonpublic information concerning the offering — *e.g.*, the name of the issuer, general information about the issuer's business and the fact that the shares would be discounted from the market price — from placement agents for the offerings. Despite being told by the placement agents that the details of such offerings were confidential and agreeing to maintain such confidence, the defendants allegedly sold short the stock of each issuer on behalf of the Deephaven Small Cap Growth Fund, LLC ("Small Cap Fund") prior to the public announcement of the PIPE offering and thereby profited from the decline in price of those shares once the offerings were announced. According

to the SEC, in two such offerings, Lieberman signed a securities purchase agreement expressly warranting that the Small Cap Fund had not sold short the PIPE issuer's stock. However, in both instances, Deephaven and Lieberman had already shorted the stock in question. Allegedly, in an effort to conceal the short positions previously established in the Small Cap Fund, Lieberman transferred them to another Deephaven fund.

Without admitting or denying the SEC's allegations, Deephaven and Lieberman each consented to final judgments permanently enjoining them from future violations of Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5. Deephaven agreed to disgorge $2,683,270 in unlawful profits, plus $343,418 in interest, and to pay a civil penalty of $2,683,270. Lieberman also agreed to pay a $110,000 civil penalty. In an administrative proceeding brought pursuant to Section 203(f) of the Investment Advisers Act of 1940, Lieberman agreed to an SEC order barring him from association with any investment adviser for three years.

A copy of the SEC's order is available at: http://www.sec.gov/litigation/admin/2006/ia-2517.pdf. A copy of the SEC's release announcing the settlement is available at: http://www.sec.gov/litigation/litreleases/2006/lr19683.htm. A copy of the SEC's complaint is available at: http://www.sec.gov/litigation/complaints/2006/comp19683.pdf.

Litigation

Court Dismisses Claims of Fraudulent Fee Arrangements Brought Under Section 36(b) of the 40 Act

Western District of Pennsylvania dismisses Section 36(b) claims as derivative under Maryland law

On April 7, 2006, the U.S. District Court for the Western District of Pennsylvania dismissed claims that the investment advisers and distributors of Dreyfus mutual funds ("defendants") had breached their fiduciary duties in violation of Section 36(b) of the Investment Company Act of 1940 (the "40 Act") through fraudulent fee arrangements. *See In re Dreyfus Mut. Funds Fee Litig.*, No. 04-0126 (W.D. Pa. Apr. 7, 2006). The court held that such claims were

derivative under Maryland law and therefore had to be brought on behalf of the investment funds themselves, rather than as a separate class action.

According to the court, the plaintiffs had filed a purported class action on behalf of persons who held shares in approximately 155 Dreyfus mutual funds between January 10, 1999 and November 17, 2003. The plaintiffs alleged that the defendants received substantial, undisclosed kickbacks in exchange for pushing the Dreyfus mutual funds on investors.

In dismissing the action, the court explained that, under Maryland law, a shareholder may bring a claim directly only if his or her injury is distinct from that suffered by the corporation. Otherwise, the claim is derivative and cannot be brought as part of a class action, but rather it must be brought on behalf of the corporation. According to the court, the plaintiffs' alleged injury — the decrease in the value of their mutual fund holdings — was the same injury that the funds themselves suffered. Therefore, the court stated, the plaintiffs' claims, and Section 36(b) claims in general, are derivative and cannot be brought independently as a class action. As it was predicated on the Section 36(b) claim, the court also dismissed the plaintiffs' claim for control person liability against the defendants' parent companies under Section 48(a) of the 40 Act.

Industry Update

Treasury Adopts Suspicious Activity Reporting Rule for Mutual Funds

Effective June 5, 2006, a new Treasury Department regulation requires open-end investment companies registered with the SEC (*i.e.*, mutual funds) to "file with the Financial Crimes Enforcement Network . . . a report of any suspicious transaction relevant to a possible violation of law or regulation." 31 CFR § 103.15. Adopted pursuant to authority granted to the Secretary of the Treasury by the Bank Secrecy Act, the new regulation supplements current rules requiring mutual funds to implement reasonable procedures to verify the identity of any person seeking to open an account, to maintain records of such verification,

and to determine whether such person is a known or suspected terrorist. The regulation is applicable to transactions occurring after October 31, 2006.

The regulation requires mutual funds to report a transaction, by filing a Suspicious Activity Report ("SAR") with the Financial Crimes Enforcement Network ("FinCEN"), if such transaction is conducted through a mutual fund, involves at least $5,000 and the mutual fund "knows, suspects, or has reason to suspect" that the transaction:

Mutual funds must now report suspicious transactions occurring after 10/31/06 to FinCEN

> "(i) Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade any Federal law or regulation or to avoid any transaction reporting requirement under Federal law or regulation;
>
> (ii) Is designed, whether through structuring or other means, to evade any requirements of [31 CFR part 103] or any other regulations promulgated under the Bank Secrecy Act, Public Law 91-508, as amended, codified at 12 U.S.C. 1829b, 12 U.S.C. 1951-1959, and 31 U.S.C. 5311-5314, 5316-5332;
>
> (iii) Has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the mutual fund knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or
>
> (iv) Involves use of the mutual fund to facilitate criminal activity."

31 CFR § 103.15(a)(2). According to the Treasury Department release accompanying the regulation (the "Release"), a mutual fund must decide whether to file an SAR based on the "facts and circumstances relating to the transaction and the customer in question." The Release provides some guidance regarding when an SAR might be required. For instance, "the fact that a customer refuses to provide information necessary for the mutual fund to verify the cus-

tomer's identity, make reports, or keep records required by this part or other regulations, provides information that the mutual fund determines to be false, or seeks to change or cancel a transaction after such person is informed of information verification or recordkeeping requirements relevant to the transactions, would indicate the probability that a Suspicious Activity Report should be filed."

The Release clarifies two possible issues left open by the language of the regulation. First, while the Release acknowledges that the "knows, suspects, or has reason to suspect" standard does incorporate a due diligence concept into the reporting requirement, it makes clear that funds are expected to determine whether to file an SAR based only on information obtained in opening accounts and/or processing transactions. Second, in the case of a transaction conducted through an omnibus account maintained by an intermediary, the Release also clarifies that it is the intermediary, not the individual customers of such intermediary, that is the mutual fund's "customer" for purposes of the regulation. As the Release explains, the intermediary is usually a financial institution which has its own anti-money laundering reporting obligations with respect to its individual customers.

In most circumstances, mutual funds are required to report suspicious transactions on Form SAR-SF within 30 days after the fund becomes aware of such a transaction. In certain situations, however, additional notification requirements are imposed. In addition to filing Form SAR-SF, mutual funds must retain a copy of each such filing and of any supporting documentation for a period of five years.

The regulation applies to mutual funds, but not to affiliates such as investment advisers, principal underwriters, administrators and other service providers. Banks and brokers and dealers are, however, already subject to similar reporting requirements. The regulation permits mutual funds to file an SAR jointly with such financial institutions and/or other mutual funds involved in the transaction, provided that certain requirements are met. Moreover, although it is ultimately responsible for complying with the rule, a mutual fund may contractually delegate the reporting duties to an affiliated or unaffiliated service provider, such as a transfer agent.

In addition, the regulation provides a safe harbor to any mutual fund or director, officer, employee, or agent thereof that files an SAR. Such persons are protected against liability arising from any disclosure in the SAR or from any failure to disclose the fact that such a report has been filed.

See Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations — Requirement that Mutual Funds Report Suspicious Transactions, 71 Fed. Reg. 26,213 (May 4, 2003). The final rule is also available at: http://www.fincen.gov/mutual_fund_sar_final.pdf.

Funds with "Side Pockets" Are Now More Likely To Be Able To List on the Irish Stock Exchange

The ISE adopts a policy change which facilitates illiquid investments by listed funds

Effective April 28, 2006, the Irish Stock Exchange ("ISE") adopted a new rule which makes ISE listing easier for investment funds with separate share classes representing special situation or illiquid investments, which are commonly referred to as "side pockets."

Until now, investment funds with side pockets have faced significant obstacles in listing on the ISE. Such difficulty resulted from the ISE's treatment of side pockets as separate funds, thereby making it impossible for most of these investment funds to meet the ISE's diversification and redemption requirements. This is because the assets of a side pocket would not generally be sufficiently diversified and the illiquid nature of the investments makes redemptions difficult.

The new rule effectively treats side pocket assets and the main portfolio as a single fund for the purposes of the ISE's diversification restrictions. An earlier change also eliminated the rule that a side pocket meet the requirement that investors be allowed to redeem quarterly.

The new rules, however, do require that, if a fund uses a side pocket structure, (i) no more than 30 percent of the gross assets of the fund be invested in the side pocket and (ii) the fund not permit direct investment solely in the side pocket.

D. Reduction of the length of time that an entity formed prior to June 1, 2006 has to cure its failure to comply with the prior publication requirements, from 18 to 12 months.

It should be noted that this version of the Amending Law represents a significant departure from earlier amendments, which had been under consideration and which had been quite controversial in the legal and business communities. In particular, the earlier proposed amendments specifically imposed the loss of limited liability status on each member/partner of a non-compliant entity. As noted above, however, the amendments enacted by the Amending Law not only do not specifically impose such a penalty, they, in fact, clarify that failure to comply with the publication requirements does not result in loss of limited liability status.

Last-minute amendments modify revisions to publication requirements for limited liability entities that were set to become effective 6/1/06

The following is a summary of the significant aspects of the revised publication law, which is now in effect, as amended by the Amending Law:

1. Beginning June 1, 2006, limited liability entities formed or applying to do business in New York will be required (within 120 days of formation or qualification) to publish, in two designated newspapers once a week for six successive weeks, a notice containing certain specified information or their articles of association. (As noted above, this notice no longer includes a requirement to disclose the limited liability entities' top 10 holders.) Once the first week's publication has been completed, entities will not be required to update the publication to reflect any changed information.

2. Not all limited liability entities will have to comply with the new requirements. Specifically, domestic entities that were formed prior to June 1, 2006 and are in compliance with the old publication requirements on such date are not required to re-publish in accordance with the new law. Similarly, foreign entities that were formed and filed their application for authority prior to June 1, 2006 and are in compliance with the old publication requirements on such date are not required to re-publish in accordance with the new law. Entities that were formed (and, in the case of foreign entities, filed their application for authority) prior to June 1, 2006 and are not in compliance with the old law on such date, however, must publish

and file proof thereof within 12 months of June 1, 2006. The new law deems a limited liability entity that was formed (and, in the case of a foreign entity, filed its application for authority) prior to June 1, 2006 to be in compliance with the old publication requirements if (a) it was formed (and, in the case of a foreign entity, filed its application for authority) on or after January 1, 1999, and, prior to June 1, 2006, the entity filed at least one affidavit of publication from a newspaper or (b) it was formed (and, in the case of a foreign entity, filed its application for authority) prior to January 1, 1999, regardless of whether it filed any affidavit of publication from a newspaper.

3. Failure to comply with the publication requirements will result in immediate and automatic suspension of the entity's authority to carry on, conduct or transact business in New York during the period of non-compliance. Nevertheless, a suspension is annulled as soon as an entity becomes substantially in compliance with the publication requirement. (As described above, the amended publication law also clarifies that such suspension will not result in any member, manager, agent or partner of the entity becoming liable for the contractual obligations or other liabilities of the entity.)

A copy of the text of the Amending Law is available at: http://www.nyls.org/Keep/S6831B.pdf. A copy of the text of the revisions, as originally enacted on February 3, 2006, is available at: http://www.nationalcorp.com/pdfs/NY_Chapt_767.pdf.

Contacts

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

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

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

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

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

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

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

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