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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 Proposal of a New Interpretive Release Regarding Soft Dollars

On September 21, 2005, the SEC voted unanimously to propose a new interpretive release with respect to Section 28(e) of the Exchange Act, which is the safe harbor permitting investment managers to use client commissions, or "soft dollars," to pay for brokerage and research services. In addition to the requirements that brokerage and research services (i) satisfy the eligibility criteria in Section 28(e) and (ii) provide lawful and appropriate assistance to the money manager in carrying out his or her investment decision-making responsibilities (as previously specified by the SEC), the interpretive guidance would narrow the definition of "research" to include only advice, analysis and reports that have intellectual and informational content. The proposed interpretative release will also clarify that a money manager is required to make a good-faith determination that the soft dollars commissions paid are reasonable in relation to the value of the products and services provided by a broker-dealer.

SEC notices the proposal for a more narrow interpretation of Section 28(e)

A copy of the SEC press release announcing the proposal is available at: http://www.sec.gov/news/press/2005-134.htm. The full text of the proposed interpretive release was not available at the time of printing.

NYSE Files Amendment to Exchange Rule

On September 2, 2005, the New York Stock Exchange (the "NYSE" or the "Exchange") noticed a proposed rule change with respect to its previous interpretation of "routine" and "non-routine" items under Exchange Rule 452 ("Rule 452"), which governs proxy voting by exchange members on behalf of the beneficial owners for which such members hold securities. Rule 452 provides that a member organization can give a proxy to vote shares registered in its name, notwithstanding the failure of the beneficial owner to instruct the firm how to vote, provided, among other things, that the proposal under consideration does not involve a matter that "may affect substantially the rights or privileges" of a beneficial owner's stock.

Member organizations will now require the instruction of beneficial owners to vote shares in favor of a new investment adviser

The NYSE previously interpreted Rule 452 to allow member organizations to vote uninstructed shares on the approval of new investment advisory agreements for investment companies where the only amendment to the substantive terms of the advisory agreement was a change in the identity of the investment adviser. After discussions with the SEC Division of Investment Management, the NYSE has now noticed a new interpretation of Rule 452. Going forward, any proposal to obtain shareholder approval of an investment company's advisory contract with a new investment adviser (which approval is required by the Investment Company Act and the Rules promulgated thereunder) will require instruction from the beneficial owner. Consequently, a proposed assignment of the investment company's advisory contract, including an assignment caused by a change of control of the investment adviser that is a party to the assigned contract, will no longer be considered "routine" and will require beneficial owner instructions to the member organization in order to vote.

A copy of the proposed amendment to Rule 452 is available at: http://reports.proxy-direct.com/files/NYSE_Rule452Change.pdf. Interested individuals are invited to submit comments at http://www.sec.gov/rules/sro.shtml (include File Number SR-NYSE-2005-61).

Enforcement Actions

SEC Continues Scrutiny of Hedge Funds

Commissioner Campos notes 11 SEC enforcement actions against hedge funds and urges caution

On September 14, 2005, SEC Commissioner Roel C. Campos spoke at the Securities Industry Association's Hedge Funds and Alternative Investments Conference in New York. Commissioner Campos observed that the hedge fund industry continues to develop at a rapid pace and that competition and other market conditions are increasing pressure on funds to generate positive performance. He cautioned that such pressure exposes a growing number of investors to the possibility of fraud, citing the SEC's enforcement action against Bingham Capital Management as one of 11 hedge fund fraud cases this year. He also commented that the SEC's resources are insufficient to comprehensively monitor the hedge fund industry and that most SEC enforcement actions are prompted by investor complaints. The SEC's enforcement approach, he said, would be "risk-based" rather than a rotating review of registered advisers.

As Commissioner Campos commented, there have been several hedge fund fraud cases initiated in recent months. The fraud case cited by Commissioner Campos involving Bingham Capital Management ("BCM") stemmed from misrepresentations by Barry Alan Bingham, BCM's principal, regarding the performance and assets of Bingham Growth Partners, L.P., as well as misappropriation of client assets by BCM. On September 29, 2005, the SEC initiated an enforcement action against Bayou Group and its founders for fraud relating to fund performance and the use of a fictional accounting firm to certify false financial statements. On the same date, the SEC also announced an enforcement action against GTC Growth Fund, L.P., a Burlington, Massachusetts-based hedge fund ("GTC"), a former Citizen's Bank employee and various others for insider trading, through personal and GTC accounts, on information related to the acquisition by Citizens Financial Group, Inc. of Charter One Financial, Inc., a bank based in Cleveland, Ohio. On September 21, 2005, the SEC initiated administrative proceedings for violations of the Investment Advisers Act against Springer Investment Management, Inc. ("SIM") and its principal, Keith Springer ("Springer") for alleged misrepresentations regarding the performance of the hedge fund managed by SIM. SIM and Springer are alleged to have overvalued the fund's investment in a privately-held "dot com" while the other public investments in the fund managed by SIM declined.

A link to the SEC's complaint in the Bayou enforcement action may be found at: http://www.sec.gov/litigation/complaints/comp19406.pdf.

A link to the SEC's complaint in the GTC enforcement action may be found at: http://www.sec.gov/litigation/complaints/comp19404.pdf.

A link to the SEC's press release regarding the BCM enforcement action may be found at: http://www.sec.gov/litigation/litreleases/lr19345.htm.

A link to the SEC's administrative order regarding the SIM matter may be found at: http://www.sec.gov/litigation/admin/ia-2434.pdf.

Broker-Dealer Settles NYSE Charges Over Failure to Deliver Fund Prospectuses and ETF Product Descriptions

NYSE fines broker for failure to deliver prospectuses

On August 15, 2005, the New York Stock Exchange (the "NYSE") announced that it had settled disciplinary actions against Merrill Lynch, Pierce, Fenner & Smith, Inc., a registered broker-dealer and NYSE member organization ("Merrill Lynch"), for failure to deliver offering materials to customers in connection with the sale of shares of registered open-end, closed-end and exchange traded funds, among other matters. In October 2004, Merrill Lynch notified the NYSE that from October 2002 to March 2004 it had not delivered prospectuses to customers in connection with approximately 64,000 transactions involving registered, open-end funds. In addition, from January 2004 to July 2004, it had not delivered prospectuses in connection with approximately 900 sales of auction rate preferred securities issued by registered, closed-end funds. In November 2004, Merrill Lynch further notified the NYSE that it had consistently failed to deliver product descriptions for 150 (of 156) exchange traded funds offered by its brokers. In each case, Merrill Lynch's failure to deliver a prospectus or product description resulted from the misidentification or improper coding of the security on its system. Merrill Lynch promptly remedied the specific system failures and, in December 2004, completed rescission offers with respect to the transactions involving registered open-end and closed-end fund shares.

Merrill Lynch was also cited for additional violations including: (i) failure to deliver offering materials in connection with various securities not referenced above; (ii) failure to ensure that its employees complete and maintain proper securities industry registrations; (iii) failure to update employee information in the securities industry's central personnel database; (iv) failure to report a significant number of customer complaints and litigation and arbitration judgments to the NYSE; (v) failure to timely register on the NYSE's electronic filing platform; and (vi) failure to provide customers the opportunity to decline the use of margin in its client agreements.

Pursuant to the settlement, Merrill Lynch agreed to a censure and payment of a $10 million fine. In addition, Merrill Lynch agreed to retain an independent consultant to review its policies and procedures governing the reporting of customer complaints to the NYSE and to implement any policies, procedures and systems recommended by the consultant. Merrill Lynch also agreed to conduct an internal review of all other policies, procedures and systems implicated by the disciplinary action. Merrill Lynch is required to report back to the NYSE regarding implementation of the consultant's recommendations and the status of its own policies, procedures and systems. Merrill Lynch neither admitted nor denied guilt in settling the matter. A copy of the settlement is available at: http://www.nyse.com/pdfs/05-087.pdf.

Industry Updates

Department of Labor Final and Proposed Amendments to the QPAM Exemption

DOL promulgates final changes to QPAM Exemption and proposes additional changes to facilitate a financial institution acting as a QPAM

On August 23, 2005, the Department of Labor ("DOL") adopted amendments to Prohibited Transaction Class Exemption 84-14, the so-called "QPAM Exemption," which provides relief from the per se prohibited transaction rules contained in the Employee Retirement Income Security Act of 1974, as amended ("ERISA") for transactions involving pension plans whose assets are managed by a "qualified professional asset manager" or "QPAM." The DOL also proposed additional changes to facilitate a financial institution acting as a QPAM for plans covering employees of the QPAM or its affiliates. The following is a summary of the major changes:

» *Definition of QPAM.* The QPAM Exemption requires that an investment adviser meet certain assets under management ("AUM") and capitalization thresholds to be considered a QPAM. The DOL increased the AUM test from $50 million to $85 million. The DOL refused to revise the condition that the AUM threshold must be measured as of the last day of a QPAM's most recent fiscal year; therefore, the requirement remains potentially problematic for start-up managers. The DOL also increased the shareholders' or partners' equity requirement for a QPAM from $750,000 to $1 million. The revised AUM and capitalization thresholds are effective as of the last day of the first fiscal year of the QPAM beginning on or after August 23, 2005.

» *Appointment/Negotiation Power.* The QPAM Exemption does not provide relief for transactions between a plan and a party in interest that has authority to appoint or terminate the QPAM or negotiate the terms of the QPAM's management agreement. The DOL clarified that this requirement only pertains to the assets involved in the specific transaction. The QPAM Exemption previously required that the party in interest not have the power to appoint the QPAM or negotiate the QPAM's agreement at the time of the transaction and during the one-year period preceding the transaction. The DOL eliminated the one-year look-back requirement.

» *Appointment Power as Applied to Investment Pools.* With respect to an investment fund subject to ERISA, the conditions of the QPAM Exemption must be met with respect to each plan invested in the fund. There has been concern that if a party in interest or an affiliate of the party in interest caused the assets of the plan to be invested in a fund (i.e., where the party in interest was a sponsor or manager of the plan) the party in interest would effectively be appointing the manager of the fund to manage the plan assets and the QPAM Exemption would not be available for any transactions between the fund and the party in interest. The DOL has relaxed this rule by only applying this appointment condition to any plan that, together with plans sponsored by the employer group, holds a 10% or more position in the investment fund.

» *"Related" Definition.* The QPAM Exemption only applies to transactions where the QPAM and the party in interest on the opposite side of the transaction are unrelated to each other. Under the prior rules, the exemption would not apply to a transaction between a plan and a party in interest if the party in interest owned a 5% interest in the QPAM or the QPAM owned a 5% interest in the party in interest. The DOL increased the direct ownership threshold from 5% to 10% and provided that an entity controlling or controlled by either the QPAM or the party in interest cannot own 20% or more of the party in interest or the QPAM, respectively. The DOL also provided that it is a disqualifying condition if an entity controlling or controlled by either the QPAM or the party in interest owns between 10% and 20% of the party in interest or QPAM, respectively and the party with the ownership interest exercises "control over the management or policies" of the other party by reason of such ownership interest.

A copy of the amendment is available at: http://www.dol.gov/ebsa/regs/fedreg/notices/20050823-2.htm.

In Response to Petitions, SEC Extends Compliance Date for New Broker Rules Requiring Advisers Act Registration

New registration requirements for broker-dealers exercising investment discretion to become effective on January 31, 2006

On September 12, 2005, the SEC announced that it would extend the compliance date for new rules addressing the circumstances under which a broker-dealer providing financial planning services or having investment discretion will have to register as an investment adviser under the Advisers Act. The rules were slated to go into effect on October 24, 2005, but will now be effective as of January 31, 2006. As reported in the September 2005 *Investment Management Regulatory Update*, the Securities Industry Association, in addition to other brokerage industry groups, had petitioned the SEC for an extension. A copy of the SEC release is available at: http://www.sec.gov/rules/final/34-52407.pdf.

GAO Study of SEC's Revised Mutual Fund Exam Strategy

GAO study of the SEC's revised examination procedures for mutual funds cites certain deficiencies

On September 19, 2005, the Government Accountability Office (the "GAO") released a report citing certain deficiencies in the SEC's risk-based strategy for conducting mutual fund examinations. The GAO report focused on the adequacy of the SEC's inspections of both mutual funds and sales of mutual funds by broker-dealers. In addition to its other conclusions, the GAO report found that despite the fact that mutual funds hold nearly twice the dollar amount of assets as insured bank deposits hold in commercial banks, the SEC has significantly fewer examiners than bank regulators relative to the number of investment advisers and fund complexes that it regulates. Commissioner Paul Atkins also recently noted that the shortage of examiners at the SEC and the resource allocation problems noted in the GAO report will be further strained by the February 1 registration deadline for hedge fund advisers and other Commission obligations.

The GAO report specifically addressed (i) changes the SEC has made to its mutual fund examination program, (ii) the quality control framework of these routine mutual fund examinations and (iii) the adequacy of the SEC's oversight of the NASD and NYSE with regard to their oversight of mutual fund sales practices. The report ultimately concluded that despite some improvement in the SEC's general oversight of the mutual fund industry, serious deficiencies remain. One of the deficiencies identified in the GAO report was the SEC's shift of resources from routine exams of mutual funds to targeted comprehensive exams of only "high risk" mutual funds. This shift may result in funds that are considered to be lower risk operating for 10 years or more without an examination. The report also found the SEC's quality control framework for these examinations to be inconsistent and incomplete. Supervisory examiners who oversee the routine examination process are not required to review work papers or document their review. There is also no system in which completed examinations and work papers are reviewed for compliance with and effectiveness of applicable policies and procedures, raising questions concerning the adequacy of the supervisory review. Further, the GAO report found that the SEC's review of the SROs' oversight of broker-dealers offering mutual funds to customers remains duplicative and inadequate. Given that the SEC and the SROs use different examination guidelines in their review of broker-dealers and that the SEC has not yet developed an automated system to track the full scope of work conducted during the exams, the SEC's oversight review provides limited guidance.

The GAO report ultimately makes four recommendations to the SEC for improving its oversight of mutual funds: (i) periodically assess resource allocations to ensure that lower risk mutual funds are timely examined; (ii) reassess the methodology for conducting broker-dealer oversight examinations to prevent duplication and possibly reallocate some resources to perform mutual fund examinations; (iii) establish additional policies or procedures to ensure examination quality and consistency throughout the SEC field offices; and (iv) electronically track information on the scope of work performed during broker-dealer oversight examinations to assess whether these exams are adequately assessing mutual fund sales practices rather than other issues. A copy of the GAO report is available at: http://www.gao.gov/cgi-bin/getrpt?GAO-05-415.

Compliance Reminder: February 1, 2006 Hedge Fund Investment Adviser Registration Deadline Approaches

Managers should file registration materials by December 15, 2005 to have Advisers Act registration declared effective prior to February registration deadline

The compliance deadline for new Rule 203(b)(3)-2, which requires investment advisers to "private funds" (i.e., many hedge funds) to register with the SEC under the Advisers Act, is February 1, 2006. By that date, advisers that fall within the rule are required to be registered and come into compliance with the Advisers Act, which includes appointing a chief compliance officer and adopting and implementing written compliance policies and procedures. To register, advisers are required to file an application on Part 1 of Form ADV ("Form ADV") through the Investment Advisers Registration Depository ("IARD") system. The SEC has up to 45 days after receipt of the Form ADV to declare an applicant's registration effective. Therefore, managers should file their Form ADVs and pay the registration fee no later than December 15, 2005. For more details regarding the rule, please refer to the Davis Polk memo "Final Advisers Act Rule Regarding Registration of Hedge Fund Advisers" distributed on December 7, 2004. Please ask your Davis Polk contact if you would like additional copies of the memo. The IARD website (www.iard.com) provides information regarding the IARD system as well as information with respect to account set up and fees. Information regarding federal registration of investment advisers is available through the SEC's website at http://www.sec.gov/info/advisers.shtml.

NYSE Releases Guidance on Disclosures and Sales Practices Concerning Mutual Funds and Variable Annuities

On August 11, 2005, the New York Stock Exchange (the "NYSE") issued an Information Memorandum (the "Memorandum") clarifying disclosure and sales practice requirements regarding mutual funds and variable annuities. The Memorandum addresses directed brokerage, revenue sharing, disclosure and suitability.

NYSE memorandum discusses directed brokerage, revenue sharing, disclosure and suitability

The Memorandum discusses recent changes to Rule 12b-1 under the Investment Company Act that prohibit certain directed brokerage practices. Specifically, it reiterates that a fund may use a broker-dealer that promotes or sells fund shares (a "Selling Broker") to execute portfolio trades only if, among other things, the fund or its adviser has implemented procedures and policies reasonably designed to prevent the individuals responsible for selecting broker-dealers to execute the fund's portfolio trades (the "Executing Brokers") from taking into account the promotion or sale of fund shares. The Memorandum notes that a Selling Broker should not execute portfolio trades, unless it (i) confirms that the fund has implemented the policies and procedures required by Rule 12b-1, (ii) ensures that the fund uses reasonable criteria in choosing Executing Brokers and (iii) knows, or has reason to believe, that the fund did not take its selling efforts into account when selecting it as an Executing Broker.

The Memorandum also discusses various types of revenue sharing arrangements and certain disciplinary actions in this area. As the NYSE's rules and the federal securities laws require members and member organizations to ensure full and adequate disclosure to customers of revenue-sharing arrangements, the Memorandum advises that such disclosure be prominently and clearly displayed and that it completely describe the existence, scope and substance of the member's, or member organization's, revenue-sharing arrangements. Additionally, the Memorandum recommends that such disclosure be delivered to the customer at the time of the transaction, as opposed to merely being available upon request.

Finally, the Memorandum notes that the marketing of variable annuity products to retail customers necessitates heightened disclosure obligations, as these products present unique suitability concerns (mainly because they contain features relating to both securities and insurance).

A copy of the Memorandum is available at: http://apps.nyse.com/commdata/PubInfoMemos.nsf/AllPublishedInfoMemosNyseCom/85256FCB005E19E88525705800712FC6/$FILE/Microsoft%20Word%20%20Document%20in%2005-54.pdf.

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