DAVIS POLK & WARDWELL

Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

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Enforcement Actions

Regulators Continue to Focus Attention on Fraudulent Market Timing and Late Trading

NASD Charges Broker-Dealer and Registered Representatives with Improper Market Timing and Late Trading

On April 6, 2006, the National Association of Securities Dealers ("NASD") announced that it had initiated disciplinary proceedings charging A.B. Watley Direct, Inc. ("ABW Direct"), a broker-dealer, and its former registered representatives, Robert Conway and Kenneth Ng, with facilitating improper market timing and late trading. The NASD also charged ABW Direct's president, Robert Malin, and its executive vice president, Linus Nwaigwe, with failing to supervise Conway and Ng. Conway and Ng were registered with A.B. Watley, Inc. ("ABW Inc."), an affiliated entity that had been a member of the NASD before being expelled in 2004 for failing to pay fines levied in prior disciplinary actions. Both ABW Direct and ABW Inc. are subsidiaries of A.B. Watley Group, Inc., a publicly traded company.

A.B. Watley Direct is charged with facilitating 405 improper market-timing trades and 243 late trades

In its complaint, the NASD charges that between approximately July 2002 and September 2003, Conway and his assistant Ng assisted hedge fund clients in making at least 405 improper market-timing trades. To evade mutual funds' market-timing restrictions, Conway and Ng are alleged to have set up multiple accounts with different names and branch codes, opened multiple accounts for one client at both ABW Direct and ABW Inc., and ignored a directive from their clearing firm to cease trading in international mutual funds until they agreed in writing to observe mutual fund's trading restrictions.

The NASD also alleges that during the same period, Conway and Ng executed at least 243 late trades by means of a computerized trading platform that enabled them to enter orders for at least an hour after market close and still receive the net asset value that had already been calculated by the funds. According to the NASD, because ABW Direct and ABW Inc. failed to main-

tain the books and records required for mutual fund transactions, Conway and Ng may actually have executed thousands of late trades. In addition, the NASD charges Nwaigwe with failing to supervise Conway and Ng and thereby uncover their wrongful conduct and it also charges Malin with failing reasonably to ensure that Nwaigwe was performing his supervisory function.

A copy of the NASD press release is available at: http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_016340&ssSourceNodeId=1346.

SEC Settles Improper Market-Timing and Late-Trading Charges Against a California Broker-Dealer, its Parent and Three Representatives

National Clearing Corporation to disgorge over $1 million and to pay $1 million in civil penalties

On April 5, 2006, the SEC announced the settlement of late-trading and improper market-timing charges against National Clearing Corporation ("NCC"), a California-based broker-dealer, its parent company J.B. Oxford Holdings ("JB Oxford"), and three former NCC executives, Kraig L. Kibble, James G. Lewis and James Y. Lin (collectively, the "Defendants"). The charges were filed by the SEC on August 24, 2004 in the U.S. District Court for the Central District of California and the court entered consensual final judgments against the Defendants in settlement of the charges on January 25, 2006.

In its complaint, the SEC alleged that from June 2002 until September 2003, the Defendants defrauded mutual fund investors by executing thousands of market-timing and late trades in more than 600 mutual funds. According to the SEC, NCC entered into written agreements with institutional clients interested in engaging in late trading and market timing and negotiated a fee in exchange for enabling the clients to do so.

Despite statements in the prospectuses of mutual funds that only trades received prior to 4:00 p.m. Eastern Time would receive that day's net asset value ("NAV"), Lewis, Kibble, and Lin allegedly authorized trades entered after 4:00 p.m. to receive that day's NAV. According to the SEC, NCC continued to accept late trades until September 3, 2003, when the New York Attorney General filed a civil complaint relating to NCC's late-trading and market-timing activities.

With respect to illegal market timing, the SEC's complaint alleged that Lewis, Kibble and Lin engaged in various deceptive practices to conceal their activities and those of their clients. These practices allegedly included providing clients with multiple account numbers, representative codes and office codes. In addition, in May 2003, NCC is alleged to have begun negotiating with a trust company to clear mutual fund trades so as to avoid detection.

The district court permanently enjoined Lewis, Kibble and Lin from future violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder and required that each pay a penalty of $200,000, $50,000 and $35,000, respectively. Lewis also agreed to be barred from serving as an officer or director of a public company for five years. The final judgment against NCC permanently enjoined it from future violations of Section 10(b), Rule 10b-5 and Rule 22c-1 under Section 22(c) of the Investment Company Act of 1940 which prohibits the purchase or sale of mutual fund shares except at a price based on the NAV that is next calculated after the trade is placed. NCC is also required to disgorge $1,035,324 of ill-gotten gains and to pay prejudgment interest of $69,000 as well as a civil penalty of $1 million.

The SEC also settled related administrative actions against JB Oxford, Lewis, Kibble and Lin who neither admitted nor denied the charges. In settlement of the administrative proceedings, JB Oxford agreed to cease and desist from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, while Lewis, Kibble and Lin agreed to be barred from association with any broker or dealer for a period of five years, four years and three years, respectively.

A copy of the SEC's release is available at: http://www.sec.gov/litigation/litreleases/2006/lr19641.htm. A copy of the SEC's order in the action against JB Oxford is available at: http://www.sec.gov/litigation/admin/34-53137.pdf. A copy of the order in the action against Lewis is available at: http://www.sec.gov/litigation/admin/34-53210.pdf. A copy of the order in the action against Lin is available at: http://www.sec.gov/litigation/admin/34-53209.pdf. A copy of the order in the action against Kibble is available at: http://www.sec.gov/litigation/admin/34-52728.pdf. A copy of the SEC's original complaint is available at: http://www.sec.gov/litigation/complaints/comp18850.pdf.

SEC Settles Deceptive Market-Timing Charges against Head of Fiserv Securities' New York Office

Thomas J. Gerbasio is barred from associating with any broker or dealer in settlement of improper market-timing charges

On April 10, 2006, the SEC issued an order in settlement of charges that Thomas J. Gerbasio facilitated deceptive market-timing trades by two hedge fund clients while he was head of the New York office of Fiserv Securities, Inc., a registered broker-dealer. The SEC found that on March 30, 2006, a final judgment was entered by consent against Gerbasio in a civil case filed by the SEC in April 2005 in the U.S. District Court for the Eastern District of Pennsylvania.

In the complaint filed in the civil case, the SEC alleged that between at least August 2002 and October 2003, Gerbasio and an associate used various fraudulent tactics to engage undetected in market-timing activities on behalf of two hedge fund clients. Specifically, the complaint alleged that, to conceal his clients' market-timing trades from mutual funds that issued hundreds of notifications rejecting such trades, Gerbasio directed his subordinates to misrepresent to the mutual funds the nature of his clients' trades, advised his clients to execute trades in amounts that would evade detection by the funds and assisted his clients in opening new accounts under different names and account numbers to hide their identities. According to the complaint, Gerbasio and his associate thereby placed thousands of market-timing trades that would otherwise have been rejected by the mutual funds. The district court permanently enjoined Gerbasio from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder and ordered Gerbasio to pay disgorgement and prejudgment interest of $540,044 (but waived all but $100,000 based on Gerbasio's sworn financial statements).

Without admitting or denying any of the findings made by the SEC, Gerbasio consented to the SEC's order barring him from association with any broker or dealer. Related to the action against Gerbasio, in April of 2005, the SEC settled charges that Fiserv Securities, Inc. and Dennis J. Donnelly, Fiserv's former Chief Operating Officer, had failed to supervise Gerbasio and his associate. Fiserv agreed to be censured, to pay $15 million in disgorgement and civil penalties and to undertake measures to prevent future misconduct.

A copy of the SEC order in the Gerbasio action is available at: http://www.sec.gov/litigation/admin/2006/34-53622.pdf. A copy of the original complaint is available at: http://www.sec.gov/litigation/complaints/comp19197.pdf. A copy of the SEC's Litigation Release is available at: http://www.sec.gov/litigation/litreleases/2006/lr19647.htm.

NASD Fines AIG Affiliate Over $1.1 Million for Improper Directed Brokerage and Other Violations

Settlement of NASD charges that broker-dealer improperly received approximately $2.7 million in directed brokerage commissions

On April 5, 2006, the National Association of Securities Dealers ("NASD") announced that it had fined American General Securities, Inc. ("AGSI"), a member company of American International Group, Inc. ("AIG") located in Houston, Texas, more than $1.1 million for various violations, including accepting directed brokerage commissions in exchange for providing preferential sales treatment to three mutual fund complexes. The NASD alleged that AGSI had violated the Anti-Reciprocal Rule, which prohibits arrangements in which brokerage commissions (a form of fund assets) are used to compensate brokerage firms for favoring a fund's shares and which, according to James Shorris, the NASD's Executive Vice President and Head of Enforcement, "is designed to ensure that firms recommend mutual funds on their merits and not because of the receipt of brokerage commissions." Specifically, the NASD found that, from January 2002 through September 2003, AGSI engaged in a "shelf space" arrangement in which mutual funds paid for preferential treatment, including being identified as a "Preferred Product Sponsor" on AGSI's internal website and being featured in its internal marketing publications. In return for such preferential treatment and in lieu of a cash fee, according to the NASD, the three mutual fund complexes improperly directed approximately $2.7 million in brokerage commissions to AGSI.

The NASD also found that, during varying time periods, AGSI failed to forward promptly more than 2,100 customer checks received in connection with certain mutual fund and variable annuity transactions, failed to retain electronic communications, and failed to maintain supervisory procedures to detect such violations. AGSI settled with the NASD without admitting or denying the charges.

A copy of the NASD's press release is available at: http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_016340&ssSourceNodeId=1346.

SEC Files Enforcement Action to Stop On-Going Fraud by Face-Amount Certificate Companies and Other Securities Law Violations

Promoter and his three face-amount certificate companies charged with violating the 40 Act

On April 4, 2006, the SEC filed for emergency relief in the U.S. District Court for the District of Maryland ("District Court") against Eric M. Westbury and three companies – SBM Certificate Company ("SBM"), SBM Investment Certificates, Inc., formerly known as 1st Atlantic Guaranty Corp. ("1st Atlantic"), and Geneva Capital Partners, LLC ("Geneva") – that Westbury allegedly owns or controls. The SEC seeks to enjoin Westbury and the three companies from committing fraud and other federal securities law violations.

According to the SEC's complaint, SBM and 1st Atlantic, of which Westbury is alleged to be Chairman, Chief Executive Officer and President, issued face-amount certificates totaling approximately $33 million to over 2,000 investors without maintaining the minimum certificate reserves required by Section 28 of the Investment Company Act of 1940 (the "40 Act"). A face-amount certificate company, which is a type of investment company that issues fixed-income debt securities, generally must maintain reserves in qualified assets (i.e., cash or "qualified investments") equal to the surrender value of the certificates issued plus interest in accordance with Sections 28(a) and (b) of the 40 Act. Section 28(b) defines "qualified investments" as "investments of a kind which life-insurance companies are permitted to invest in or hold under the provisions of the Code of the District of Columbia" and such other investments as the SEC deems to be qualified by rule or regulation. According to the SEC, as of December 31, 2005, SBM had $30,883,385 in certificate liabilities, but only $30,288,180 in qualified assets, and 1st Atlantic had $2,160,980 in certificate liabilities, but only $1,339,441 in qualified assets thus violating both the reserve requirement and a 2003 District Court order permanently enjoining 1st Atlantic from maintaining such deficiencies. Neither SBM nor 1st Atlantic show the potential of ever becoming compliant with the Section 28 reserve

requirement, according to the SEC. The SEC further charges that both SBM and 1st Atlantic violated Section 30(e) of the 40 Act by failing to provide their investors, who are being offered the opportunity to roll over existing certificates, with accurate financial information. The SEC also charges that $6.0 million that appears on SBM's books as purported loans to charter schools does not exist.

Also according to the SEC's complaint, Geneva and Westbury, allegedly the sole owner of Geneva, have since at least August 2003 perpetrated a separate fraud on the District of Columbia Department of Banking and Financial Institutions/Credit Enhancement Fund (the "District") in violation of Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"). The District allegedly invested in Geneva approximately $21 million of District of Columbia and federal funds earmarked for the D.C. charter school Credit Enhancement Fund, which provides loans and guaranties to charter schools to improve their creditworthiness. The SEC, however, alleges that in this investment Geneva and Westbury defrauded the District through misrepresentations and then used the District's money to try to keep Westbury's other troubled companies afloat.

In addition to violations of the 40 Act and the Advisers Act, the SEC complaint charges 1st Atlantic, SBM, Geneva and Westbury with violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The SEC seeks a permanent injunction against further violations of the federal securities laws and an order requiring the disgorgement of all ill-gotten gains, as well as civil penalties against Geneva and Westbury. The SEC is also seeking the appointment of a receiver for, and the freezing of, the assets of SBM, 1st Atlantic and Geneva, expedited discovery, a prohibition on the alteration or destruction of documents and an accounting from the defendants.

A copy of the SEC's complaint is available at: http://www.sec.gov/litigation/complaints/2006/comp19638.pdf. A copy of the SEC release is available at: http://www.sec.gov/litigation/litreleases/2006/lr19638.htm.

Litigation

Texas District Court Allows SEC's Market-Timing Claims To Proceed, but Dismisses Aiding and Abetting Charges

Court holds that aiding and abetting claim must allege fraud by primary actor under Section 10(b) of Exchange Act

On March 13, 2006, the U.S. District Court for the Northern District of Texas denied defendants Scott B. Gann and George B. Fasciano's motion to dismiss security fraud claims brought by the SEC in connection with an allegedly deceptive mutual fund market-timing scheme they conducted on behalf of one hedge fund client. Nonetheless, the court granted the defendants' motion to dismiss charges that they aided and abetted the hedge fund's uncharged violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

According to the SEC's January 10, 2005 complaint, between February 2003 and September 2003, Gann and Fasciano, who were brokers at Southwest Securities, Inc., a registered broker-dealer and investment adviser, executed approximately 2,000 market-timing trades in an aggregate amount of $650 million by using deceptive tactics to circumvent the restrictions imposed by the mutual funds in which they were trading. Specifically, the SEC alleged that, to avoid detection and conceal their own identity and that of their client, Gann and Fasciano used different registered representative numbers and branch identification numbers, opened multiple accounts, and divided trades into dollar amounts small enough to evade detection.

In their motion to dismiss for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6), Gann and Fasciano argued that the securities fraud claim should be dismissed because: (1) the SEC failed to plead with particularity the circumstances of the alleged fraud; (2) the SEC failed to allege the requisite scienter; and (3) market timing is not *per se* illegal. The district court disagreed. With respect to the third argument, the court held that the fact "[t]hat market timing is not *per se* illegal is not germane; rather, the relevant inquiry is whether, while practicing market timing, [Gann and Fasciano] committed fraud by engaging in deceptive practices in violation of the securities laws." *SEC v. Gann*, 2006 U.S. Dist. LEXIS 9955, at *21 (N.D. Tex., Mar. 13, 2006).

The district court agreed with Gann and Fasciano, however, that the SEC's aiding and abetting claim must fail, because such a claim must allege "'the existence of the predicate Section 10(b) violation by the primary party, knowledge of the violation by these defendants and substantial assistance by these defendants in aiding and abetting the violation.'" *Id.* at *22 (quoting *Dennis v. Gen. Imaging, Inc.*, 918 F.2d 496, 508 (5th Cir. 1990)). Because the SEC had not sufficiently pled a primary violation by Gann and Fasciano's hedge fund client, the court dismissed the SEC's claim that Gann and Fasciano had aided and abetted the client's securities law violation.

See SEC v. Gann, 2006 U.S. Dist. LEXIS 9955 (N.D. Tex., Mar. 13, 2006). A copy of the SEC's January 2005 complaint is available at: http://www.sec.gov/litigation/complaints/comp19027.pdf.

S.D.N.Y. Dismisses Class Action Claims Over "Shelf Space" Arrangement

Court finds no private right of action under Sections 34(b) and 36(a) of the Investment Company Act

On March 24, 2006, the U.S. District Court for the Southern District of New York dismissed a class action charging the investment adviser, distributors, and other affiliates of the Evergreen mutual fund complex, which is related to the Wachovia Corporation (collectively, the "Defendants"), with participating in a "shelf space" arrangement whereby the mutual funds received marketing from brokerage houses in exchange for making improper payments to the brokerages.

The complaint was filed on June 14, 2004 by Evergreen mutual fund investors (collectively, the "Plaintiffs"). According to the complaint, the Defendants made improper payments to brokerage houses, such as Morgan Stanley Dean Witter, AG Edwards, Salomon Smith Barney, Merrill Lynch and Wachovia Securities, in exchange for pushing their clients into the Defendants' funds. The payments made by the Defendants allegedly included improper "directed brokerage" and excessive commissions in the form of "soft dollars." The Plaintiffs claimed that these improper payments were financed by the Defendants through excessive fees charged to investors who were never informed about such arrangements. The Plaintiffs further alleged that even

though the Defendants used shareholder fees to increase fund assets through these "shelf space" arrangements, none of the gains were ever passed on to shareholders.

The district court dismissed the action in its entirety. Among several other holdings, the court concluded that there was no private right of action under either Section 34(b) of the Investment Company Act, which renders it unlawful to "make any untrue statement of a material fact in [a] registration statement," 15 U.S.C. § 80a-33(b), or Section 36(a), which authorizes the SEC to bring an action against various persons for "breach of fiduciary duty involving personal misconduct in respect of any registered investment company," 15 U.S.C. § 80a-35(a). In so finding, the court agreed with the reasoning of other courts in the Southern District of New York.

See In re Evergreen Mut. Funds Fee Litig., 2006 U.S. Dist. LEXIS 12501 (S.D.N.Y. Mar. 24, 2006).

Industry Update

SEC Fills Senior Regulatory Positions, Including Director of the Division of Investment Management

SEC names Andrew "Buddy" Donohue Director of the Division of Investment Management and Thomas A. Biolsi Associate Regional Director for Examinations in the SEC Northeast Regional Office

On April 10, 2005, the SEC named Andrew "Buddy" Donohue Director of the Division of Investment Management. Donohue will be sworn in on May 15, 2006, thereby filling a position left vacant when Paul F. Roye who had served as Director since 1998 left the SEC last spring.

Donohue is currently Global General Counsel for Merrill Lynch Investment Managers, where he oversees legal and regulatory compliance functions related to the management of over $500 billion in assets and serves as Chairman of the Global Risk Oversight Committee. Prior to Merrill Lynch Investment Managers, Donohue was Executive Vice President, General Counsel, Director, and a member of the Executive Committee of Oppenheimer Funds for more than a decade. Previously, he served as gen-

eral counsel of First Investors Corporation and he has also been in private practice. A copy of the related SEC press release is available at: http://www.sec.gov/news/press/2006/2006-52.htm.

On April 12, 2005, the SEC named Thomas A. Biolsi Associate Regional Director for Examinations in the SEC's Northeast Regional Office ("NERO"). As such, Biolsi will direct accountants and examiners responsible for inspecting investment advisers and investment companies within the Northeast Region. Biolsi will assume his new position in mid-June 2006. Biolsi has been a Managing Director in the Regulatory Compliance Group of PricewaterhouseCoopers ("PWC") for the last nine years. For the seven years prior to joining PWC, Biolsi was a Compliance Director and then the Chief Compliance Officer at Prudential Insurance Company of America. Prior to Prudential, Biolsi was a staff examiner and then Branch Chief in the Investment Adviser Examination Program in NERO for nine years. A copy of the related SEC press release is available at: http://www.sec.gov/news/press/2006/2006-54.htm.

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