DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

SEC Rules & Regulations

SEC Will Not Appeal *Goldstein* Decision

On August 7, 2006, SEC Chairman Christopher Cox announced that the SEC will not seek *en banc* review of the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Goldstein v. Securities and Exchange Commission*, No. 04-1434, 2006 U.S. App. LEXIS 15760 (D.C. Cir. June 23, 2006). As discussed in greater detail in the June 23, 2006 *IMG Bulletin: Controversial SEC Hedge Fund Adviser Registration Rule is Vacated*, the *Goldstein* decision vacated the SEC's controversial rule requiring the registration of many hedge fund advisers—*i.e.*, Rule 203(b)(3)-2 (the "Hedge Fund Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

According to Chairman Cox, instead of further appeal, which "would be futile and would simply delay and distract from our goal of advancing investor protection," the SEC is "moving aggressively on an agenda of rulemaking and staff guidance." As he previously discussed on July 25, 2006, in testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, which is described in greater detail in the *August 2006 Investment Management Regulatory Update*, Chairman Cox stated that such rulemaking will include "a new anti-fraud rule under the Investment Advisers Act that would have the effect of 'looking through' a hedge fund to its investors." Chairman Cox also reiterated that the SEC is considering an increase in "the minimum asset and income requirements for individuals who invest in hedge funds." Further, according to Chairman Cox, in order "to eliminate disincentives for voluntary registration," the SEC intends to "address the grandfathering, transition and other miscellaneous relief necessitated by the vacating of the rule."

> Chairman Cox announces that SEC will respond to *Goldstein* decision via rulemaking rather than seeking judicial review

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More generally, Chairman Cox said: “The SEC will continue to vigorously enforce the federal securities laws against hedge funds and hedge fund advisers who violate those laws. Hedge funds are not, should not be, and will not be unregulated.”

A copy of Chairman Cox’s statement is available at: http://www.sec.gov/news/digest/2006/dig080806.txt.

SEC Interpretations: No-Action Letters

SEC No-Action Letter Permits Variation of Man-Glenwood Three-Tier, Master-Feeder Structure

Relief permits non-U.S. investors to invest directly in unregistered mid-tier fund

On July 10, 2006, the SEC Division of Investment Management issued a no-action letter (the “No-Action Letter”) regarding the applicability of Sections 7(d) and 12(d)(1)(E) of the Investment Company Act of 1940 (the “40 Act”) to a three-tier, master-feeder structure (the “Proposed Structure”) that is identical, except in one respect, to the structure approved by the SEC in Man-Glenwood Lexington TEI, LLC, SEC No-Action Letter, [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,811 (Apr. 30, 2004) (the “Man-Glenwood Structure”). As described in more detail in the *June 2004 Investment Management Regulatory Update*, the Man-Glenwood Structure comprised a top-tier fund (“Top-Tier Fund”), which was a U.S. closed-end investment company registered under the 40 Act, a mid-tier fund (“Offshore Fund”), which was a non-U.S. unregistered fund, and a master fund (“Master Fund”), which was a registered closed-end U.S. investment company. In the Man-Glenwood Structure, the Top-Tier Fund acts as a feeder fund for the Master Fund by investing all of its assets in the Master Fund through the Offshore Fund. The Top-Tier Fund offers its securities in a U.S. registered public offering to tax-exempt retirement plans and certain other tax-exempt entities. The interpositioning of the Offshore Fund between the Master Fund and the Top-Tier Fund is designed to allow Top-Tier Fund investors to receive dividend income instead of unrelated business taxable income generated by the Master Fund.

The Proposed Structure differs from the Man-Glenwood Structure in that non-U.S. investors (the "Non-U.S. Investors") would be allowed to invest, to a limited extent, directly in the Offshore Fund. In granting no-action relief, the SEC relied on the same representations as it did in considering the Man-Glenwood Structure in addition to representations that the Top-Tier Fund would continually monitor the sales of interests in the Offshore Fund to its Non-U.S. Investors to ensure that (i) such investors would not own in the aggregate more than 33% of the outstanding voting securities of the Offshore Fund and (ii) no single Non-U.S. Investor or group of related Non-U.S. Investors would own more than 25% of the outstanding voting securities of the Offshore Fund (collectively, the "Non-U.S. Investor Limitations").

The SEC's No-Action Letter also highlighted the applicant's representations that (a) to ensure compliance with the Non-U.S Investor Limitations, the Offshore Fund's organizational documents would allow the Offshore Fund to force redemption of all or a portion of the shares held by the Non-U.S. Investors and (b) such mandatory redemptions "would be effected in a manner that is consistent with the requirements of the 1940 Act, as if the [Offshore] Fund were registered as an investment company."

For purposes of its Section 12(d)(1)(E) analysis, the SEC noted the applicant's representation that no Non-U.S. Investor that meets the definition of "investment company" in Section 3(a) of the 40 Act, including any entity excluded from the definition by Sections 3(c)(1) or 3(c)(7), would be permitted to invest in the Offshore Fund. The SEC expressly took "no position" regarding the applicability of Section 12(d)(1)(E) to a three-tier, master-feeder arrangement in which a Non-U.S. Investor that meets such definition invests in the Offshore Fund.

A copy of the SEC's No-Action Letter is available at: http://www.sec.gov/divisions/investment/noaction/2006/aip071006.htm.

SEC Issues No-Action Letter to the ABA in Wake of *Goldstein*

No-action letter restores several provisions affecting hedge fund advisers that were vacated by *Goldstein*

On August 10, 2006, the SEC Division of Investment Management issued a no-action letter (the "No-Action Letter") relating to the regulation of hedge fund advisers in the wake of the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Goldstein v. Securities and Exchange Commission*, No. 04-1434, 2006 U.S. App. LEXIS 15760 (D.C. Cir. June 23, 2006), to vacate the SEC's controversial rule requiring the registration of most hedge fund advisers —*i.e.*, Rule 203(b)(3)-2 (the "Hedge Fund Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (the "Adopting Release"). The No-Action Letter was issued in response to a letter submitted on July 31, 2006, by the Subcommittee on Private Investment Entities of the Committee on Federal Regulation of Securities, Section of Business Law, of the American Bar Association (the "Request Letter").

As discussed in more detail in the *August 2006 Investment Management Regulatory Update*, on July 25, 2006, SEC Chairman Christopher Cox testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs regarding the SEC's remedial plans for hedge-fund regulation in the wake of *Goldstein* and indicated that the SEC views the *Goldstein* decision as vacating not only the client counting rule, but also the other related rules and interpretations promulgated in the same rulemaking as the Hedge Fund Rule. The No-Action Letter confirms this view and restores to legal effect several of the transitional and exemptive rules vacated by *Goldstein*. Specifically, in response to questions posed in the Request Letter, the No-Action Letter provides the following guidance:

Offshore Investment Advisers to Offshore Funds. Offshore advisers that remain registered as investment advisers will be subject to the substantive provisions of the Advisers Act with respect to offshore clients only to the extent set forth in the Adopting Release. The No-Action Letter notes, however, that all of the substantive provisions of the Advisers Act (and the SEC's rules) are applicable with respect to any U.S. clients that an offshore adviser may have (though an offshore adviser may treat an offshore fund as an offshore client, even if the fund has U.S. investors in it).

Records Supporting Performance Information. With respect to Advisers Act rules requiring an adviser to maintain certain records to support its use of performance information, the SEC staff will not recommend enforcement action against advisers that registered as a result of the Hedge Fund Rule and that continue to rely on now vacated Rule 204-2(e)(3)(ii), pursuant to which such advisers were not required to have the books and records supporting performance information for periods ending prior to February 10, 2005. This rule was designed to accommodate newly registered hedge fund advisers that may not have kept sufficient records prior to registering.

Performance-Based Compensation Arrangements. Likewise, the SEC staff will not recommend enforcement action against registered advisers that receive performance-based compensation from clients that are not "qualified clients" or from funds that have investors that are not qualified clients, to the extent such advisers would have been permitted to do so under the now vacated Rule 205-3(c)(2) or (3). Such rules permitted hedge fund advisers that registered as a result of the Hedge Fund Rule to continue receiving performance-based compensation from non-qualified clients (or funds with non-qualified client investors) if such persons became equity investors in the hedge fund or entered into advisory contracts prior to February 10, 2005.

Custody Rule. The SEC staff will not recommend enforcement action against an adviser to a "fund of funds" (as defined in vacated Rule 206(4)-2(c)(4)) that relies on the annual audit exception to the custody rule, if such fund of funds distributes its audited financial statements to investors within 180 days (as opposed to 120 days) of the fund of fund's fiscal year end, as had been provided in the now vacated amendments to Rule 206(4)-2.

Continued Availability of Section 203(b)(3) for Advisers that Withdraw their Registrations. The SEC staff will not recommend enforcement action under Section 203(a) of the Advisers Act against a hedge fund adviser that registered as a result of the Hedge Fund Rule and that withdraws from registration by February 1, 2007, even if such adviser, while registered (i) held itself out as an adviser generally to the public and/or (ii) had more than 14 clients (counting each hedge fund as a single client), *provided* that the adviser ceases to hold itself out publicly and reduces its number of clients to fewer than 15 by the date it withdraws.

Form ADV-W Balance Sheet Requirements. The SEC staff will not recommend enforcement action if a hedge fund adviser that registered as a result of the Hedge Fund Rule and that withdraws before February 1, 2007, does not provide the otherwise required balance sheet with the Form ADV-W it uses to withdraw its registration.

The SEC also discussed two issues not raised by the Request Letter. First, the SEC noted that Form ADV will revert to the version that was in effect prior to the ADV changes effected by the Hedge Fund Rule and the SEC will post on its website (http://www.sec.gov/divisions/investment/iard.shtml) guidance on how to complete the Form ADV as it appears on the Investment Adviser Registration Depository ("IARD") until IARD reflects such changes.

Second, the SEC addressed the amendment to Rule 204-2, which had provided, prior to *Goldstein*, that a hedge fund's records are records of the adviser (and thus potentially subject to SEC examination), if the adviser or any related person acts as the hedge fund's general partner, managing member, or in a comparable capacity. The No-Action Letter clarifies that: "A registered investment adviser must make records available for examination in accordance with section 204 of the Act. The adviser may not evade this requirement by holding records by or through any other person, including a related person or private fund."

A copy of the No-Action Letter is available at: http://www.sec.gov/divisions/investment/noaction/aba081006.pdf.

SEC Enforcement Actions

Prudential Admits Criminal Wrongdoing in Settling Market-Timing Charges

Prudential agrees to pay $600 million as part of market-timing settlement

On August 28, 2006, federal and state regulators, including the SEC, the NASD and the Department of Justice ("DOJ"), announced that Prudential Equity Group, LLC ("PEG") (formerly known as Prudential Securities Inc.) agreed to settle charges of improper trading in mutual fund shares. PEG, which is a registered broker-dealer and was at the time of the alleged offenses an investment adviser subsidiary of Prudential Financial, Inc., the life insurance company, agreed to pay $600 million pursuant to a global civil and criminal settlement with the SEC, the NASD, the DOJ, the Massachusetts Securities Division, the New Jersey Bureau of Securities, the New York Attorney General's Office and the New York Stock Exchange.

According to the SEC's order of settlement (the "Order"), from late 1999 until mid-2003, registered representatives of PEG (the "Representatives") in Boston and New York used deceptive tactics to conceal their own identities and those of their customers (primarily hedge funds) in order to evade mutual funds' prospectus limitations on market timing. The shares of as many as 25 mutual funds, including funds managed by Putnam, Janus and Fidelity, were involved. Such tactics allegedly included the use of multiple broker identifying numbers, multiple customer accounts and "under the radar" trading—*i.e.*, the practice of dividing one trade into multiple smaller trades. Despite receiving hundreds of notifications to cease such trading practices from mutual funds, PEG allegedly failed to enforce properly its own policies and procedures or to curtail the deceptive conduct. Rather, senior management at PEG allegedly continued to enable such conduct by, among other things, issuing additional identification numbers and accounts and failing to comply with the requests of mutual funds or to discipline the brokers at fault. According to the Order, PEG also failed to maintain required records relating to the Representatives' trading practices.

Based on such conduct, the SEC alleged that PEG willfully violated: (i) Section 17(a) of the Securities Act of 1933, which prohibits fraudulent conduct in the offer and sale of securities; (ii) Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder; and (iii) Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder, which require the maintenance of certain books and records. PEG agreed to settle the SEC's charges without admitting or denying its findings.

In addition to censuring PEG, the SEC ordered the firm to pay $270 million into a distribution fund to compensate the mutual funds and shareholders harmed by the Representatives' conduct. PEG is required to retain an independent distribution consultant in connection with the distribution of the $270 million.

In settling the charges of other regulators, PEG must also pay to the DOJ a criminal penalty of $325 million and a civil penalty of $5 million to the Massachusetts Securities Division. The $600 million total settlement amount is one of the largest imposed against a financial institution for improper market timing.

As part of a five-year deferred-prosecution agreement with the DOJ, PEG admitted to criminal wrongdoing, which is the first such admission in the context of the market-timing scandal. PEG also agreed to certain terms and conditions for a period of five years, including cooperating with the DOJ in its ongoing investigation of fraudulent trading practices.

Separately, the SEC has filed a related civil injunctive action in the Southern District of New York, charging four registered representatives at PEG branch offices in New York with improper market-trading activities for their involvement in these matters. The SEC's investigation as to other individuals is ongoing.

A copy of the SEC's Order is available at: http://www.sec.gov/litigation/admin/2006/34-54371.pdf. A copy of the DOJ's press release is available at: http://www.usdoj.gov/opa/pr/2006/August/06_odag_574.html. A copy of the consent order with the Massachusetts Securities Division is available at: http://www.sec.state.ma.us/sct/sctpru/pru_consent.pdf. A copy of the press release issued by the New Jersey Bureau of Securities is available at: http://www.nj.gov/oag/newsreleases06/pr20060828c.html. A copy of the New York State Attorney General's assurance of discontinuance is available at: http://www.oag.state.ny.us/press/2006/aug/Prudential%20AOD.pdf.

SEC Accuses Three of Allowing Improper Market Timing and Frequent Trading in Janus Mutual Funds

The SEC filed cease-and-desist proceedings against three former Janus officers for permitting improper trading and for failing to disclose such arrangements

On July 31, 2006, the SEC filed an order (the "Order") instituting an administrative cease-and-desist proceeding against three former officers of Janus Capital Management, LLC ("JCM"), a registered investment adviser, for allegedly permitting and facilitating improper market timing and frequent trading in mutual funds managed by JCM (the "Funds"). According to the Order, three individuals—Warren Lammert, who was portfolio manager of Janus Mercury Fund until 2003; Lars Soderberg, an executive vice president and managing director in sales at JCM until 2004; and Lance Newcomb, an assistant vice president and regional sales director for JCM until 2003 (collectively, the "Respondents")—entered into special arrangements with two brokerage firms whereby their customers were permitted to trade in excess of trading limits disclosed in the Funds' prospectuses and enforced against other investors. Specifically, the SEC alleged that in 2001, Lammert entered into an arrangement with brokerage firm Trautman Wasserman whereby Trautman customers traded in excess of certain Funds' annual exchange limits. According to the SEC, the Respondents allowed this arrangement to continue until 2003. In addition, Lammert allegedly entered into a similar arrangement with brokerage firm Brean Murray & Co., Inc. Pursuant to this arrangement, a Brean Murray customer was allegedly permitted to trade in a Fund in excess of the Fund's limitation of four exchanges per year in return for an agreement that the customer would make a long-term investment in a Janus money market fund. According to the SEC, such arrangements violated the prospectus disclosures of such Funds. Moreover, the Respondents allegedly failed to disclose such preferential treatment to the Funds' shareholders or boards of trustees.

Based on these claims, the Respondents are alleged to have willfully violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder or to have willfully aided and abetted and caused JCM's violations of such provisions. Respondents are also alleged to have willfully aided and abetted and caused JCM's violations of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940. In addition, Lammert and Soderberg allegedly aided and abetted and caused JCM's violations of Section 34(b) of the Investment Company Act of 1940 (the "40 Act") by making an untrue statement of material fact in a registration statement, while Newcomb is alleged to have aided and abetted and caused JCM's violations of Section 17(d) of the 40 Act and Rule 17d-1 thereunder by effecting transactions in connection with joint arrangements in which the Funds participated without SEC approval. The SEC's Order requires that the Respondents appear at a hearing before an administrative law judge to determine the truth of such allegations.

A copy of the Order is available at: http://www.sec.gov/litigation/admin/2006/33-8727-o.pdf.

Litigation

Tennessee Court Finds that State Consumer Protection Act Applies to the Sale of Securities and Provision of Investment Advice

Court holds that offering securities for sale and providing investment advice are consumer transactions within the purview of consumer protection act

On June 30, 2006, in a matter of first impression, the Court of Appeals of Tennessee (the "Court") held, among other things, that the Tennessee Consumer Protection Act (the "TCPA")—a remedial statute with a coverage "far broader than the scope of common-law actions for deceit"—applies to the marketing and sale of securities. *Johnson v. John Hancock Funds*, No. M2005-00356-COA-R3-CV (Tenn. Ct. App., June 30, 2006). In so holding, the Court reversed the decision of the Chancery Court for Davidson County and reinstated the claims of three investors—Mary Anne Howland, 76-year-old Annie Johnson and her daughter Linda Johnson (collectively, the "Appellants")—against Signator Investors, Inc., a retail broker-dealer and registered investment adviser in the John Hancock Financial Services network with which Marcus Henderson, a financial adviser who provided investment advice to the Appellants and who runs the Henderson Financial Group in Nashville, is affiliated.

By way of background, the Appellants originally sued Mr. Henderson, Signator Investors and three other related John Hancock companies, alleging common-law fraud and misrepresentation, negligence, breach of fiduciary duty and violation of the TCPA. These claims were based on allegations that Mr. Henderson purchased for the Appellants investments that were excessively risky given their stated investment goals and that his purchase of Class B mutual fund shares on their behalf resulted in higher fees than they would have had to pay had he purchased Class A mutual fund shares. When purchased in amounts over $100,000, Class A shares generally provide for lower fees than Class B shares. Nevertheless, according to the Court, Mr. Henderson sold to the Appellants John Hancock Class B mutual fund shares in transactions that exceeded $100,000.

Finding that the TCPA does not apply to conduct connected with the sale of securities, the trial court dismissed the Appellants' TCPA claims for failure to state a claim upon which relief could be granted. In its June 30 decision, the Court reversed this holding and instead concluded that offering securities for sale and providing investment advice *are* consumer transactions for purposes of the TCPA. In reaching this conclusion, the Court found that securities are "goods" and investment advice a "service." The Court also reasoned that the federal and state securities laws cannot "be construed as limiting the remedies available to consumers who purchase securities to the remedies provided in [such] laws" and found nothing to the effect that the TCPA "or similar Acts passed by other states do not apply to the marketing or sale of securities." Therefore, the Court concluded, "neither the federal nor the state statutes regulating the marketing or sale of securities provide exclusive remedies for unfair or deceptive acts or practices in connection with the marketing or sale of securities."

Separately, the Court also held that the trial court had erred in excluding the Appellants' expert testimony and in dismissing their fraud, misrepresentation and breach of fiduciary duty claims. The Court remanded the case for further proceedings.

A copy of the Court's opinion is available at: http://www.tsc.state.tn.us/OPINIONS/TCA/PDF/062/JohnsonAEHopn.pdf.

Fairfax Seeks $6 Billion from Hedge Funds for Alleged Short-Selling Scheme

Hedge funds are accused of engaging in a "massive and fraudulent disinformation campaign" against Fairfax

On July 26, 2006, Fairfax Financial Holdings Limited ("Fairfax"), an insurance and financial services holding company based in Toronto, and Crum and Forster Holdings Corp. (collectively, the "Plaintiffs"), an indirect subsidiary of Fairfax, filed a lawsuit in New Jersey Superior Court against more than 30 hedge funds and related persons (collectively, the "Defendants"). Among the Defendants are S.A.C. Capital Management, LLC, Steven A. Cohen, Exis Capital Management, Inc. and investment bank Morgan Keegan & Company ("Morgan Keegan"). The Plaintiffs are seeking $6 billion in compensation for an alleged scheme to drive down Fairfax's stock in order to profit from short positions in such stock—the so-called "Fairfax Project."

According to the Plaintiffs' complaint, in 2002 when Fairfax stock began trading on the New York Stock Exchange, some of the Defendants began aggressively acquiring short positions. Thereafter, beginning in early 2003, the Defendants, including a Morgan Keegan analyst, allegedly began to drive down the stock price by "disseminating materially false and misleading information, orchestrating negative news articles, commissioning, dictating, or otherwise influencing unwarranted, false and exaggerated negative reports from biased stock analysts, and using such manufactured misinformation to engender investor suspicion and legal and regulatory scrutiny." For instance, according to the Plaintiffs, the Morgan Keegan analyst issued a report in early 2003 that "grossly distorted" the facts about Fairfax and that caused its stock to plummet. Conduct of this nature allegedly caused shareholders to sell and Standard & Poor's to reduce Fairfax's credit rating to BB from BB+ despite Fairfax's record year.

Based on these and other claims, the Plaintiffs allege various state law violations, including commercial disparagement, tortious interference with contractual relationships and civil conspiracy. In addition, the Plaintiffs allege violations of the New Jersey Racketeer Influenced and Corrupt Organizations Act.

A copy of the Plaintiffs' complaint is available at: http://www.fairfax.ca/Assets/Downloads/Press/fpr2006-07-26.pdf.

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