DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

SEC Enforcement Actions

SEC Brings Enforcement Action Against Hedge Fund Managers for General Solicitation

On July 8, 2005, the SEC brought a settled enforcement action against two affiliated hedge fund managers/investment advisers, Gerald Klein & Associates, Inc. ("GKA") and Klein Pavlis & Peasley Financial, Inc. ("KPP"), for violating the private offering requirements under both the Securities Act and the Investment Company Act. According to the SEC, GKA and KPP, as investment advisers to two hedge funds (the "Funds"), caused the Funds to engage in a public offering by making a general solicitation. The SEC alleged that a general solicitation occurred when GKA and KPP discussed particular information about the Funds during a radio program, and then again at an investment seminar, while the Funds were being offered to investors. Additionally, performance data and contact information were available on the shared website of GKA and KPP, which was not password protected for a period of time, and thereby temporarily accessible to the public.

> SEC files public administrative and cease-and-desist proceedings regarding integration and public offering violations

The SEC also alleged that the Funds should have been integrated for the purposes of counting holders under Section 3(c)(1) of the Investment Company Act because the investment strategies and portfolio holdings of the Funds were virtually identical. Together, the Funds had 112 investors, 64 of which were not accredited investors within the meaning of Regulation D. Accordingly, GKA and KPP were found to have, among other things, willfully aided and abetted and caused the Funds' violation of Section 7(a) of the Investment Company Act. Based on these findings, in addition to censuring GKA and KPP, the SEC ordered GKA and KPP to (i) cease and desist from committing or causing any future violations of the relevant provisions of the Securities Act and the Investment Company Act, (ii) pay a $20,000 civil penalty and (iii) comply with certain undertakings, which included engaging an Independent Consultant to conduct quarterly compliance reviews of GKA's and KPP's investment advisory operations for a period of three years (with a report to the SEC on the results

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of each compliance review within 30 days). A copy of the SEC's administrative proceeding is available at: http://www.sec.gov/litigation/admin/33-8585.pdf.

U.S. Chamber of Commerce Sues SEC Over Re-Adoption of Mutual Fund Independence Rules

Chamber brings second suit regarding mutual fund independence provisions

On July 7, 2005, the U.S. Chamber of Commerce (the "Chamber") filed a petition in the U.S. Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit") challenging, for a second time, certain provisions of the SEC's mutual fund independence rules and the re-adoption of such provisions eight days after the D.C. Circuit remanded the rules for additional consideration. On June 29, as reported in the *July 2005 Investment Management Regulatory Update*, the SEC re-adopted the rule mandating that a mutual fund board have (i) no less than 75% independent directors and (ii) an independent chairman. The proposed rule is slated to take effect in early 2006.

On July 13, the Chamber requested that the SEC stay the re-adopted independence provisions, including the January 16, 2006 compliance date, pending resolution of the D.C. Circuit's resolution of the action. The SEC denied the Chamber's motion, by a 2-2 vote, on July 15, 2005. Then, on July 26, the Chamber asked the D.C. Circuit to stay the controversial requirements, or, alternatively, to provide "expedited review" and a ruling before August 16.

Separately, on July 28, the Chamber appealed to the D.C. Circuit to reconsider its June 21 conclusion that the SEC "adequately justified the adoption of the regulatory provisions…as 'prophylactic'" under certain Investment Company Act exemptions. In its petition for rehearing, the Chamber argued that the SEC adopted the amendments for the effect they were expected to have on activities "outside the exemptive rules," thereby exceeding its regulatory authority. A copy of the Chamber's July 7 petition for review is available at: http://www.uschamber.com/NR/rdonlyres/efaykd5egedsrs67m66irc35rykhz5k6sdas4uzu6calzxbgchkuzxkwpxwswmymbpb4p6xfe3y4syzfmqhcy67cczh/CoCUSvUSSECPetitionforReview070705.pdf. At press time, a copy of the Chamber's July 28 petition for rehearing was unavailable.

Litigation

SEC Sues Vermont Company and Owner Alleging Fraud in "Auto-Trading" Programs

SEC investor alert describes auto-trading programs as "highly risky"

On June 30, 2005, the SEC filed civil charges in the U.S. District Court for the District of Vermont against Terry's Tips Inc. ("Terry's"), a Vermont corporation, and its founder, owner and control person, Terry F. Allen ("Allen"), alleging antifraud violations related to their operation of "auto-trading" programs.

"Auto-trading" refers to programs where investors appoint an online adviser to direct trades in an investor's brokerage account without consulting the client about the price, the type of security, the amount and when to buy and sell. Auto-trading programs are often sold in connection with subscription-based online financial publications.

The SEC alleges that Terry's and Allen utilized false and misleading performance projections, and promises of substantial returns, to encourage hundreds of subscribers to enroll in their auto-trading program. Those clients who subscribed to Terry's auto-trading service, 1,200 in total, were told that their money was safely invested and that they "would not experience substantial losses." In this manner, clients were encouraged to adopt the auto-trading program for their individual retirement accounts. Those clients did not achieve the advertised returns but, rather, incurred substantial financial losses. The SEC contends that Terry's deceived investors through "false promises of unrealistic and unreasonable investment returns," thereby violating Sections 206(1) and (2) of the Advisers Act. Based on these and other alleged violations of the federal securities laws, the SEC, in its complaint, seeks permanent injunctive relief, disgorgement of profits with prejudgment interest and civil monetary penalties.

In addition to filing its case against Terry's, which has managed over $14 million in client assets through its auto-trading programs since September 2004, the SEC issued an Investor Alert, "All About Auto-Trading," which explains how to review an auto-trading program. A copy of the SEC's complaint is available at: http://www.sec.gov/litigation/complaints/comp19291.pdf. A copy of "All About Auto-Trading" is available at: http://www.sec.gov/investor/pubs/autotrading.htm.

SEC Sues Broker Alleging Abusive Mutual Fund Trades

Broker charged with engaging in late trading and market timing

On July 7, 2005, the SEC charged Scott A. Christian ("Christian"), a broker and registered representative of Trautman Wasserman & Co. Inc. ("Trautman"), with (i) engaging in late trading and market timing of mutual funds on behalf of clients and (ii) taking actions to attempt to conceal those trades. Between January 2001 and September 2003, the SEC alleges that Christian, together with others at Trautman, executed tens of thousands of trades in a scheme whereby they had customers submit proposed mutual fund trading orders during the trading day and then Christian would have the trades time-stamped just before 4 p.m. Christian, however, did not enter the trades for execution at that time. Instead, he would communicate with customers for several hours after 4 p.m., deciding, based on market information received after the 4 p.m. close, whether to execute the proposed trades or alter the orders. If a decision was made to go forward on a trade, Christian would then enter the trade using Trautman's system.

In an effort to avoid having potentially harmful market timing trades detected by mutual fund companies, the SEC alleges that Christian opened and traded in multiple accounts for his market-timing customers and used numerous different registered representative identification numbers. In its complaint, the SEC requests that the court order a permanent injunction against future violations, disgorgement and civil fines. A copy of the SEC's complaint is available at: http://www.sec.gov/litigation/complaints/comp19294.pdf.

Industry Updates

Cox Sworn In as SEC Chairman

Cox replaces Donaldson

On August 3, 2005, Rep. Christopher Cox was sworn in as the 28th chairman of the SEC. On July 29, 2005, the Senate approved Cox as chairman of the SEC by unanimous consent. Cox replaces William Donaldson, who, as reported in the *July 2005 Investment Management Regulatory Update*, resigned as chairman of the SEC on June 30, 2005. A copy of the press release is available at: http://www.sec.gov/news/press/2005-107.htm.

Reuben Jeffery to Serve as Chairman of the CFTC

Jeffery to replace Brown-Hruska as CFTC Chairman

On July 11, 2005, Reuben Jeffery III ("Jeffery") was sworn in as the new chairman of, and a commissioner at, the Commodities Futures Trading Commission (the "CFTC"). Jeffery was nominated for the position by President Bush on May 17, 2005 and was confirmed on June 30, 2005. He will serve the remainder of a five-year term that expires on April 13, 2007. Sharon Brown-Hruska has served as acting chairman of CFTC since July 2004. Jeffery is a former associate of Davis Polk & Wardwell. A copy of the CFTC's press release is available at: http://www.cftc.gov/opa/press05/opa5097-05.htm.

New SEC Rule Requires Funds to Identify Their Series and Classes in EDGAR Filings

SEC continues its effort to modernize the EDGAR system and improve disclosure

On July 18, 2005, the SEC adopted final rules that expand the information certain open-end management investment company and insurance company separate account filers must submit electronically about their series, classes and contracts. The rules also require that, effective June 12, 2006, investment companies submit two additional filings electronically, namely (i) sales literature and (ii) fidelity bonds.

The EDGAR system does not currently generate a record of filings on a series, class or contract basis. The rules, as amended, will require funds and separate accounts that register on Forms N-1A, N-3, N-4 and N-6 to obtain identifiers for their series, classes and contracts ("Identifiers"), which can be done on a newly created information page on the EDGAR filing Web site (the "EDGAR Information Page"). The Identifiers will be used to identify, electronically, for which of the funds or separate accounts a particular filing is being made. The information that contains the Identifiers will be searchable by the public and the SEC staff.

The EDGAR Information Page is currently available, on a voluntary basis, for the entry of information on series and classes. As of February 6, 2006, however, funds will be required to have that information entered and to have received their Identifiers. After that date, EDGAR will not accept filings without Identifiers. Going forward, funds will be obligated to update and keep current their series, class and contract information.

According to the rules, third-party filers, including parties to mergers, will also be required to use such series and class information in their filings. Additionally, the rules necessitate that third-party registrants submitting proxy filings with respect to investment companies designate the type of investment company and include the Identifiers in the designated proxy submission type. A copy of the final rule is available at: http://www.sec.gov/rules/final/33-8590.pdf.

FFIEC Releases the Bank Secrecy Act/Anti-Money Laundering Examination Manual

On June 30, 2005, the Federal Financial Institutions Examination Counsel (the "FFIEC") released the Bank Secrecy Act/Anti-Money Laundering Examination Manual (the "BSA/AML" and the "Manual," respectively) to assist with a more consistent application of the Bank Secrecy Act and related anti-money laundering regulations. The release of the Manual is of interest to financial institutions and pooled investment vehicles as it contains an overview of (i) BSA/AML compliance program requirements, (ii) BSA/AML risks and risk management expectations, (iii) industry practices and examination procedures and (iv) sanctions developed with the assistance of the Office of Foreign Assets Control (OFAC) of the Department of Treasury. A copy of the Manual is available at: http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man.pdf.

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