

A Summary of  
Current Investment  
Management Regulatory  
Developments

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## SEC Interpretations: No-Action Letters

### **SEC Responds to Securities Industry Association Letter Regarding Advisers Act Regulation of Broker-Dealer Financial Planning Activities**

On December 16, 2005, the SEC Division of Investment Management (“IM”) responded to a letter submitted by the Securities Industry Association (“SIA”), dated August 5, 2005, requesting IM’s views on certain aspects of the Advisers Act’s regulation of the financial planning activities of broker-dealers. Specifically, the SIA sought clarification regarding (i) whether a broker-dealer will be deemed to be holding itself out as an investment adviser based on advertisements referencing the availability of financial planning services or based on a broker-dealer’s representative using a business card or letterhead advertising a degree such as “Certified Financial Planner,” (ii) the differences between financial planning and brokerage services, and (iii) the application of certain notice and consent requirements for broker-dealers that are also registered as investment advisers in connection with principal or agency transactions.

In April 2005, the SEC adopted Advisers Act Rule 202(a)(11)-1 (the “Rule”) excepting from Advisers Act regulation any broker-dealer providing non-discretionary investment advice that is solely incidental to its brokerage services if the broker-dealer charges an asset-based or fixed fee and makes specific disclosure that an investor’s account is a brokerage account and not an advisory account, as well as disclosure regarding the conflicts inherent in the broker-dealer relationship. However, the Rule provides that a broker-dealer does not provide advice solely incidental to its brokerage services if it both (i) provides advice as part of a financial plan or in connection with providing financial planning services and (ii) either: (a) holds itself out generally to the public as a financial planner or as providing financial planning services; (b) delivers to the customer a financial plan; or (c) represents to the customer that the advice is provided as part of a financial plan or in connection with financial planning services. In the release adopting the Rule (the “Adopting Release”), the SEC stated that financial planning services involve a broker-dealer’s services to clients in identifying long-term goals, analyzing a client’s current financial situation and developing a comprehensive financial program to achieve such objectives. The Adopting Release noted that a financial plan typically address-

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es a wide spectrum of financial needs, such as insurance, savings, tax and estate planning and investments, often with an eye towards anticipated retirement.

In response to the SIA's inquiries regarding the Advisers Act's regulation of the financial planning activities of broker-dealers, IM provided the following guidance:

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## SEC provides guidance regarding the regulation of financial planning activities of broker-dealers under the Advisers Act

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- » *Holding Out Issues.* IM opined that a broker-dealer would not be holding itself out as an investment adviser merely because it informs a customer that such broker-dealer also offers financial planning or other investment advisory services. Instead, a broker-dealer will be subject to Advisers Act regulation if it publicly portrays itself as a financial planner in advertisements or otherwise as a financial planner and provides investment advice in connection with financial planning services. IM also confirmed that a broker-dealer representative's use of an educational or specialized training credential or degree such as "Certified Financial Planner" on a business card or letterhead would constitute "holding out," but emphasized that a broker-dealer would not be required to treat as an advisory client each customer to whom a card or letterhead is delivered unless the broker-dealer also provides investment advice to that customer as part of a financial plan or in connection with financial planning services.
- » *Definition of "Financial Plan."* IM took a fact-intensive approach and noted that whether a particular document or financial tool constitutes advice that is solely incidental to brokerage services or is a financial plan depends on whether such materials are used in the context of delivering advice related to a financial plan. IM also emphasized that a broker-dealer's disclosure regarding the intended use of a particular document or financial tool (*i.e.*, disclosure that such tool is a brokerage service and not a financial plan) can be helpful in determining whether such materials are provided as solely incidental to brokerage services. IM also added that how a reasonable investor would perceive the services would bear on whether a broker-dealer is providing brokerage services or financial planning services.

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- » *Notice and Consent Issues for Dual Registrants.* IM stated that a firm dually registered as a broker-dealer and as an investment adviser (a “Dual Registrant”) may serve a given customer in both capacities, explaining that whether an adviser-client relationship exists for purposes of the Advisers Act depends upon the facts and circumstances, such as the contractual terms of the relationship and the course of dealing. However, IM emphasized that the notice and consent requirements of the Advisers Act for principal and agency transactions set out in Section 206(3) would not apply where a Dual Registrant is not acting in an advisory capacity with respect to the transaction. Specifically, IM noted that where a client has not received advice to buy or sell a particular security, Section 206(3) would not be applicable. IM stated that where a broker-dealer provides “generalized, non-specific investment advice to a customer (e.g., ‘invest a portion of your account in equity securities’),” an adviser-client relationship does not exist. IM added that a Dual Registrant may discontinue its adviser-client relationship and then assume a brokerage relationship, provided that the Dual Registrant provides the client full disclosure about the change in the relationship and any resulting change in the obligations assumed by the broker-dealer.

A copy of the no-action letter is available at: <http://www.sec.gov/divisions/investment/noaction/sia121605.htm>.

### **SEC Responds to Broker-Dealer’s Letter Regarding Programs to Rebate 12b-1 Fees to Customers**

On November 30, 2005, the SEC Division of Investment Management (“IM”) responded to a letter submitted by E\*Trade Securities LLC (“E\*Trade”) requesting clarification regarding certain E\*Trade programs designed to rebate fees to E\*Trade customers charged by certain mutual funds to cover promotions, distributions, marketing expenses and commissions to unaffiliated brokers pursuant to Rule 12b-1 under the Investment Company Act (“12b-1 Fees”). 12b-1 Fees must be approved by a fund’s board of directors (a “board”) and its shareholders, documented in a written plan pursuant to Rule 12b-1 (a “12b-1 Plan”), and the board must approve a 12b-1 Plan’s continuation. In this regard,

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### SEC provides guidance regarding broker-dealer programs that rebate 12b-1 Fees to customers

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a board must determine that a 12b-1 Plan will benefit the fund and its shareholders. In a 2003 no-action letter (the “Mahaffy Letter”), the SEC generally questioned whether a 12b-1 Plan under which broker-dealers rebate 12b-1 Fees to their customers would benefit a fund and its shareholders. E\*Trade sought clarification that a board could indeed make such a determination, and the SEC agreed that it could.

E\*Trade currently offers a program to its customers under which E\*Trade rebates 12b-1 Fees and certain administrative fees on a semi-annual basis to eligible customers with active accounts holding shares through E\*Trade’s mutual fund supermarket (the “Program”). E\*Trade sought clarification as a result of funds asking to be excluded from the Program for fear of running afoul of the guidance set out in the Mahaffy Letter. IM responded that, while a board should consider broker-dealer rebates of 12b-1 Fees as a pertinent factor in its review and approval of a 12b-1 Plan, IM did not intend to indicate in the Mahaffy Letter that a board could never approve a 12b-1 Plan if a broker-dealer rebated 12b-1 Fees to its customers. Rather, the appropriateness of a board’s determination would depend upon all of the relevant facts and circumstances. IM posited that if all or almost all of the 12b-1 Fees that a fund paid to broker-dealers under its 12b-1 Plan were being rebated, the fund’s board might reasonably conclude that continuation of the 12b-1 Plan would no longer be reasonably likely to benefit the fund and its shareholders. The board, at such time, might elect to discontinue the 12b-1 Plan or reduce 12b-1 Fees paid by the fund.

While acknowledging that a fund’s board could conclude that a 12b-1 Fee rebate program benefits the fund and its shareholders, IM also noted in its response that rebate programs may, depending on the facts and circumstances, raise other issues under the Investment Company Act that should be considered by a fund’s board. IM posited that a fund that rebates 12b-1 Fees to select shareholders indirectly through broker-dealers may violate other sections of the Investment Company Act, including those prohibiting a fund from selling any class of senior securities (Section 18(f)); prohibiting a fund, its principal underwriter and dealers from selling fund shares at a price other than the current offering price set forth in the fund’s prospectus (Section 22(d)); and making it

unlawful for any person to do any act indirectly which it would be unlawful for such person to do directly under the Investment Company Act (Section 48(a)).

A copy of the no-action letter is available at: [www.sec.gov/divisions/investment/noaction/etrade113005.htm](http://www.sec.gov/divisions/investment/noaction/etrade113005.htm).

## **SEC Grants Broker-Dealers Relief Permitting Extensions of Credit on Exchange Traded Fund Issues**

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SEC grants exemptive relief from prohibitions of Section 11(d)(1) of the Exchange Act to broker-dealers engaged in the issuance of ETF shares

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On November 21, 2005, the staff of the SEC Division of Market Regulation (the “Staff”) granted exemptive relief allowing broker-dealers involved in the issuance and redemption of exchange traded fund (“ETF”) shares to extend, maintain or arrange for credit for or to customers on such shares. Section 11(d)(1) of the Securities Exchange Act of 1934 (“Exchange Act”) prohibits a person who is both a broker and a dealer from extending, maintaining or arranging for the extension or maintenance of credit to or for a customer on any non-exempt security that is part of a new issue in the distribution of which the broker-dealer participated as a member of a selling syndicate within the previous 30 days. The no-action letter, issued in response to a request for relief made by the Securities Industry Association, extends the relief from Section 11(d)(1) that was previously available for broker-dealers that trade ETF shares solely in the secondary market to include broker-dealers that as “authorized participants” (*i.e.*, broker-dealers that enter into an agreement with an ETF’s principal underwriter to become authorized participants and are not compensated by the ETF in connection with the issuance or redemption of such ETF shares) also participate in the issuance of “qualifying” ETF shares (*i.e.*, ETFs that meet certain registration, listing and diversification requirements and limitations).

The no-action request explained that Section 11(d)(1) was intended to address conflicts of interest in circumstances where a person acts as both a broker and a dealer. The rule seeks to prevent broker-dealers from inducing customers to buy on credit securities which the broker-dealer has undertaken to distribute to the public. The no-action request argued that broker-dealers involved in the issuance of ETF shares do not have the same incentives to engage in such “share pushing” because they do not have the same risk exposure that underwriters face in firm-commitment offerings of new issues. Further, the no-

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action request asserted that ETF shares have many unique features (*e.g.*, liquidity and transparency in pricing) that provide additional protection to investors beyond those available for most new issues. The Staff concurred and granted the requested relief from Section 11(d)(1), subject to the following conditions: (i) the broker-dealer may not receive compensation or other economic incentive to promote or sell the ETF shares to investors outside the fund complex; and (ii) the broker-dealer may not extend, maintain or arrange for the extension or maintenance of credit to or for a customer on ETF shares before 30 days from the date such shares commence trading.

A copy of the no-action letter is available at: <http://www.sec.gov/divisions/marketreg/mr-noaction/sia112105.htm>.

## SEC Enforcement Actions

### SEC Continues to Monitor and Penalize Mutual Fund Trading Abuses

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SEC settles various charges and brings new actions against investment advisers for improper market timing and illegal late trading

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The SEC continued its pursuit of market timing and late trading in mutual fund shares, filing various new complaints and settling numerous charges regarding such abuses. In December 2005, the SEC's enforcement activity included actions against mutual fund advisers that permitted market timing activity inconsistent with fund disclosure, broker-dealers that failed to adequately disclose conflicts and revenue-sharing arrangements with mutual funds and hedge funds and their associated persons that employed deceptive trading practices, such as trading through cloned accounts and shell entities, to avoid detection by funds' market timing prevention procedures.

On December 1, 2005, the SEC settled two actions against Ameriprise Financial Inc., formerly known as American Express Financial Corp. ("AEFC") and Ameriprise Financial Services Inc., formerly known as American Express Financial Advisors Inc. ("AEFA"), an investment adviser and broker-dealer, respectively, arising out of charges of illegal market timing in AEFC funds and inadequately disclosed revenue-sharing arrangements

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between AEFA and various mutual funds. In the first action, the SEC alleged that AEFC allowed certain shareholders to market time AEFC mutual funds despite statements in fund prospectuses expressly prohibiting such activity. AEFC officers purportedly justified exceptions to the funds' disclosed market timing prohibition on the basis that certain customers should be provided additional flexibility based on the size of their investments. In addition, the SEC charged that AEFC failed to implement procedures to monitor its employees and related companies from market timing through their 401(k) accounts. In the second action, the SEC alleged that AEFA failed to disclose millions of dollars in revenue-sharing payments and directed brokerage commissions it received from 27 mutual fund families for preferred distribution of fund shares. AEFA provided these preferred fund families benefits not available to fund families that did not make such payments, including exclusive shelf space for the sale and marketing of their funds, varying levels of access to AEFA's financial advisors and reduced or no transaction charges. AEFC and AEFA agreed to pay close to \$60 million in disgorgement and civil penalties to settle these actions. AEFC and AEFA also settled related charges with the NASD. AEFC and AEFA neither admitted nor denied the findings in the SEC's orders of settlement.

On December 22, 2005, the SEC settled illegal market timing and late trading charges against two hedge funds, Veras Capital Master Fund and VEY Partners Master Fund (together, the "Veras Funds"), their investment adviser Veras Investment Partners LLC and its two managing members, Kevin D. Larson and James R. McBride, for approximately \$38 million. The SEC charged that between January 2002 and September 2003, the Veras Funds used deceptive techniques to market time mutual funds that either prohibited such trading or limited the frequency of trading in and out of such funds. The Veras Funds allegedly disguised their identities from such mutual funds by creating eight different legal entities with names unrelated to "Veras," used these entities to open multiple accounts at multiple broker-dealers, and used such multiple accounts to divide trades into smaller dollar amounts to avoid detection. Further, the SEC alleged that the Veras Funds engaged in late trading of certain mutual funds, routinely purchasing and selling mutual fund shares after 4:00PM at prices set as of market close. Indeed, Veras proprietary trading software, on which the alleged late trades were based, considered market informa-

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tion gathered after the 4:00PM pricing of fund shares in determining whether to purchase and sell such shares. The aggrieved mutual funds were purportedly diluted by approximately \$35.5 million in the aggregate. Separate settlements with the Commodity Futures Trading Commission and the New York Attorney General were also announced for \$500,000 and approximately \$1.8 million, respectively.

On December 16, 2005, the SEC issued separate orders instituting administrative proceedings against John S. Pepper, Martin J. Druffner and Skifter Ajro, for deceptive trading practices while employed as registered representatives of Prudential Securities, Inc. The SEC charged Pepper, Druffner and Ajro for employing deceptive techniques, including the creation and use of multiple broker identification numbers and customer account numbers, to hide their identities in order to market time in mutual funds that had previously taken steps to block their respective trading activity. While the orders issued against Druffner and Ajro are pending public hearings, Pepper agreed to a settlement. Pepper was ordered to disgorge approximately \$450,000 in ill-gotten gains, plus prejudgment interest, but the SEC waived all but \$50,000 of such disgorgement in exchange for certain information Pepper provided in an enforcement action filed against Druffner in the U.S. District Court for the District of Massachusetts.

On December 22, 2005, the SEC filed charges in the U.S. District Court for the Northern District of California against two former San Francisco-based hedge fund managers Brent Federighi and Michael Hoffman (together, the "Defendants"). The complaint alleged that while acting as co-managers of certain hedge funds known only as the Ilytat hedge fund and the Gage hedge fund from 2000 to 2003, the Defendants placed thousands of illegal late trades, defrauding affected mutual funds of approximately \$49 million. The Defendants were able to place late trades through a direct order system for fund shares known as the Mutual Fund Routing System ("MFRS"), proprietary software provided to the Defendants' funds by their broker. The SEC alleged that the Defendants deliberately exploited a loophole in the MFRS program that allowed the Defendants to bypass their broker and place over 3,000 illegal late trades in over 400 different mutual funds. The complaint also alleged that the Defendants engaged in fraudulent market timing of mutual fund shares by trading through

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multiple account numbers that were non-consecutively numbered to conceal their identity from mutual funds seeking to block market timers. In addition to these allegations, the Defendants were charged with failing to disclose their involvement in late trading and market timing to certain hedge fund investors, in breach of their fiduciary duties as investment advisers. The SEC's enforcement action seeks injunctive relief, disgorgement and civil monetary penalties.

A copy of the AEFC settlement is available at:

<http://www.sec.gov/litigation/admin/ia-2451.pdf>.

A copy of the AEFA settlement is available at:

<http://www.sec.gov/litigation/admin/33-8637.pdf>.

A copy of the Veras settlement is available at:

<http://www.sec.gov/litigation/admin/33-8646.pdf>.

A copy of the Peffer settlement is available at:

<http://www.sec.gov/litigation/admin/34-52962.pdf>.

A copy of the Druffner order is available at:

<http://www.sec.gov/litigation/admin/34-52963.pdf>.

A copy of the Ajro order is available at:

<http://www.sec.gov/litigation/admin/34-52964.pdf>.

A copy of the SEC's complaint in the Federighi and Hoffman matter is available at: <http://www.sec.gov/litigation/complaints/comp19510.pdf>.

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## Hedge Fund and Associated Individuals Settle State and Federal Charges of Market Timing for More Than \$180 Million

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SEC and New York Attorney General fines hedge fund and its associated persons for deceptive market timing scheme

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On December 1, 2005, the SEC and the New York Attorney General announced a settlement of charges against Millennium Partners, L.P. (“Millennium Partners”), Millennium Management, L.L.C. (“Millennium Management”) and Millennium International Management, L.L.C. (“Millennium International Management”) (collectively, “Millennium”) for engaging in a deceptive multi-pronged market timing scheme. In addition, several individuals associated with Millennium, including Millennium founder Israel Englander, chief operating officer Terence Feeney, general counsel Fred Stone and trader Kovan Pillai (collectively, the “Individual Respondents”) were fined more than \$32 million in the aggregate for their knowledge of and participation in such market timing scheme. Proceeds of the foregoing fines have been placed in an account to be distributed to aggrieved investors.

The SEC alleged that the Individual Respondents knew that mutual funds generally discouraged market timing activity and often sought to block such activities. Millennium had, over time, received hundreds of block letters and notices from different mutual fund families in response to its market timing activities. The SEC alleged that from 1999 to 2003, Millennium engaged in various fraudulent means to conceal its identity from mutual funds to avoid detection and circumvent the restrictions employed by such mutual funds to prevent market timing. The SEC specifically charged that Millennium: (i) created approximately 100 new legal entities with unrelated names to hide its identity from mutual funds and used these entities to open approximately 1,000 brokerage accounts at approximately 39 different clearing brokers; (ii) used variable annuity contracts as a vehicle to gain market timing capacity in underlying mutual funds that were known to prohibit market timing; (iii) used brokers with multiple registered representative numbers to evade mutual funds’ market timing detection; (iv) used structured trading and omnibus account trading strategies to disguise timing activities (*i.e.*, broke up larger trades into several smaller transactions, left small positions when trading out of a mutual fund and used clearing brokers who aggregated trades in omnibus accounts that concealed the

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identities of the individual entities); (v) used “sticky assets” to obtain timing capacity from certain mutual funds; and (vi) rented additional post office boxes from a private mail service for use when opening new brokerage accounts.

As part of the settlement, Millennium Partners agreed to disgorge \$121.4 million, and Millennium Management and Millennium International Management agreed to, jointly and severally, disgorge \$26.6 million. Further, Englander was fined a \$30 million penalty, Feeney and Stone were fined \$2 million and \$25,000, respectively, and Pillai was fined \$150,000, resulting in an aggregate total fine of more than \$180 million against the Millennium entities and its officers. Millennium also agreed to certain corporate governance undertakings, including retention of an independent compliance consultant, an independent distribution consultant and the establishment of several oversight committees, as part of the settlement. A copy of the settlement is available at: <http://www.sec.gov/litigation/admin/33-8639.pdf>.

### **Commission Bars Former Owner of Financial Services Firms From Association with Any Broker, Dealer or Investment Adviser**

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Former owner of broker-dealer and investment advisory firms is barred from securities industry for fraudulent conduct

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On December 16, 2005, the SEC issued an order barring Nathan A. Chapman, Jr., former head of The Chapman Company (“TCC”), a registered broker-dealer, and Chapman Capital Management (“CCM”), a registered investment adviser, from association with any broker, dealer or investment adviser as a result of federal criminal convictions under the Advisers Act and Exchange Act related to a fraudulent scheme conducted by Chapman and others in connection with the June 2000 initial public offering (“IPO”) of and subsequent secondary market trading in the stock of the parent company for TCC and CCM, eChapman.com, Inc. (“EMCN”).

EMCN was formed by Chapman for the purpose of bringing together the financial services capabilities of TCC and CCM and to create a website offering various financial services. In November 1999, EMCN filed an initial registration statement with the SEC for EMCN’s IPO with a price range of \$14 to \$16 per share. During the bookbuilding process, it became apparent that the marketing

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of an internet-related company would be difficult. The lack of interest reduced the proposed IPO price range and delayed the desired timing for the offering. EMCN's registration statement finally went effective on June 15, 2000 with an IPO price of \$13 per share. Trade settled T+5 on June 20, 2000. EMCN shares dropped to \$8 per share once public market trading began.

Chapman and others were alleged to have engaged in various fraudulent activities in connection with the flagging IPO, including using the proceeds of the IPO to buy thousands of shares in the months following the offering and propping up the trading price by discouraging CCM's advisory clients and TCC's brokerage customers from selling their EMCN stock. In addition, a registered representative of TCC was alleged to have executed a series of unauthorized trades for EMCN shares in at least 28 customer accounts. Moreover, Chapman purportedly used his control of TCC and CCM to have almost one-third of the IPO shares placed with a CCM advisory client, with a portion of those shares sold to the advisory client a week after EMCN trading began in the secondary market and backdated to the initial trading price of \$13 (rather than the market price of \$7 per share). When EMCN's share price dropped, the advisory client suffered losses.

Chapman consented to the bar without admitting or denying any findings of wrongdoing. In addition to the bar, Chapman was sentenced to 90 months in jail and ordered to pay \$5 million in restitution in his criminal case. A civil complaint filed by the SEC against Chapman and others is also pending. A copy of the original complaint is available at: <http://www.sec.gov/litigation/complaints/comp18203.htm>. A copy of the recently issued order was not available at print time.

## NASD Developments

### **NASD Fines Broker-Dealers \$19.4 Million for Suitability and Supervisory Violations Relating to Sales of Class B and C Mutual Fund Shares**

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Firms are fined for recommending mutual fund share classes without properly considering or adequately disclosing the impact of sales charges and expenses

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On December 19, 2005, the National Association of Securities Dealers (“NASD”) announced that it had fined Merrill Lynch, Pierce, Fenner & Smith, Wells Fargo Investments and Linsco/Private Ledger Corporation (together, the “Firms”) a total of \$19.4 million for suitability and supervisory violations relating primarily to sales of Class B (*i.e.*, shares with no load but a contingent deferred sales charge (“CDSC”) and convertible into Class A shares) and Class C (*i.e.*, shares with no load but a CDSC that is lower than that of Class B shares and that do not convert into Class A shares) mutual fund shares. The NASD investigated transactions at the Firms during an 18-month period between January 2002 and July 2003. The NASD noted that the cases are part of an ongoing investigation into mutual fund sales practices.

NASD suitability rules require a broker to consider a customer’s anticipated holding period and all costs associated with each share class, such as front-end sales charges, expenses and CDSCs. The Firms allegedly recommended and sold Class B and/or Class C share mutual funds to their customers without considering or adequately disclosing on a consistent basis that the fees and expenses paid on an equal investment in Class A shares would generally have been more advantageous to those customers. The NASD also alleged that the Firms did not have adequate supervisory and compliance procedures in place relating to the manner in which the Firms’ personnel recommended and sold Class B and Class C shares.

The Firms agreed to the fines and a remediation plan that generally covers investors who, between January 1, 2002 and the dates of the settlement with each firm, purchased Class B shares totaling \$50,000 or more depending upon the expenses and charges of the fund and who, under any ordinary circumstances, would have been better off had they purchased Class A shares instead of Class B shares. The offer will also be extended to a limited number of Class C share investors who, during the same time frame, made purchases of

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\$500,000 or more and who, in view of all relevant circumstances, would have been better off had they purchased Class A shares instead of Class C shares. The Firms settled with the NASD without admitting or denying the allegations, but consenting to the entry of the NASD's findings. A copy of the NASD press release is available at: [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_015753&ssSourceNodeId=9](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015753&ssSourceNodeId=9).

## Industry Update

### IRS Revenue Ruling: Commodity Index Derivative Contracts Are Not Securities for Purposes of the Code

On December 16, 2005, the Internal Revenue Service ("IRS") ruled that a derivative contract that provides for a total return exposure on a commodity index is not a security for purposes of Section 851(b)(2) of the Internal Revenue Code ("Code") and income from such a derivative contract is not qualifying income under the provisions of the Code applicable to regulated investment companies ("RIC").

Section 851(b)(2) states that a corporation shall not be considered a RIC for any taxable year unless it meets an income test and an asset test. Under the income test, at least 90% of its gross income must be derived from certain qualifying sources ("qualifying income"). Under the asset test, at least 50% of its total assets must be comprised of cash, cash items, government securities, securities of other RICs and "other securities." Failure to meet these tests would render such non-qualifying investment company's income taxable. The IRS ruling turns on whether such derivative contracts are securities for purposes of Section 851(b)(2) or generate "other income" derived from the company's business of investing in securities and thus, constitute qualifying income. Qualifying income includes "dividends, interest, payments with respect to securities loans...gains from the sale or other disposition of stock or securities (as defined in [the Investment Company Act]) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC's] business of investing in such

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Revenue ruling concludes that income from derivative contracts linked to the return on a commodity index do not meet the qualifying income requirement for RICs under the Code

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stock, securities or currencies...” The IRS ruling looked to the legislative history of, and Congressional floor statements related to, the Tax Reform Act of 1986 in concluding that Congress did not intend to incorporate an expansive construction of the term “securities” for purposes of the Code. A copy of the IRS ruling is available at: <http://www.irs.gov/pub/irs-drop/rr-06-01.pdf>

### FinCEN Final Anti-Money Laundering Rule Applicable to Mutual Funds

FinCEN issues final rule on anti-money laundering due diligence under USA PATRIOT Act

In December 2005, the U.S. Department of the Treasury’s Financial Crimes Enforcement Network (“FinCEN”) issued final regulations implementing the anti-money laundering (“AML”) due diligence provisions under Section 312 of the USA PATRIOT Act for foreign correspondent accounts and private banking accounts. FinCEN administers the Bank Secrecy Act, which authorizes the collection, analysis and dissemination of financial information important to the prevention of money laundering and terrorist financing. FinCEN has been designated by the U.S. Department of the Treasury as one of the primary agencies to establish, oversee and implement policies to detect and prevent money laundering and terrorist financing. Although banks and broker-dealers have been subject to FinCEN AML diligence requirements pursuant to an interim final rule adopted in July 2002, mutual funds had not previously been covered. In addition to the final regulation, FinCEN also issued a notice of proposed rulemaking relating to one provision of the USA PATRIOT Act that requires enhanced due diligence for correspondent accounts maintained for certain foreign banks that, due to their location or business and affairs, give rise to AML concerns.

- » *General Due Diligence.* The final rule requires U.S. banking institutions, securities broker-dealers, futures commission merchants and introducing brokers in commodities and mutual funds (collectively, the “Covered Entities”) to perform due diligence with respect to correspondent accounts maintained for certain foreign financial institutions. FinCEN retained the broad definition of “correspondent account” contained in the USA PATRIOT Act, which includes any account established for a foreign financial institution to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other

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financial transactions related to such foreign financial institution. Covered Entities must establish a due diligence program that includes appropriate, specific, risk-based, and, where necessary, enhanced policies, procedures and controls that are reasonably designed to detect and report known or suspected money laundering activity conducted through or involving any correspondent account established, maintained, administered or managed in the United States. The final rule also requires periodic review of correspondent account activity.

- » *Enhanced Due Diligence.* FinCEN also issued a notice of proposed rule-making setting forth an enhanced due diligence process to be followed by Covered Entities when establishing or maintaining a correspondent account for a foreign bank that is operating: (i) under an offshore license; (ii) in a jurisdiction found to be non-cooperative with international AML principles; or (iii) in a jurisdiction found to be of primary money laundering concern under Section 311 of the USA PATRIOT Act. Such enhanced AML diligence involves additional review of a foreign bank's customers, owners and account operations.
- » *Private Banking Provisions.* Under the final rule, Covered Entities are required to establish AML due diligence policies and procedures for private banking accounts similar to those for correspondent accounts. The rule defines a private banking account as an account that is established or maintained for the benefit of one or more non-U.S. persons, requires a minimum aggregate deposit of funds or other assets of not less than \$1,000,000 and is assigned to a bank employee who is a liaison between the financial institution and the non-U.S. person. The final rule requires enhanced scrutiny of private banking accounts maintained for senior foreign political figures, their immediate family members or persons widely and publicly known to be close associates of such individuals.

Covered Entities have 90 days from the publication of the final rule to implement the foregoing AML procedures with respect to "new" correspondent and private banking accounts. A new account is one established at least 90 days after the date of the regulation's publication. For existing accounts and those accounts established before the 90-day time frame, the final rule will take effect 270 days after publication. The final regulation has not yet been published, but

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FinCEN has issued a fact sheet, a copy of which is available at: <http://www.fincen.gov/312factsheet.pdf>. The final regulation is expected to appear in the Federal Register sometime in January 2006.

### FERC Rules for Public Utility Holding Companies To Become Effective

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FERC's recently adopted rules under the 2005 Public Utility Holding Company Act subject SEC-registered investment companies and investment advisers to filing requirements in connection with investments in public-utility companies or their holding companies

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On December 8, 2005, the Federal Energy Regulatory Commission ("FERC") issued a final rule release (the "Release") adopting rules to implement the Public Utility Holding Company Act of 2005 ("2005 Act"). Earlier this year, the 2005 Act was signed into law and repealed the Public Utility Holding Company Act of 1935. The 2005 Act transfers regulatory authority over public utility holding companies from the SEC to the FERC. The new rules adopted by the FERC will become effective on February 8, 2006.

The new rules may impose additional regulation upon SEC-registered investment companies and investment advisers as public utility holding companies, and affiliates thereof, and require certain notice filings with the FERC. As stated in the Release, the 2005 Act is primarily a books and records statute (*i.e.*, requiring certain accounting and records-retention) and does not give the FERC any new substantive authorities. The new rules define "holding company" to include any company "that directly or indirectly owns, controls, or holds, with power to vote, 10 percent or more of the outstanding voting securities of a public-utility company or of a holding company of any public-utility company." Companies that meet the definition of a "holding company" as of February 8, 2006 are required to notify the FERC no later than March 8, 2006 by filing FERC-65 (Notification of Holding Company Status).

The new rules provide an exemption for "passive investors" from the books and records requirements applicable to holding companies. Although the rules do not define "passive investor," the FERC states that the exception is available to the following entities: (i) mutual funds; (ii) collective investment vehicles whose assets are managed by banks, savings and loan associations and their operating subsidiaries, or broker/dealers; and (iii) persons that directly or indirectly through their subsidiaries and affiliates, buy and sell the securities of public utilities in the ordinary course of business as a broker/dealer, under-

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writer or fiduciary, and do not exercise operational control over the utility. To rely on the passive investor exemption, companies must make a one-time filing of FERC-65A (Exemption Notification) within 30 days after becoming a “holding company.” Persons or companies who file FERC-65A in good faith will be deemed to have a temporary exemption upon filing, and the exemption will be deemed granted if FERC takes no action within 60 days of filing.

A copy of the Release is available at: <http://www.ferc.gov/eventcalendar/files/20051208193508-RM05-32-000.pdf>.

## Contacts

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

Nora Jordan  
212-450-4684  
[nora.jordan@dpw.com](mailto:nora.jordan@dpw.com)

Yukako Kawata  
212-450-4896  
[yukako.kawata@dpw.com](mailto:yukako.kawata@dpw.com)

Danforth Townley  
212-450-4240  
[danforth.townley@dpw.com](mailto:danforth.townley@dpw.com)

Leor Landa  
212-450-6160  
[leor.landa@dpw.com](mailto:leor.landa@dpw.com)

Martin Small  
212-450-4947  
[martin.small@dpw.com](mailto:martin.small@dpw.com)

Kathy Calio  
212-450-4337  
[kathy.calio@dpw.com](mailto:kathy.calio@dpw.com)

*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice.*