September 2005

DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

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SEC Enforcement Actions

SEC Charges Former Citigroup Executives with Fraud Related to Citigroup Mutual Funds

On August 8, 2005, the SEC filed an enforcement action in the United States District Court for the Southern District of New York charging Thomas W. Jones ("Jones") and Lewis Daidone ("Daidone"), two former Citigroup executives, with fraud related to Citigroup's creation of an affiliated transfer agent to serve its Smith Barney family of mutual funds (the "Funds") at steeply discounted rates. As discussed in the June 2005 Investment Management Regulatory Update, rather than passing the substantial fee discount on to the Funds, Jones, Daidone and others caused Citigroup to take the majority of the benefit of the discount, reaping tens of millions of dollars in profit at the expense of the Funds' shareholders. In its complaint, the SEC claims that Jones and Daidone were two of the officers primarily responsible for the fraud. The action against the two individuals follows the SEC's settlement with Citigroup in May, in which Citigroup agreed to pay $208 million to be distributed to victims of the fraud.

SEC claims that former Citigroup executives did not fulfill their fiduciary duties

The SEC alleges that Jones, the former chairman and CEO of Citigroup's asset management division ("CAM"), spearheaded an effort to negotiate a deal that allowed CAM to retain much of the profit that First Data Investor Services Group ("First Data"), the Funds' former full-service transfer agent, had been making. With Jones' approval, CAM recommended a proposal to the Funds' boards of directors (the "Boards"), which the Boards eventually approved, whereby upon the expiration of First Data's contract, the Funds would replace First Data with Citicorp Trust Bank, one of CAM's affiliates ("CTB") as the Funds' transfer agent. Under the proposed structure, which Jones and Daidone did not fully explain to the Boards, except for minimal services that CTB would provide, First Data would continue to perform the same work it had been performing under the expiring contract, but at a significant discount. CAM would then keep the majority of the savings it had negotiated with First Data for itself, rather than passing it along to the Funds.

According to the SEC, Jones and Daidone had a fiduciary responsibility to, at a minimum, disclose this opportunity to the Funds, which they did not. Additionally, the SEC alleges that in the board presentation that Daidone prepared, and Jones approved, there were material misrepresentations about the proposed arrangement, including the extent of benefits that CAM would realize and the fact that First Data would provide substantially the same services that it had provided in the past.

The SEC's complaint charges Jones and Daidone with aiding and abetting CAM's violations of Sections 206(1) and 206(2) of the Advisers Act, which prohibit registered investment advisers from engaging in fraud or deceit upon clients or prospective clients and seeks permanent injunctions against future fraudulent activities, disgorgement and civil penalties. A copy of the SEC's complaint is available at:
http://www.sec.gov/litigation/complaints/comp19330.pdf.

NASD Developments

NASD Investigates Hedge Fund Sales

Reports that the NASD is evaluating whether firms are offering unsuitable investments to retail investors

On August 17, 2005, the Bloomberg news service ("Bloomberg") reported that the NASD is investigating the sale of hedge-fund products to retail investors by a number of large Wall Street firms. Reportedly, the NASD's probe is examining the sales of hedge-fund products marketed with minimum investment thresholds of $50,000 or less. Bloomberg reported that the NASD sent a letter in June to several large brokerage firms requesting information about sales of hedge-fund products to individual retail investors. Specifically, the investigators are searching for evidence that certain firms induced non-professional investors to make unsuitably risky or expensive investments. The NASD declined to comment on the existence of the letter, but confirmed that the issue has been a concern for a number of years. In particular, the NASD inquiry appears focused on: (i) what warnings firms gave investors when selling such hedge-fund products; (ii) whether brokers received any sales incentives; (iii) the types of compensation, if any, paid to brokers for selling such products; and

(iv) whether investors who were not "qualified clients" (as defined in the Advisers Act; generally, a person who has a net worth of more than $1.5 million or has $750,000 under management with the adviser) were sold these investments. The NASD letter has not been made public and no link was available at the time of printing.

Litigation

D.C. Circuit Stays Effectiveness of SEC Mutual Fund Governance Rule

Compliance date is stayed pending judicial review

On August 10, 2005, the U.S. Court of Appeals for the District of Columbia Circuit (the "D.C. Circuit") unanimously issued an order sought by the Chamber of Commerce (the "Chamber"), and discussed in the August 2005 Investment Management Regulatory Update, staying the provisions of an SEC mutual fund governance rule. The provisions, requiring that both 75% of a mutual fund's board and its chairman be independent, were scheduled to go into effect on January 16, 2006. Final briefing on the matter must be fully submitted by November 14, 2005. In its order, the D.C. Circuit directed the parties to address whether the SEC had the authority to act on the D.C. Circuit's remand decision prior to the issuance of the D.C. Circuit's mandate and order sending the case back to the SEC. A link to the D.C. Circuit's order was not available at the time of printing.

Industry Updates

Investment Adviser Association Opposes Securities Industry Association Request for Compliance Date Extension

IAA argues that acceding to SIA's request will further delay efforts to adequately inform investors of the differences between brokerage and advisory accounts

On August 4, 2005, the Investment Adviser Association (the "IAA") told the SEC that it strongly opposes a petition by the Securities Industry Association (the "SIA") for an extension of certain compliance dates relating to the broker-dealer exception under the Advisers Act. On April 6, the SEC unanimously adopted Rule 202(a)(11)-1 of the Advisers Act, which provides that a registered broker-dealer will not be deemed to be an investment adviser so long as any investment advice for which it receives special compensation, such as an asset-based or fixed fee, is "solely incidental" to the brokerage services provided to those accounts.

On July 28, the SIA requested that the SEC extend compliance dates with respect to various portions of Rule 202(a)(11)-1 so that the industry can implement the necessary changes, which are said to include changes to customer contracts, disclosure statements and certain operational systems. On August 4, the IAA responded with a letter to the SEC opposing, specifically, the SIA's request to delay implementation of the aspect of the rule that requires brokerage firms to treat accounts as investment advisory accounts if the broker exercises investment discretion on more than a "temporary or limited" basis. The IAA's opposition to the SIA's request is based primarily on its beliefs that (i) the required determination of whether a broker has investment discretion on more than a temporary or limited basis is neither difficult nor time consuming, (ii) the SIA and its members have been aware for several years of the inevitability that the final rule would require brokers to treat discretionary accounts as advisory accounts and (iii) any further delay in implementing the rule will impede efforts to inform investors about the differences between brokerage and advisory accounts. A copy of the IAA's letter is available at: http://www.icaa.org/public/letters/comment080405.pdf. A copy of the SIA's petition is available at: http://www.sec.gov/rules/petitions/petn4-507.pdf.

MFA Releases 2005 Best Practices for Hedge Fund Managers

MFA provides guidance intended to benefit hedge fund managers, hedge fund investors and others who monitor the hedge fund industry

On August 2, 2005, the Managed Funds Association (the "MFA") released its 2005 Sound Practices for Hedge Fund Managers (the "2005 Sound Practices"), which updates its previously issued 2003 Sound Practices for Hedge Fund Managers. To provide hedge fund managers with guidance on issues critical to the industry, the 2005 Sound Practices expands coverage on topics such as responsibilities to investors, valuation, internal trading controls and risk controls, and contains recommendations intended to promote sound business practices. Recommendations in the 2005 Sound Practices are divided into seven areas: (i) management and internal trading controls; (ii) responsibilities to investors; (iii) valuation policies and procedures; (iv) risk monitoring; (v) regulatory controls; (vi) transactional practices; and (vii) business continuity and disaster recovery. In addition, two new appendices are included in the 2005 Sound Practices to provide checklists for developing compliance manuals and codes of ethics. A copy of the MFA's 2005 Sound Practices is available at: http://www.mfainfo.org/images/PDF/MFAs_2005_Sound_Practices_FINAL.pdf.

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