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DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

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Industry Updates

Court Approves SEC's Mutual Fund Governance Rules But Remands to SEC for Evaluation of Cost; SEC Re-adopts Rules on Remand at Open Meeting

On June 21, 2005, the U.S. Court of Appeals for the District of Columbia (the "Court") remanded one of the SEC's mutual fund regulatory reforms relating to independent directors for further SEC consideration of at least one alternative approach as well as its cost to funds. The Court held, however, that the SEC did not exceed its statutory authority in adopting the rule's two provisions in question under the "Exemptive Rules" set forth in the Investment Company Act (the "ICA"), which require that, in order to engage in certain transactions otherwise prohibited by the ICA, a mutual fund must have a board (i) with no less than 75% independent directors and (ii) an independent chairman.

> D.C. Circuit issues decision on Chamber of Commerce petition to review SEC Exemptive Rule conditions

On August 2, 2004, the SEC amended ten Exemptive Rules by imposing five requirements upon any fund that wished to engage in an otherwise prohibited transaction. In September 2005, the U.S. Chamber of Commerce (the "Chamber") petitioned for review of two of those requirements, specifically the independence requirements, arguing that the SEC did not have the power to impose such conditions. In particular, the Chamber argued that the ICA does not give the SEC authority to regulate corporate governance. Additionally, the Chamber contended that the SEC failed to adhere to the requirements of the Administrative Procedure Act (the "APA") in the rulemaking by which it promulgated the amendments to the Exemptive Rules.

The Court found that the SEC does, in fact, have the authority to make "precautionary or prophylactic responses to perceived risks" and that, in this case, because the SEC's effort to do so was not "arbitrary, capricious, or in any way an abuse of its authority," it did not violate the APA. The Court found, however, that the SEC did violate the APA by failing to adequately consider a proposed alternative, specifically a disclosure approach, to the independent chairman condition. The Court concluded that the SEC also violated the APA by failing to meet its statutory obligation to determine, as best as possible, the economic implications of the rule it proposed. The Court granted in part the Chamber's petition and remanded the matter to the SEC to "address the deficiencies" in the two challenged independence requirements. A copy of the D.C. Circuit's opinion is available at: http://pacer.cadc.uscourts.gov/docs/common/opinions/200506/04-1300a.pdf.

On June 29, 2005, the SEC re-adopted the mutual fund independence rules at an open meeting by a 3-2 vote, from which Commissioners Cynthia Glassman and Paul Atkins dissented on the basis that the SEC had failed to undertake meaningful review of the Court-mandated economic analysis and alternative disclosure-based approach. The dissenting Commissioners noted, in addition, that it was impossible to have complied with the letter and spirit of the Court's ruling in the eight days since its remand for additional consideration by the SEC Staff.

Outgoing Chairman Donaldson defended the SEC's decision to act swiftly, and without an additional notice and public comment period, citing extensive analysis of the rules' costs on the existing record by the SEC Staff in the days since the Court's ruling, and concluding that the costs were minimal when compared to the benefits of the heightened independence rules to investors. Donaldson added that the SEC's prompt re-adoption of the governance rules also sought to avoid any "uncertain limbo" that might result during the period in which a new SEC Chairman is confirmed and able to consider the rulemaking record.

The Chamber stated that it intends to challenge the SEC's re-adoption of the independence rules.

A copy of Chairman Donaldson's opening statement at the SEC open meeting is available at: http://www.sec.gov/news/speech/spch062905whd-b.htm. A copy of Commissioner Glassman's remarks before the SEC open meeting is available at: http://www.sec.gov/news/speech/spch062905cag.htm.

CFTC Chairman Delivers Speech Regarding Hedge Fund Registration and Regulation

Brown-Hruska concerned about regulators' efforts to more vigorously regulate risk taking and thereby potentially depriving the markets of efficiency-enhancing liquidity that funds provide

On June 7, 2005, at the Managed Funds Association's Annual Forum in Chicago, acting Commodities Futures Trading Commission ("CFTC") Chairman Sharon Brown-Hruska spoke on the issue of hedge fund registration and regulation. She stated that she is "leery" about current efforts by regulators to regulate risk taking by hedge funds. In her speech, Brown-Hruska defended the current oversight regime, stating that critics of that regime are mistaken in saying that there is not enough information about the hedge fund industry. Brown-Hruska explained that, as the regulator of commodity pools and futures markets, the CFTC knows a great deal about the hedge fund industry, including hedge fund operators, investment positions and valuation techniques. She noted that even before the SEC voted to require hedge fund advisers to comply with the registration requirements of the Investment Advisers Act, the CFTC was collecting information from all funds that invested in any market under the CFTC's jurisdiction. She added that hedge funds investing in the commodities and futures markets ("Commodity Pools"), as well as their advisers, even if exempt from CFTC registration as commodity pool operators ("CPOs"), are still under the CFTC's general jurisdiction and, more specifically, subject to the CFTC's prohibitions on fraud and market manipulation.

In addition to information gleaned from the reporting required of registered Commodity Pools and those filings with the CFTC claiming exemption from registration as a CPO, Brown-Hruska said that the CFTC watches and analyzes the activity of Commodity Pools very closely through real-time surveillance. The CFTC commissioners and staff, including Brown-Hruska, are briefed weekly on the surveillance results. Based on the CFTC's close monitoring of Commodity Pools, and to avoid duplicative and unnecessary regulation, Brown-Hruska believes that CPOs and others already registered with the CFTC (such as commodity trading advisors) should be exempted from the SEC's new registration requirements. A copy of Brown-Hruska's speech is available at: http://www.cftc.gov/opa/speeches05/opabrownhruska34.htm.

GAO Issues Second Report Regarding Mutual Fund Trading Abuses

GAO finds that SEC consistently applies procedures in setting penalties but could strengthen certain of its internal controls

On May 16, 2005, the Government Accountability Office (the "GAO") released a second report to Congress addressing mutual fund trading abuses, regulatory reform and the value of early detection of improper activities and improved coordination among the SEC, other federal authorities and state enforcement officials. The GAO's first report was released in April and addressed in the *April 2005 Investment Management Regulatory Update.*

The GAO's second report surveys the SEC's settlements in cases involving abusive and undisclosed trading practices by mutual fund investment advisors as well as enforcement actions involving broker-dealers, brokerage advisory and other financial services entities involved in such improper practices. While state agencies, the report observes, may have initiated certain regulatory charges, the SEC typically coordinated its own negotiations, penalties and disgorgements with state regulators. The GAO report also notes that the SEC's employee exit procedures may not go far enough to ensure compliance with federal post-employment rules for former executive branch employees, which are, among other things, designed to avoid certain conflicts of interest. The report states that the SEC's recent promulgation of rules requiring funds to employ a chief compliance officer may increase demand for those with SEC experience, and therefore, proper monitoring of post-employment activities should be given more importance.

Overall, the GAO report concludes that since September 2003, the SEC has brought 24 enforcement actions against both investment advisers and brokerage/financial services firms and a comparable number of enforcement actions against individuals, all for mutual fund trading abuses. In these actions, the GAO notes that the SEC (i) consistently applied the criteria it has established with respect to pursuing enforcement actions and crafting settlements, including the degree of intent with which a party may have acted, the amount of harm to investors and the market and the seniority of those involved and their cooperation, and (ii) obtained very high penalties, among the highest in the agency's history, in late trading and market timing cases. The report finds, however, that the SEC's capacity to effectively manage its criminal referral process is limited by inadequate recordkeeping.

To strengthen the agency's management procedures and better ensure that its responsibilities are being met, the report recommends that the SEC take certain actions, including (i) documenting referrals to criminal authorities for potential criminal prosecutions, and the reasons for such referrals, and (ii) establishing procedures to have exiting employees identify subsequent employers and reviewing exiting employees' work should the SEC determine that a conflict of interest may exist. The GAO report is available at: http://www.gao.gov/new.items/d05385.pdf.

NASD Developments

15 Broker-Dealers to Pay $34 Million to Settle NASD Directed Brokerage Charges

Broker-dealers charged with violating Anti-Reciprocal Rule by providing certain benefits to selected funds

On June 8, 2005, the NASD announced that 15 broker-dealers settled charges with the NASD, agreeing to pay more than $34 million in connection with the receipt of "directed brokerage" in exchange for preferential treatment for certain mutual fund companies. The NASD brought charges against 14 retail brokerage firms and one mutual fund distributor.

All of the firms were charged with violating NASD Conduct Rule 2830(k), otherwise known as the "Anti-Reciprocal Rule," which prohibits firms from favoring the sale of shares of particular mutual funds based upon the brokerage commissions received by the firm. The NASD found that 14 retail broker-dealers were operating "shelf space" or "preferred partner" programs, providing additional benefits to a few mutual fund complexes in return for extra fees, which were paid out of the assets of the mutual funds rather than the broker-dealers' own accounts. Those benefits offered included, among other things, higher visibility on the broker-dealer firms' internal websites, participation in training or "top producer" meetings, increased access to the firms' sales forces and promotion of the funds of those mutual fund complexes on a broader basis than was available for other funds. In addition, certain of the firms settled charges stemming from a failure to retain emails in accordance with the federal securities laws and NASD rules. The NASD also found that a mutual fund distributor paid for some of its shelf space obligations by having its affiliated investment adviser direct portfolio transactions to, or for the benefit of, firms to which the distributor owed revenue sharing fees. A copy of the NASD's press release is available at: http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ss DocName=NASDW_014340.

Litigation

Sihpol Found Not Guilty of Improper Mutual Fund Trading

Former Bank of America stockbroker acquitted on charges of late trading

On June 9, 2005, a New York State Supreme Court jury found Theodore Sihpol III, a former Bank of America Corp. stockbroker, not guilty on 29 of 33 criminal counts he faced in *New York v. Sihpol*. Sihpol was the first defendant arrested in New York Attorney General Eliot Spitzer's ongoing probe of the mutual fund industry. Sihpol was alleged, among other things, to have assisted New Jersey-based hedge fund Canary Capital Partners LLC with abusive trading practices, including late trading, in mutual fund shares. After the jury was unable to reach a verdict on the four remaining counts, two counts of falsifying business records, one count of scheming to defraud and one count of violating the New York State securities laws, the Court declared a mistrial on those charges. It remains unknown whether Sihpol will be retried on those charges. At the time of publication, a link to court records of the Sihpol trial was not yet available.

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