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DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

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SEC Enforcement Actions

Dual Registered Broker-Dealer and Investment Adviser Settles Late Trading Charges

On February 8, 2006, the SEC issued a cease-and-desist order in settlement of charges that Morgan Keegan & Co., Inc. ("Morgan Keegan"), a dual registered broker-dealer and investment adviser, willfully violated Rule 22c-1(a) under the Investment Company Act by facilitating late trading in mutual fund shares by a client that was a hedge fund adviser. Rule 22c-1(a) requires dealers to process orders for mutual fund shares at a price based on the net asset value ("NAV") next computed after receipt of the order. As found by the SEC, the mutual funds at issue calculated their NAVs at 4:00 p.m. Eastern Time. The SEC determined, however, that Morgan Keegan represented to the hedge fund adviser that orders for mutual fund trades received as late as 5:30 p.m. Eastern Time would be processed at that day's NAV. The SEC found that, from the time the late trading began in May 2003 through early September 2003, Morgan Keegan, acting as the hedge fund adviser's dealer, processed approximately ninety orders at that day's NAV even though they were received after the cut off time established by the mutual funds.

> SEC settles charges of illegal late trading with dual registered broker-dealer and investment adviser

As part of the settlement, the SEC censured Morgan Keegan and ordered it to disgorge approximately $459,000, including prejudgment interest, and pay a civil penalty of $100,000. Morgan Keegan consented to the entry of the order without admitting or denying the SEC's findings. A copy of the order is available at: http://www.sec.gov/litigation/admin/34-53251.pdf.

Registered Investment Adviser and Executives Settle Fraud Charges

On February 21, 2006, the SEC issued a cease-and-desist order in settlement of charges that New England Securities Corp. ("NES"), a registered investment adviser and broker-dealer owned by MetLife, Inc., willfully violated Section

206(2) of the Investment Advisers Act of 1940 ("Advisers Act") by failing to provide the portfolio rebalancing services promised to clients of its Investment Manager Program ("IM Program").

For purposes of the order, the SEC made the following findings of fact. The IM Program was a non-discretionary wrap investment program in which NES would recommend to clients an asset allocation among no-load and fee-waived mutual funds. From the start of the IM Program, NES consistently told existing and prospective investors that, when asset allocation percentages deviated from predetermined ranges, NES would notify them and rebalance their portfolios upon request. Nevertheless, as early as 1999, senior NES executives became aware through internal compliance audits that their systems were unable to perform the required monitoring and rebalancing. Despite being aware that NES was failing to provide the rebalancing services that had been promised to IM Program clients, NES executives failed to take effective corrective action until March 2003 and NES continued to market its rebalancing services to new clients until December 2002. NES finally reported the failures to the SEC in March 2003 and an independent consultant, retained by NES after an SEC investigation, determined that NES's failure to provide the promised rebalancing services caused over $7.5 million in damages to IM Program clients from reduced returns and increased losses. In 2004, NES distributed this amount to the injured clients along with $425,765 in interest.

SEC settles charges against investment adviser for failing to provide portfolio rebalancing services and improperly imposing Rule 12b-1 fees

The SEC also found that NES incorrectly imposed Rule 12b-1 fees and sales commission charges on accounts in the IM Program. NES had promised according to the SEC order, that IM Program clients would not have to pay sales commissions for the purchase or sale of IM Program mutual funds, and NES had also agreed to refund all Rule 12b-1 fees it collected from mutual funds purchased by ERISA and IRA clients. Nonetheless, the SEC found that NES did not rebate over $2.25 million in Rule 12b-1 fees to ERISA and IRA accounts and improperly charged some IM Program clients approximately $116,000 in mutual fund sales commissions. After commencement of the SEC investigation, according to the SEC order, NES refunded the affected IM Program clients the total amount of all unrebated Rule 12b-1 fees, incorrectly charged sales commissions and interest.

Based on these facts, the SEC found that NES had violated Section 206(2) of the Advisers Act, which prohibits any investment adviser, either directly or indirectly, from committing fraud or deceit upon a client or potential client through the undertaking of any practice, course of business or transaction. In deciding to accept the offer by NES to settle the charges, the SEC took into consideration that NES voluntarily: (i) ceased new IM Program sales; (ii) contacted IM Program clients about its failure to provide rebalancing services; (iii) self-reported the failure to the SEC; (iv) hired an independent consultant to review IM Program clients' portfolios to determine what the correct portfolio values would have been had rebalancing services been provided as promised; (v) paid almost $8 million to IM Program clients whose accounts suffered reduced returns or losses; (vi) rebated over $2.5 million to clients in Rule 12b-1 fees and sales commissions; and (vii) employed a major accounting firm to examine the IM Program rebalancing service and to review the procedures for rebating Rule 12b-1 fees and complying with contractual terms regarding sales commissions. As part of the settlement, NES was ordered to pay over $2 million in disgorgement, as well as prejudgment interest of nearly $575,000. NES was also required to provide a copy of the order to IM Program clients and to retain an independent consultant to review NES's operations and procedures related to its violations.

In two related actions, also announced on February 21, 2006, the SEC settled aiding and abetting charges against Jonathan M. Rozek, the former NES vice president of product origination, and Thomas W. McConnell, the former NES president. The SEC found that the two former officers willfully aided and abetted and caused the NES violations described above. As part of the settlements, Rozek was suspended from the securities industry for one year and McConnell was permanently barred, with a right to reapply after one year. Rozek was also fined $10,000 and McConnell was ordered to pay $100,000 in civil penalties and $10,000 in disgorgement, in addition to approximately $2,000 in prejudgment interest.

A copy of the NES settlement is available at: http://www.sec.gov/litigation/admin/ia-2489.pdf.

A copy of the Rozek settlement is available at: http://www.sec.gov/litigation/admin/34-53340.pdf.

A copy of the McConnell settlement is available at: http://www.sec.gov/litigation/admin/34-53339.pdf.

NASD Developments

Broker-Dealer Ordered to Pay Over $2.2 Million for Facilitating Market Timing

NASD fines broker-dealer for facilitating illegal market timing transactions and failing to comply with record-keeping rules

On February 14, 2006, the National Association of Securities Dealers ("NASD") announced that it had ordered Diversified Investors Securities Corp. ("Diversified Investors") to pay over $2.2 million (consisting of $1.3 million in fines and almost $950,000 in restitution) for permitting certain institutional and other customers to make prohibited market timing trades in its Diversified Investors International Equity Fund (the "Fund"). Specifically, the NASD found that before June 2003, certain clients had established accounts at Diversified Investors to facilitate market timing trades in shares of the Fund made pursuant to agreements between these clients and Diversified Investment Advisors, Inc., the Fund's investment advisor and Diversified Investors's parent company. Following the establishment of these arrangements, the Fund's prospectus was amended to add provisions strictly limiting the ability of investors to make market timing trades in shares of the Fund. Nonetheless, the NASD determined, Diversified Investors failed to apply the prospectus restrictions to those clients and, from July 2003 through October 2003, they carried out an estimated 400 market timing transactions, with a value totaling over $160 million. The NASD further found that it was never disclosed to other Fund shareholders that the Fund's anti-market timing policies were being only selectively applied.

The NASD also found that Diversified Investors did not have an adequate system for saving emails from November 2000 to December 2003 and that it failed to ensure the retention of emails in accordance with NASD record-keeping

rules. In settling, Diversified Investors neither admitted nor denied the charges, but consented to the entry of the NASD findings. A copy of the NASD press release is available at: http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015974&ssSourceNodeId=9.

Industry Update

Governor Pataki Signs New Law Affecting Publication Requirements of Limited Liability Entities in New York State

Certain limited liability entities required to publish holders of the most valuable interests in such entity

On February 3, 2006, New York Governor George E. Pataki signed into law Senate Bill No. 85-A which amends, effective June 1, 2006 (the "Effective Date"), the newspaper publication requirements applicable to foreign and domestic limited liability companies, professional service limited liability companies, limited partnerships and limited liability partnerships in New York State. As discussed in further detail below, among the other changes it effects to the New York publication system, the new legislation requires the publication of additional disclosure regarding the members or partners of such entities and establishes potentially worrisome consequences for entities that fail to comply with the new law. Many entities, however, will be exempt from some or all of the new requirements.

Beginning on the Effective Date, limited liability entities will have 120 days from the effectiveness of their requisite articles of association (for domestic entities) or the filing of their application for authority to conduct business in the state (for foreign entities) to publish a copy of or a notice containing the substance of such articles or application in two local newspapers. Upon completion of the publication requirement, they must file a certificate of publication and affidavits of publication from the publishing newspapers with the New York Department of State. The copy or notice must be published once a week in both a weekly and a daily newspaper for four consecutive weeks, which is a reduction from the previous standard of six consecutive weeks. The newspapers will be chosen by the county clerk and must be in the county in which

the office of the limited liability entity is intended to be located. In terms of size, the notice must be published as though it "were a notice or advertisement of judicial proceedings."

The new legislation also requires substantive changes in the content of the published notice. Under the amended law, the published notice must now disclose the names of the ten (or, if fewer than ten, all of the) members/partners who are actively engaged in the business and affairs of the entity and have the most valuable interests in the entity. In complying with this provision, the new law specifies that the entity may choose to determine its ten most valuable interests on the basis of (i) rights to share in profits and losses, (ii) rights to receive distributions, or (iii) rights to vote and participate in management. Notably, if the ownership interests in an entity change at any time following the completion of the first week of publication, the entity is not required to publish a revised notice. The new law does not indicate whether entities that choose to publish a copy of their articles or application, as opposed to a notice containing the substance thereof, must also make this investor disclosure.

Not all limited liability entities will have to comply with the new requirements. Specifically, domestic entities that were formed prior to the Effective Date and are in compliance with the old publication requirements on the Effective Date are not required to re-publish in accordance with the new law. Similarly, foreign entities that were formed and filed their application for authority prior to the Effective Date and are in compliance with the old publication requirements on the Effective Date are not required to re-publish in accordance with the new law. Entities that were formed (and, in the case of foreign entities, filed their application for authority) prior to the Effective Date and are not in compliance with the old law on the Effective Date, however, must publish and file proof thereof in accordance with the new publication requirements within 18 months of the Effective Date. The new law deems a limited liability entity that was formed (and, in the case of a foreign entity, filed its application for authority) prior to the Effective Date to be in compliance with the old publication requirements if (i) it was formed (and, in the case of a foreign entity, filed its application for authority) on or after January 1, 1999 and, prior to the Effective Date the entity filed at least one affidavit of publication from a newspaper or (ii) it

was formed (and, in the case of a foreign entity, filed its application for authority) prior to January 1, 1999, regardless of whether or not it filed any affidavit of publication from a newspaper.

Further, the following entities are exempt from the new investor-disclosure requirement: (i) investment advisers as defined in the Investment Advisers Act of 1940 (including unregistered investment advisers) or commodity pool operators and commodity trading advisors as defined in the Commodity Exchange Act; and (ii) collective investment vehicles or any direct or indirect subsidiary or affiliate that is sponsored, advised or managed by any investment adviser, commodity pool operator or commodity trading advisor. These entities must still comply with the other aspects of the publication requirements.

In addition, the new law establishes a new penalty for failure to comply with the publication requirements. Under the new law, failure to comply with the new publication requirements after the Effective Date results in suspension of an entity's authority to carry on, conduct or transact business in New York State, as opposed to the previous statutory penalty which prohibited the non-compliant entity from maintaining an action or special proceeding in New York State. Such suspension will automatically occur without notice upon conclusion of the 120-day filing period or, in the case of entities eligible for the 18-month grace period discussed above, at the end of such grace period. The precise effect of such a suspension is unclear, and some commentators have speculated that it could cause the investors in the entity to forfeit their limited liability. On the other hand, the new law does provide that the suspension of such entity's authority will not limit or impair the validity of any contract or act of such entity or limit the rights of other parties to seek an action against such entity. Upon filing the required certificate and affidavits in compliance with the new law, an entity's suspension will be annulled.

Although this bill has been signed into law by Governor Pataki, there continues to be ongoing discussions within the legislature and by lobbying groups as to possible further amendments to the New York publication regime that may be implemented prior to the Effective Date. One proposed amendment would specifically impose joint and several liability on investors in a non-compliant

entity for the debts of such entity. Significant further developments in this regard will be addressed in future newsletters. A copy of the full text of the new law is available at: http://www.nationalcorp.com/pdfs/NY_Chapt_767.pdf.

BlackRock and Merrill Lynch Announce Merger of Investment Management Businesses

BlackRock and Merrill Lynch merger will result in one of the largest asset management firms in the world with close to $1 trillion in assets under management

On February 16, 2006, BlackRock, Inc. and Merrill Lynch announced an agreement to merge BlackRock with Merrill Lynch's investment management business to form a new independent company. With estimated assets of nearly $1 trillion and over 4,500 employees in 18 countries, the new company, which will retain the BlackRock name, will be one of the largest asset management firms in the world. It will offer equity, fixed income, cash management and alternative investment products in both the domestic and international institutional and retail investor markets, and it is expected to be a key participant in the major markets of the United States, the United Kingdom, Asia, Australia, the Middle East and Europe.

Under the reported terms of the transaction, Merrill Lynch will receive a 49.8% ownership stake and a 45% voting interest in the combined company and PNC Financial Services Group, Inc., which currently has a 70% stake in BlackRock, will hold 34%. The remainder will be owned by employees and public shareholders. BlackRock's current CEO, Laurence D. Fink, will serve as Chairman and CEO of the combined company and Ralph L. Schlosstein, currently President of BlackRock and a BlackRock director, will continue in those positions. Robert C. Doll, the current President and Chief Investment Officer of Merrill Lynch Asset Management, will become Vice Chairman, CIO of Global Equities and Chairman of the Private Client Operating Committee of the new company. Doll is also expected to become a board member of the new company, along with Robert S. Kapito, the current Vice Chairman and Head of Portfolio Management of BlackRock.

The boards of BlackRock and Merrill Lynch have both approved the merger. The transaction remains subject to customary conditions, client consents, various regulatory approvals and the affirmative vote of BlackRock shareholders, but it is anticipated to close in the third quarter of 2006.

Associate Director of OCIE Speaks About the SEC Examination Program

Senior SEC staff member discusses the coordination and priorities of the examination program

On February 7, 2006, Mary Ann Gadziala, the Associate Director of the Office of Compliance Inspections and Examinations ("OCIE") of the SEC, spoke at the Bond Market Association's Annual Legal and Compliance Conference in New York City regarding coordination and priorities of the SEC's examination program. With respect to coordination, Gadziala described at length an SEC initiative to "leverage off" the internal audit work done by firms in order to achieve more effective and efficient SEC risk management examinations. Specifically, Gadziala stated, if SEC examiners are comfortable that a firm conducts effective independent oversight and takes necessary corrective action, the examiners would rely more on their past examinations and the firm's own compliance work. The examiners could then limit the scope of their review of the firm to high risk areas not adequately covered by the firm's internal review, which could reduce the length and burden of an examination.

Gadziala further indicated that, in assessing whether a firm's internal audit program could be relied upon, SEC examiners would take into consideration whether: (i) the internal auditors had sufficiently established the areas of risk, risk rankings and the effectiveness of risk controls at the firm; (ii) the foregoing risk information had been successfully integrated into the design and implementation of the internal audit plan; (iii) the firm's upper management was kept current on audit issues; and (iv) the internal auditors were unbiased, competent and effective. A copy of the SEC speech is available at: http://sec.gov/news/speech/spch020706mag.htm.

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