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DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

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SEC Interpretations

SEC's Division of Investment Management Responds to ABA Letter Regarding the Rule Requiring Registration of Hedge Fund Advisers

On December 8, 2005, the SEC's Division of Investment Management ("IM") responded to a letter submitted by the American Bar Association Subcommittee on Private Investment Entities, dated June 23, 2005 (the "ABA Letter"), requesting IM's views on a variety of issues arising under Advisers Act Rule 203(b)(3)-2 (the "Final Rule"). The Final Rule requires many hedge fund advisers, both in the U.S. and abroad, that rely on the "private adviser exemption" from registration (*i.e.*, fewer than 15 clients) to register with the SEC by February 1, 2006. In addition, these advisers must have compliance policies and procedures in place and designate a chief compliance officer by February 1, 2006.

IM provides guidance regarding timing of lock-ups, registration issues and various compliance matters

» *Two-Year Requirement*. IM clarified that the two-year lock-up to avoid "private fund" status should be understood as permitting redemptions only on or after the "second anniversary" of the date of investment. IM posited the example that an interest acquired on January 1, 2007, that is redeemed on December 31, 2008, would be redeemable "within two years," thus causing the fund to be considered a "private fund" under the Final Rule, but redemption on January 1, 2009, one day later, of the same investment, would not. We believe that hedge funds could adapt to this clarification by shifting their subscription date to the last business day of any fiscal period but providing that such new investors do not participate in any share of the profits of the fund until the close of business on that day.

» *Withdrawals by Advisers and Affiliates.* IM also declined to carve-out withdrawals of investments by the adviser, general partner and knowledgeable employees in ascertaining whether a fund permits redemptions "within two years of the purchase." IM took the position that this type of carve-out would encourage "insiders" to take preferential liquidity terms and would not further the objectives of investor protection. IM, however, did note that it would *not* recommend enforcement for the failure to register under circumstances in which advisers or their affiliated general partners withdraw deferred incentive fees or accrued incentive allocations within two years of the date of deferral or accrual - that is, such withdrawals would not constitute redemption of an interest within two years for purposes of the definition of a "private fund."

» *Extraordinary Events - Significant Adviser Withdrawals.* The SEC staff disagreed with the request that significant withdrawals of capital by an adviser may be treated as an extraordinary event under the new hedge fund rule that would permit early withdrawals. We believe that it may be possible to reach a different conclusion if such an event were to lead to an early dissolution of the entire fund.

» *Registration of General Partner Entities.* IM also addressed fund structures in which an investment adviser to a private fund establishes a separate special purpose entity to act as the private fund's general partner (a "GP Entity"). IM noted that under circumstances in which a GP Entity has no employees or other persons acting on its behalf other than officers, directors, partners or employees of the registered adviser, and where the GP Entity would comply with the Advisers Act (and be subject to examination by the SEC), the GP Entity could essentially look to and rely upon the registered adviser's SEC registration in not registering itself.

» *Timing of Filing.* Finally, while IM urged advisers to submit their applications no later than December 15, 2005, IM did note that if an adviser required to register under the Final Rule files its initial application for registration as an investment adviser on Form ADV with the SEC no later than January 9, 2006, the SEC will endeavor to act on the application by the February 1, 2006, compliance date.

In addition to the items discussed above, IM's response to the ABA Letter also addressed: (i) the transfer of interests among classes of a fund; (ii) captive master-feeder fund structures; (iii) the treatment of family funds as "private funds" and non-family members as clients; and (iv) a host of compliance matters pertaining to principal and agency trades involved in rebalancing transactions executed across an adviser's fund clients *(i.e.*, trades designed to assure that each fund client maintains pro rata ownership in the overall complex's portfolio), custody of client assets in the context of arrangements with offshore prime brokers and privately offered securities as well as accounting matters related to the amortization of organizational expenses and delivery of client account statements and record-keeping requirements.

A copy of IM's response to the ABA Letter is available at: http://www.sec.gov/divisions/investment/noaction/aba120805.htm.

SEC Enforcement Actions

Money Manager and its Principal Settle Charges of Fraud

SEC settles claims with New York-based money manager and its principal for overstating holdings in distressed debt positions to gain access to creditors' committees and inside information

On November 7, 2005, the SEC settled charges against Van D. Greenfield, the principal of Blue River Capital LLC ("Blue River"), a former registered broker-dealer, and Blue River for fraudulently misrepresenting the value of Blue River's holdings in WorldCom, Inc. ("WorldCom") bonds in order to gain a position on the creditors' committee. The SEC also concluded that Blue River failed to implement effective policies to prevent the misuse of inside information regarding valuations and market activity obtained by Greenfield during his service on the WorldCom and other creditors' committees, resulting in the improper use of such nonpublic information.

Greenfield, through his control of Blue River, pursued investments in the securities of distressed companies, including telecommunications companies such as Globalstar, L.P. ("Globalstar"), Adelphia Communications Corporation ("Adelphia") and WorldCom. Greenfield served on the creditors' and equity holders' committees in bankruptcies filed by Globalstar and Adelphia, where he received nonpublic information regarding proposed restructurings, valuations and potential takeover and sale terms for such companies by third parties. Although Greenfield caused Blue River to maintain a general policy regarding the protection of inside information, the SEC notes that Blue River did not maintain an effective information barrier between Greenfield and the Blue River traders (of which there were only two). Greenfield would often have informal meetings with the traders, walk through the trading room (which was actually a converted dining room in his residence and adjacent to his office) and request market quotes for Adelphia and WorldCom securities from the traders. Blue River, moreover, did not restrict trading in Globalstar, Adelphia or WorldCom during the period in which Greenfield had inside information regarding the affairs of these companies.

On July 21, 2002, the day that WorldCom filed for bankruptcy (the "Petition Date"), Blue River owned $6.5 million in WorldCom bonds. The SEC alleged that several days later, Greenfield caused Blue River to execute a simultaneous purchase and short sale of $400 million in WorldCom bonds, and to backdate such transactions as prior to the Petition Date. At the same time, Greenfield requested Blue River's appointment to the WorldCom creditors' committee, representing to the trustee that Blue River held a $400 million unsecured claim, but failing to disclose that it also held an offsetting $400 million short position in such bonds (*i.e.*, Blue River had no net economic interest), that the trades had occurred after the Petition Date and that the trades had been marked "as of" a pre-Petition Date. These misrepresentations placed Blue River among the top 20 unsecured creditors of WorldCom, earning it a seat on the creditors' committee. Subsequently, Greenfield caused Blue River to cancel the $400 million purchase and short sale of the WorldCom bonds, leaving Blue River with its original $6.5 million position.

Greenfield and Blue River neither admitted nor denied any wrongdoing. The settlement requires Greenfield and Blue River to pay, on a joint and several basis, a civil penalty of $150,000. A copy of the settlement is available at: http://www.sec.gov/litigation/admin/34-52744.pdf.

Mutual Fund Manager and Affiliates Settle Charges of Market Timing and Late Trading

On November 28, 2005, the SEC announced a settlement of charges against three subsidiaries of Federated Investors, Inc. ("Federated") for improper market timing and late trading of mutual fund shares. Federated and its subsidiaries neither admitted nor denied the SEC's allegations in connection with the settlement. The SEC alleged that Federated Investment Management

SEC censures and fines registered investment adviser and affiliated entities for failing to disclose market timing arrangements and permitting late trading

Company ("FIMC") and Federated Securities Corp. ("FSC"), which, respectively, serve as the registered investment adviser and broker-dealer for the mutual funds in the Federated mutual fund complex (the "Federated Funds"), approved yet failed to disclose three market timing arrangements. The SEC also alleged that Federated Shareholder Services Company ("FSSC," and together with FIMC and FSC, the "Federated Subsidiaries"), a former registered transfer agent for the Federated Funds, allowed certain employees and customers to engage in illegal late trading of certain Federated Funds.

From January to July 2003, FIMC and FSC purportedly approved "timing capacity" in six Federated Funds for Canary Capital Partners LLC ("Canary"), a New Jersey-based hedge fund, and failed to disclose such arrangement to the boards and other shareholders of the Federated Funds. The SEC alleged that FIMC and FSC knowingly allowed Canary to conduct 46 undisclosed "roundtrip" trades (*i.e.*, frequent purchase and sales) in an aggregate amount of more than $1.6 billion in six domestic equity funds. In return for the right to engage in such timed trades, Canary allegedly agreed to make up to a $50 million investment, and actually made a $10 million investment, of "sticky assets" in an off-shore Federated Fund.

As part of the settlement, the Federated Subsidiaries agreed to pay a civil penalty in the amount of $45 million, disgorgement of $27 million and, in what has been reported as the terms of a concurrent settlement with the New York Attorney General, to reduce management fees by approximately $20 million over the next five years. A copy of the settlement is available at: http://www.sec.gov/litigation/admin/34-52839.pdf.

Litigation

Criminal Charges Against Former CIBC Executive Dismissed

New York Attorney General dismisses criminal charges against former Managing Director of CIBC related to market timing and late trading of mutual fund shares

On November 21, 2005, the New York Attorney General dropped criminal charges against Paul A. Flynn, a former Managing Director of Equity Investments for a subsidiary of Canadian Imperial Bank of Commerce ("CIBC"), who was arrested and charged under the New York state securities laws and penal code in February 2004 for aiding in the market timing and late trading of the shares of certain mutual funds.

The felony complaint alleged that Flynn used his position at CIBC to arrange financing for the market timing and late trading of mutual fund shares by two of his hedge fund clients, Canary Capital Partners, LLC and Samaritan Asset Management (collectively, the "Hedge Funds"). Such trades were placed through Security Trust Company, N.A. ("STC"). The complaint further alleged that Flynn deceived the mutual funds by falsely representing the Hedge Funds' trades to be those of STC's other clients including retirement plans, defined contribution plans and third party administrators. These misrepresentations permitted the Hedge Funds to engage in undisclosed market timing and illegal late trading of mutual fund shares while avoiding detection by personnel of such funds. In connection with these allegations, criminal actions were also brought against CIBC's broker-dealer and financing subsidiaries, and certain officers of STC.

In July 2005, CIBC agreed to pay $125 million to settle New York state and SEC charges for facilitating deceptive mutual fund trades by the Hedge Funds. Also, in August 2005, certain STC officers pleaded guilty and were sentenced to each pay $50,000 and serve five years' probation for their involvement in the Hedge Funds' illegal late trading scheme. In light of the fact that Flynn was charged as an accomplice (rather than a principal), coupled with CIBC's acceptance of corporate responsibility tending to suggest that Flynn's conduct was known and approved by the firm, the Attorney General recommended that the criminal charges be dismissed, noting in substance that CIBC's knowledge of Flynn's conduct did not negate Flynn's legal guilt, but mitigated his moral culpability and the societal need for a criminal conviction.

The SEC's related administrative proceedings against Flynn are still pending. A copy of the original complaint is available at: http://www.oag.state.ny.us/press/2004/feb/feb3b_04_attach.pdf. A copy of the recently filed court papers were not available at print time.

NASD Developments

NASD Issues Alert Reminding Members of Their Responsibilities Toward Investors

NASD urges members to review mutual fund dealer arrangements

On November 22, 2005, the National Association of Securities Dealers ("NASD") released a member alert highlighting the importance of executing dealer agreements that adequately delineate the responsibilities of all parties in a manner that ensures the protection of investors during the mutual fund sales and distribution process. More specifically, the NASD reminded members that fund sales must be consistent with the federal securities laws, disclosure provided to customers and any applicable dealer agreement. The NASD further cautioned members that failure to comply with provisions of dealer agreements (especially if such noncompliance results in financial harm to investors) may be a violation of NASD Rule 2110, which provides that a "member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

A copy of the NASD member alert is available at: http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015562&ssSourceNodeId=5.

NYSE Developments

Retail Brokerage Firm Fined $1 Million for Failure to Supervise

NYSE censures and fines retail brokerage firm for failing to supervise non-employee investment advisers and protect client assets

On November 15, 2005, Charles Schwab & Co. ("Schwab") settled charges brought by the New York Stock Exchange Regulation ("NYSER") for failure to properly supervise and protect customer accounts managed by non-employee investment advisers. The charges relate to Schwab's non-employee investment adviser platform, where selected non-employee advisers manage approximately 1.3 million of Schwab-custodied cash, margin and option accounts with assets of approximately $350 billion. Schwab provides these non-employee advisers and their clients with clearing and other support services, as well as a website to access account and related information.

NYSER found that during a period from 1998 until early 2003, certain of the non-employee investment advisers misappropriated customer assets through forged letters of authorization and forged checks. Although neither Schwab nor any of its employees were involved in these misappropriations, NYSER cited Schwab for failing to establish appropriate supervisory and control procedures with respect to the disbursement of customer assets that were custodied by Schwab and managed by the non-employee investment advisers, and for failing to protect such customer assets. These failures included the lack of a separate system of follow-up and review with respect to the transfer of funds from customer accounts to third parties and a failure to preserve and maintain certain electronic communications in required format and for required retention periods.

In particular, NYSER found that Schwab (i) did not routinely conduct comparisons of signatures on letters of authorizations and wire transfer requests (to transfer assets to third parties) to signatures on original account documents, (ii) did not maintain an adequate system to detect and prevent the use of blank printable checks for fund transfers between customer accounts and (iii) did not routinely send letters of confirmation to customers for third party transfers of assets. Further, Schwab failed to preserve and maintain internal e-mail communications and instant messaging communications via Bloomberg terminals as required under Section 17(a) of the Securities Exchange Act of 1934 and New York Stock Exchange Rule 440. Based on the foregoing, Schwab was fined $1 million and required to institute and review certain policies and procedures to prevent future violations. A copy of the exchange panel decision is available at: http://www.nyse.com/pdfs/05-110.pdf.

Industry Updates

Oral Argument Scheduled in Chamber of Commerce Lawsuit Challenging SEC Mutual Fund Governance Rules

Chamber of Commerce submits final briefing in challenge to the SEC's re-adoption of two mutual fund governance provisions

On November 7, 2005, the U.S. Chamber of Commerce ("Chamber") filed its final brief in the U.S. Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") in connection with its challenge of two mutual fund governance provisions adopted by the SEC in June 2004. As reported in the *August 2005 Investment Management Update*, the SEC adopted certain mutual fund governance rules affecting a fund's ability to rely on the "Exemptive Rules," ten exemptions under the Investment Company Act of 1940 ("1940 Act"), for certain transactions that raise conflicts requiring board review. Under the new rules, in order to take advantage of any Exemptive Rule, a mutual fund board must have (i) no less than 75% independent directors and (ii) an independent chairman.

In September 2004, the Chamber filed suit against the SEC to overturn such rules, arguing that such requirements exceeded the SEC's federal statutory mandate and infringed upon state law. In June 2005, the court ruled that the SEC did not exceed its statutory authority in adopting such governance provisions. However, the court also concluded that the SEC failed to adequately consider the costs of compliance and a proposed alternative to the independent chair requirement. The matter was then remanded to the SEC to address these deficiencies. Eight days later, the SEC, in a 3 to 2 vote, reaffirmed and re-adopted the independence rules in question. The Chamber responded with a new challenge, filing an emergency motion in the D.C. Circuit requesting that the compliance date of the contested fund governance rules, January 16, 2006, be stayed pending judicial review, which the court unanimously granted in August 2005. The Chamber renewed its argument that the SEC violated both the Administrative Procedure Act and the 1940 Act in its re-adoption of the governance rules without public comment, thereby failing to adequately fact-find, deliberate and consider the deficiencies cited by the D.C. Circuit on remand.

In its final brief, the Chamber reaffirmed its position that the SEC exceeded its authority and also noted that the SEC's presentation of facts in its opposition brief beyond those in the record constituted further evidence that the SEC's consideration of the matters remanded by the D.C. Circuit in June 2005 was incomplete and requires a period for public comment. The Chamber's motion is now fully briefed and oral arguments are scheduled for January 6, 2006. A copy of the Chamber's November 7 brief was unavailable at press time.

SEC Deputy General Counsel and Acting Director of Division of Investment Management Announces Retirement

On December 6, 2005, the SEC announced the retirement of Meyer Eisenberg, Deputy General Counsel and Acting Director of the Division of Investment Management, to take effect in January 2006. Eisenberg has served as Deputy General Counsel since December 1998 and as Acting Director of the Division of Investment Management since April 2005. He will leave his post at the SEC to become a Visiting Professor of Law at Willamette University College of Law in Salem, Oregon. A copy of the press release is available at: http://www.sec.gov/news/press/2005-173.htm.

Acting Director of the SEC's Division of Investment Management announces retirement from SEC

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