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DAVIS POLK & WARDWELL
Investment Management Regulatory Update

A Summary of Current Investment Management Regulatory Developments

Contents

SEC Rules & Regulations 1
SEC Enforcement Actions 4
Litigation 8
Industry Update 12

SEC Rules & Regulations

Court of Appeals Vacates SEC Mutual Fund Governance Rules but Stays Effect of Ruling for 90 Days

On April 7, 2006, the United States Court of Appeals for the District of Columbia Circuit held for the U.S. Chamber of Commerce ("Chamber") and against the SEC in its latest ruling over the controversial mutual fund governance provisions promulgated by the SEC. As discussed in the *December 2005 Investment Management Regulatory Update*, the Chamber has repeatedly challenged the SEC's July 2004 adoption of a rule requiring (i) at least 75% of the directors on a mutual fund's board to be independent and (ii) the board to have an independent chair, if the fund relies on certain important exemptive rules under the Investment Company Act of 1940.

In an August 2005 ruling that set the stage for this decision, the court unanimously held, in response to a petition filed by the Chamber, that the SEC had violated the Administrative Procedure Act ("APA") in promulgating the new governance rule, because it had not determined the costs of the two conditions and had not considered an alternative proposal. The court stayed the effectiveness of these two conditions and remanded the case to the SEC. On remand, the SEC determined that it was unnecessary to reopen the rulemaking record for further public comment. Instead, the SEC, using information in the record and publicly available information not in the record, estimated the costs of complying with the two conditions, and, based on such estimates, determined not to modify the two conditions.

> U.S. Chamber of Commerce prevails in its latest challenge to the SEC's mutual fund governance rules requiring 75% independent directors and an independent chair

In response, the Chamber again challenged the SEC's action, this time asserting that the SEC's reliance on materials outside the record was improper. The court agreed and, in its April 7 ruling, held that the SEC process on remand violated section 553 of the APA, which requires an agency to give notice to the public of a proposed rule setting forth the terms or substance of the proposed

rule, including "technical studies and data" upon which the agency relies, in order to give interested persons an opportunity to comment and participate in the rulemaking. The court rejected the SEC's argument that public notice and comment were not required because the extra-record materials were "publicly available" on the internet and were simply supplementary, filling gaps in the rulemaking record that had already been subject to public comment. Rather, the court held that the SEC had treated the extra-record materials as primary evidence and that the materials were not so readily available and reliable as to be exempt from the public notice and comment requirement. The court therefore vacated the 75% independent director and independent chair conditions.

The court, however, provided the SEC with an opportunity to correct its procedural errors and to reinstitute the challenged conditions. Specifically, given that a significant portion of the mutual fund industry has already complied with the conditions, the court determined that immediate vacation would be too disruptive and therefore withheld the issuance of its mandate for 90 days. The court stated that the 90-day period would provide the SEC with the opportunity to reopen the record for public comment on the costs of compliance with the two conditions. The SEC must also file a status report with the court within 90 days. A copy of the court opinion is available at: http://pacer.cadc.uscourts.gov/docs/common/opinions/200604/05-1240a.pdf.

SEC Proposes Amendments to Rule 22c-2 of the Investment Company Act

On February 28, 2006, the SEC issued proposed amendments to Rule 22c-2 under the Investment Company Act of 1940 (the "Rule") to reduce the costs of compliance and clarify the Rule's application. The Rule was adopted in March 2005 (with an effective date of October 16, 2006) to deter excessive short-term trading in mutual fund shares.

Among other things, the Rule requires a mutual fund that permits short-term redemptions (or its principal underwriter) to enter into written information-sharing agreements with financial intermediaries (e.g., broker-dealers and retirement plan administrators) that use omnibus accounts to hold shares of the fund on behalf of other investors. Under these agreements, such intermediaries

are required to provide certain investor identity and transaction information upon the request of the fund, so that the fund can monitor short-term trading in omnibus accounts. Such intermediaries must also, under these agreements, comply with the fund's instructions to restrict or prohibit further transactions by an underlying account that has been identified as engaging in market timing or other abusive trading practices in violation of the fund's policies.

Proposed amendments to redemption rule limit its application and clarify consequences of non-compliance

The three proposed amendments to the Rule (i) reduce the number of intermediaries with which funds must negotiate such information-sharing agreements, (ii) address the Rule's application to chains of intermediaries and (iii) clarify the consequences for a fund not entering into such an information-sharing agreement with one of its intermediaries. More specifically, the first proposed amendment excludes from the definition of "financial intermediary" any intermediary that is treated as an individual investor for purposes of a fund's short-term trading policies (e.g., a small business retirement plan that holds mutual fund shares on behalf of a small number of employees). For example, if a fund applies a redemption fee to transactions conducted by a retirement plan, rather than to transactions by the employees in the plan, such plan would not be considered a "financial intermediary" under the Rule.

The second proposed amendment addresses financial intermediaries who hold shares on behalf of other intermediaries and the difficulty of obtaining shareholder information through multiple layers of intermediaries. If adopted, the proposed amendment would require a fund only to enter into an information-sharing agreement with financial intermediaries that submit purchase or redemption orders directly to the fund, its principal underwriter or transfer agent or a registered clearing agency (each a "First-Tier Intermediary"). The proposed amendment would further modify the required contents of the information-sharing agreements. Specifically, under the proposed amendment, these agreements would have to require First-Tier Intermediaries to use their best efforts, when requested by the fund, to obtain and forward to the fund shareholder information of underlying accounts of other financial intermediaries that hold fund shares through the First-Tier Intermediary. If an intermediary refused to provide information requested by the First-Tier Intermediary, under these agreements, the First-Tier Intermediary would be obligated, when

requested by the fund, to prohibit such indirect intermediary from purchasing additional shares through it. The proposed amendment would also modify the Rule to include transfer agents and registered clearing agents among the service providers that may enter into information-sharing agreements with financial intermediaries on behalf of the fund.

The final proposed amendment addresses the possibility under the Rule that, if a fund did not enter into information-sharing agreements with all of its intermediaries, the fund could be prohibited from redeeming, within seven days of purchase, shares of any of its shareholders and not just those trading through the non-complying intermediary. In order to prevent this wholesale prohibition, the proposed amendment would revise the Rule to provide that if a fund fails to enter into an information-sharing agreement with a certain intermediary, only that intermediary will thereafter be prohibited from purchasing securities issued by the fund.

A copy of the proposed amendments is available at: http://www.sec.gov/rules/proposed/ic-27255.pdf.

SEC Enforcement Actions

SEC Fines Broker-Dealer and Affiliated Clearing Firm $250 Million for Facilitating Illegal Market Timing and Late Trading in Mutual Fund Shares

On March 16, 2006, the SEC issued a cease-and-desist order in settlement of charges that Bear, Stearns & Co., Inc. (“BS&Co.”), an introducing broker-dealer, and Bear, Stearns Securities Corp. (“BSSC”), a clearing firm that clears trades for BS&Co. and other firms, had facilitated extensive late trading and market timing of mutual fund shares by their customers.

For purposes of the order, the SEC found that from 1999 through September 2003, certain brokers at BS&Co. knowingly processed numerous market timing trades for favored hedge fund customers despite stop notices from mutual

funds and assisted such hedge funds in avoiding detection by mutual funds that prohibited market timing activities. BS&Co., the SEC found, took affirmative steps to conceal the identities of their market timing customers by assigning them multiple account numbers, registered representative numbers and alternative branch codes. According to the order, over 340 account numbers were used to facilitate market timing by approximately 14 customers.

SEC settles charges against Bear Stearns for facilitating extensive trading abuses

The SEC order further found that BSSC, which clears trades for customers of BS&Co. brokers as well as for prime brokerage and correspondent firm customers, facilitated market timing transactions by also providing deceptive identity-concealing devices and recommending evasion techniques. More specifically, according to the order, BSSC established a "timing desk" to manage the increasing flow of market timing trades by hedge fund customers and to assist customers in late trading and canceling unprofitable trades the following day. Tape recorded conversations, the SEC found, revealed that timing desk employees acted as consultants and trouble shooters for market timers and late traders, often assisting them in evading the restrictions imposed by mutual funds. The timing desk, the SEC found, also advised customers on dollar size thresholds likely to trigger market timing restrictions by mutual funds as well as branch codes most likely to be blocked by mutual funds.

During the relevant period, according to the order, timing desk employees were also advised by their supervisor to falsify order time information and to record all orders for 3:59 or 4:00 p.m., regardless of what time after 4:00 p.m. such orders were received. The SEC further found that BSSC gave certain correspondent brokers and prime brokerage customers direct access to its electronic mutual fund order entry system, thereby allowing them to place tens of thousands of late trades on behalf of their customers. Based on recorded telephone conversations, the SEC concluded that BSSC knew that such customers were using the direct access to place orders received after 4:00 p.m.

Based on the alleged misconduct described above, the SEC found BSSC in violation of Section 17(a) of the Securities Act, which prohibits fraudulent conduct in the offer or sale of securities, and Rule 22c-1 under the Investment Company Act, which requires the sale and redemption of mutual fund shares at NAV prices next computed after receipt of an order. BS&Co. was held in violation

of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act, which also prohibits fraudulent conduct in the offer or sale of securities, and was found to have aided and abetted BSSC's violation of Rule 22c-1 of the Investment Company Act. Further, both BSSC and BS&Co. were found in violation of Section 15(c) of the Exchange Act, which prohibits broker-dealers from effecting or inducing the purchase or sale of securities by deceptive or fraudulent means.

In view of these violations, the SEC imposed extensive undertakings on the respondents, including the establishment of a Director of Compliance as a position reporting directly to BSSC's Board of Directors, and ordered BS&Co. and BSSC to disgorge $160 million and pay a civil penalty in the amount of $90 million. Pursuant to a distribution plan, such funds will be placed in an account for distribution to mutual funds and mutual fund shareholders harmed by such misconduct. At the same time, BS&Co. and BSSC also settled charges brought by the New York Stock Exchange ("NYSE") based on the same alleged misconduct. Payment of the $250 million fine imposed by the SEC will be deemed to satisfy the monetary fines imposed by the NYSE.

A copy of the SEC order is available at: http://www.sec.gov/litigation/admin/33-8668.pdf. A copy of the NYSE settlement is available at: http://www.nyse.com/pdfs/05-169-170.pdf.

SEC Continues to Pursue Market Timing and Late Trading Abuses in Mutual Fund Shares

SEC bars president of broker-dealer and investment adviser from industry for trading abuses

On March 17, 2006, the SEC issued an order in settlement of charges that Kautilya "Tony" Sharma, the president of Geek Securities, Inc. ("Geek Securities"), a registered broker-dealer, and Geek Advisors, Inc. ("Geek Advisors"), a registered investment adviser, facilitated pervasive market timing and late trading by institutional clients. The order found that on February 9, 2006, a final judgment was entered by consent against Sharma in a civil case filed by the SEC in June 2004 in the U.S. District Court for the Southern District of Florida.

In the complaint filed in the civil case, the SEC alleged that between September 2001 and November 2003, Sharma, through Geek Securities and Geek Advisors, used various deceptive techniques to engage undetected in market timing and late trading activities in mutual fund shares on behalf of institutional clients, including several hedge funds. More specifically, Sharma kept track of the various mutual funds that had restricted his clients from trading due to their past market timing activities and he suggested to them alternative methods of bypassing such restrictions. For example, Sharma suggested the use of multiple accounts and clearing firms and the use of "cloned" accounts for purposes of evading detection. In addition, the SEC alleged that Sharma, through Geek Securities and Geek Advisors, advised clients on the maximum trade size that could be executed without detection and on how many round-trip trades a client could make before being banned by a particular fund family. Further, Sharma, through Geek Securities and Geek Advisors, systematically accepted trade instructions after the 4:00 p.m. closing of the market and illegally processed them through a clearing firm at that day's NAV price. The SEC alleged that Geek Securities' and Geek Advisors' primary business purpose was to provide market timing and late trading services to such clients.

Without admitting or denying any of the findings, Sharma consented to the order barring him from association with any broker-dealer or investment adviser. A copy of the SEC order is available at: http://www.sec.gov/litigation/admin/34-53507.pdf. A copy of the original complaint is available at: http://www.sec.gov/litigation/complaints/comp18738.pdf.

Litigation

Massachusetts Federal District Court Dismisses SEC Case Against Mutual Fund Executives Charged with Market Timing Scheme

SEC suffers set back in case against executives for abusive trading of mutual fund shares

On February 21, 2006, Judge Nathaniel M. Groton of the U.S. District Court for the District of Massachusetts dismissed a civil fraud action brought by the SEC in February 2005 against Joseph Tambone and Robert Hussey (together, the "Defendants"). The Defendants were senior executives at Columbia Funds Distributor, Inc. ("Columbia Distributor"), a registered broker-dealer that served as the principal underwriter and distributor for over 140 mutual funds in the Columbia mutual fund complex (the "Columbia Funds").

In its complaint, the SEC alleged that from 1998 through September 2003, the Defendants knowingly approved arrangements that allowed certain preferred investors to engage in market timing in at least 16 Columbia Funds in contravention of such funds' prospectus disclosures. In return for these arrangements, the Defendants allegedly required long-term investments (so-called "sticky assets") in other Columbia Funds. During this five-year period, these arrangements allegedly resulted in market timing trades totaling approximately $2.5 billion. Further, the SEC charged that electronic mail communications revealed that the Defendants were aware of the excessive trading by certain investors and were aware of the detrimental effect such trading had on long-term investors, yet took no action to halt such trading abuses. In addition, the SEC alleged that the Defendants never disclosed to other investors in the Columbia Funds the existence of these private arrangements, even though the Columbia Funds' prospectuses purported to ban such market timing activity.

Upon a motion by the Defendants, the court dismissed the complaint for failure to state the claims with requisite particularity. As of March 9, 2006, the SEC was in the process of drafting an amended complaint. A copy of the original complaint is available at: http://www.sec.gov/litigation/complaints/comp19069.pdf. A copy of the district court opinion is available at: http://pacer.mad.uscourts.gov/dc/opinions/gorton/pdf/tambone.pdf.

Delaware Chancery Court Finds Contractual Limitation on Liability for Intentional Misrepresentation Unenforceable

Decision handed down in suit by one private equity firm against another private equity firm for fraudulently selling a portfolio company based on inflated EBITDA

On February 14, 2006, the Delaware Chancery Court ruled on a motion to dismiss by Providence Equity Partners, Inc. and its affiliated entities (collectively, "Providence"), a private equity firm, in a case brought by another private equity firm, ABRY Partners V, L.P. and its affiliated entities (collectively, "ABRY"), seeking to rescind the $500 million sale by Providence to ABRY of a portfolio company, F&W Publications, Inc. (the "Company"), a special interest books and magazines publisher. The case arose after the sale of the Company when ABRY discovered financial irregularities at the Company. ABRY alleged that Providence and the Company's management manipulated the Company's financial statements to artificially inflate its EBITDA and included false representations and warranties in the stock purchase agreement in order to fraudulently induce ABRY to overpay for the Company. As a result of these fraudulent statements, ABRY claimed that it had lost over $100 million. Providence sought to dismiss the case, claiming that whether or not the false statements were intentionally made, ABRY's exclusive remedy under the stock purchase agreement was a claim for breach of the representations and warranties which was capped at 4% of the purchase price, $20 million, under the agreement's indemnity provisions.

In denying the motion to dismiss, the Court held that under Delaware law, public policy "will not permit the Seller to insulate itself from the possibility that the sale would be rescinded if the Buyer can show either 1) that the Seller knew that the Company's contractual representations and warranties were false; or 2) that the Seller itself lied to the Buyer about a contractual representation and warranty," and that therefore the exclusive remedy clause was unenforceable in this context.

The Court distinguished this ruling from cases that have held that the risk of factual error (as opposed to intentional misrepresentation) on the part of the seller may be allocated by the parties in the contract. The Court also expressly recognized Delaware case law giving effect to "non-reliance" provisions (which disclaim any reliance on any facts or representations not expressly contained in the transaction agreement) and noted that ABRY did not allege misrepresentations by Providence that were not written into the contract. A copy of the Court's opinion was not available at press time.

SEC Files Suit Against Hedge Fund Promoter and Investment Advisers To Halt Fraudulent Offerings

Court grants temporary restraining order, halting seven allegedly fraudulent hedge fund offerings

On February 27, 2006, the SEC filed a complaint and an emergency application for a temporary restraining order in the U.S. District Court for the Northern District of Georgia to stop an ongoing offering of interests in seven hedge funds by Kirk S. Wright, an Atlanta-based promoter, his two investment advisory companies, International Management Associates, LLC and International Management Associates Advisory Group, LLC, and the seven hedge funds that they manage (collectively, the "Defendants"). In its complaint, the SEC alleged that from February 1997 through present day, the Defendants raised as much as $185 million from up to 500 investors through a fraudulent investment scheme that included misrepresentations in quarterly statements regarding assets that had been largely dissipated and rates of return that were fabricated.

On the same day it was filed, Judge Charles A. Pannell granted the emergency application and issued a temporary restraining order, enjoining the Defendants from future securities violations, appointing a receiver for all of the Defendants except Wright, providing for expedited discovery and prohibiting the destruction of documents. The SEC is seeking permanent injunctions, an accounting and disgorgement of ill-gotten gains and civil penalties. A copy of the complaint was not available at press time. A copy of the SEC release is available at: http://www.sec.gov/litigation/litreleases/lr19581.htm.

SEC Brings Civil Action in Illinois Against Investment Adviser for Defrauding Hedge Fund Investors

On March 2, 2006, the SEC filed civil charges against Directors Financial Group, Ltd. ("DFG"), a registered investment adviser, and its owner and president, Sharon E. Vaughn, in the U.S. District Court for the Northern District of Illinois for allegedly placing managed fund assets in a fraudulent trading program. According to the complaint, DFG and Vaughn formed a private hedge fund, Directors Performance Fund, L.L.C. (the "Fund"), which by June 2005, raised $28 million from 29 investors. The Fund's offering memorandum, as described in the complaint, represented that it would apply a trading strategy that generally involved the direct purchase of government and other high-quality debt with minimal credit risk from issuers, dealers and institutional bond

desks. The offering memorandum, the complaint alleged, also set forth a list of permitted investments for the Fund which included U.S. Treasury bills, certificates of deposits, long-term corporate debt and other low risk securities. In addition to the offering memorandum, DFG and Vaughn allegedly made oral representations to investors during several in-person meetings expressly stating that investor funds would be kept in "non-depletion accounts."

SEC accuses investment adviser and owner of fraud

The SEC complaint charged that during the Fund's three-year existence, DFG and Vaughn made only three significant investments, none of which fell within the scope of disclosures made to investors. In particular, the SEC complaint alleged that DFG and Vaughn invested $25 million of the Fund's assets in a fraudulent prime bank trading program contrary to the fund's stated trading strategy.

In this regard, the SEC complaint alleged that around March 2005, DFG and Vaughn were approached by a promoter who claimed to operate a trading program in certain discounted fixed income instruments that he would not identify. The promoter, the SEC alleged, represented to DFG and Vaughn that he could purchase these unidentified securities at a discount and resell them for a substantial profit, assuring a return in excess of 10% per month. The promoter further represented, the SEC alleged, that the underlying trading market was confidential but overseen by "the Fed," that he was one of the few traders licensed to trade on such market and that a portion of profits from the trading program would be used to fund "humanitarian and charitable projects around the world." Based on these vague promises and without further investigation into the background of the promoters or the legitimacy or suitability of such a trading program as an investment for the Fund, the SEC alleged, DFG and Vaughn committed the Fund's capital to the trading program. Following the Fund's investment in the program, the SEC asserted, DFG and Vaughn were tricked through various ruses into handing complete control over fund assets to the scheming promoters, without obtaining any documentation evidencing DFG's ultimate ownership of these monies. The SEC identified this as a typical "prime bank" scheme in which promoters guarantee exorbitant returns, without risk to the investor's capital, through complex trading on an exclusive, confidential market in unspecified securities.

Based in part on these events, the court permanently enjoined DFG and Vaughn from violating securities laws and from violating and aiding and abetting violations of, the recordkeeping provisions of the Advisers Act. DFG and Vaughn

consented to the court's judgment without admitting or denying the allegations and agreed to pay more than $800,000 in disgorgement and prejudgment interest. A copy of the original complaint is available at: http://www.sec.gov/litigation/complaints/comp19589.pdf.

Industry Update

Director of OCIE Discusses Fiduciary Duty at Annual Meeting of Investment Advisers

SEC director addresses the importance of an investment adviser's fiduciary obligations and common compliance deficiencies

On February 27, 2006, Lori A. Richards, Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), spoke at the Eighth Annual Investment Adviser Compliance Summit in Washington, D.C. regarding the importance of an investment adviser's fiduciary obligations and the common compliance issues facing investment advisers today. In addressing the concept of fiduciary duty and its application to investment advisers, Ms. Richards described the five major responsibilities that advisers, as fiduciaries, have when it comes to their clients: (i) to put clients' interests first; (ii) to act with utmost good faith; (iii) to provide full and fair disclosure of all material facts; (iv) not to mislead clients; and (v) to expose all conflicts of interest to clients. A firm understanding of its fiduciary duty, Ms. Richards suggested, would help advisers avoid the various compliance violations most often detected by the SEC.

In that regard, Ms. Richards then discussed the top five compliance deficiencies cited in OCIE examinations of investment advisers: (i) deficiencies in portfolio management, stemming from inadequate controls to ensure that investment decisions are consistent with client mandates and goals; (ii) deficiencies in monitoring advisory employees' personal trading, resulting in abuses such as front-running, trading on non-public information and usurping investment opportunities from clients; (iii) deficiencies in performance calculations, including overstating performance results, comparing results to inappropriate indices and advertising misleading historical results; (iv) deficiencies in brokerage arrangements and execution, resulting in less than "best execution" and the use of client money for goods and services that benefit the adviser rather than the client; and (v) deficient disclosure.

Ms. Richards devoted the majority of her remarks to deficient disclosure, which she cited as being the most frequently-found deficiency, often arising from inaccurate and misleading information in Form ADV and disclosure regarding business practices and fees. Ms. Richards emphasized that disclosure is at the heart of the OCIE examination process. Prior to and throughout the examination process, examiners continuously focus on the public information released by the adviser regarding its business practices and services, and whether such disclosure is consistent with actual practice. Any discrepancies between the two would result in heightened scrutiny during the examination process. In order to prevent disclosure issues, Ms. Richards suggested that firms conduct periodic in-depth reviews of their Form ADV along with other written materials disseminated to clients and compare such disclosures against the firm's actual business operations and practices, confirming that the representations are true in actual practice. This type of periodic review of client portfolios, Ms. Richards indicated, would also be helpful in ensuring consistency between portfolio transactions and disclosure to and instructions from clients.

A copy of the SEC speech is available at: http://www.sec.gov/news/speech/spch022706lar.htm.

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