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Developments of Note

➢ SEC Announces Settlement of Administrative Proceedings Against Mutual Fund Adviser and Certain Adviser Personnel Related to Travel, Entertainment and Gifts Provided by Brokerage Firms

The SEC announced that it had settled enforcement proceedings against two affiliated registered advisers (collectively, the "Adviser"), a senior executive of the Adviser, a former executive of the Adviser with supervisory responsibility for the Adviser's equity trading desk and a former equity trader for the Adviser (collectively, the "respondents"), regarding approximately $1.6 million in travel, entertainment and gifts provided to the individual respondents and to certain other former equity traders of the Adviser and the Adviser's former head of equity trading, by brokerage firms that were doing business through the Adviser's trading desk with a family of mutual funds (the "Funds") managed by the Adviser and with the Adviser's other collective investment vehicle and separate account clients. Separately, the SEC announced that it was instituting administrative and cease-and-desist proceedings regarding related allegations against the Adviser's former head of equity trading and nine other former equity traders. This article summarizes the SEC's findings in the settlement orders; the respondents have neither admitted nor denied the SEC's findings.

The activities addressed in the settlement orders have previously served as the basis for SEC and NASD disciplinary action against a broker-dealer, a former trader for the broker-dealer and the trader's former supervisor based on the regulators' findings regarding travel, gifts and entertainment provided by the former trader to certain equity trading personnel of the Adviser, which used the broker-dealer to execute trades for the Funds (see the December 19, 2006 *Alert*). In addition, the Funds' independent trustees conducted an investigation of the activities discussed in the settlement orders. Although the investigation did not determine that the Funds had sustained any financial loss, it ultimately resulted in December 2006 undertakings by the Adviser to pay $42 million to the Funds and close to $10 million to the Adviser's non-mutual fund clients, along with interest and the expenses of the independent trustees'

investigation. The remainder of this article discusses the violations of various provisions of the Investment Company Act of 1940, as amended (the "1940 Act"), and the Investment Advisers Act of 1940, as amended (the "Advisers Act"), found by the SEC in the settlement orders, the remedial action taken and to be taken by the Adviser, the fines and penalties imposed by the SEC under the settlement orders and further proceedings against other former Adviser trading personnel.

Improper Compensation. The SEC found that by accepting gifts, travel and entertainment from a brokerage firm through which they executed transactions on behalf of the Adviser's clients, the Adviser's former executive respondent, the Adviser's former head of equity trading and various former equity traders, including the former trader respondent, violated Section 17(e)(1) of the 1940 Act. The SEC also found that the senior executive of the Adviser, who also served as an interested trustee of the Funds for a portion of the period in question, caused violations of Section 17(e)(1) through his requests for, and receipt of, tickets to sporting and entertainment events from the Adviser's traders, knowing that the traders would secure the tickets from brokerage firms doing business with Adviser's trading desk. Section 17(e)(1) prohibits certain affiliates of a mutual fund's adviser (including the adviser's personnel), when acting as agent, from accepting "compensation" from any source (other than a salary or wages from the fund) for the purchase or sale of any property to or for the fund. In connection with these findings, the SEC indicated that it viewed a violation of Section 17(e)(1) as complete upon receipt of the "compensation."

Failure to Supervise. The SEC found that the Adviser's failure to adopt and implement controls sufficient to detect, deter and prevent receipt of improper compensation by its executives and equity traders in violation of Section 17(e)(1) of the 1940 Act (as discussed above) was a violation of Section 203(e)(6) of the Advisers Act. Section 203(e)(6) generally requires a registered adviser to reasonably supervise its personnel to prevent violations of the federal securities laws. In particular, the SEC found that the former head of the Adviser's equity trading desk failed to monitor the former traders' receipt of travel, entertainment and gifts from brokers on any systematic basis and failed to take steps to enforce the Adviser's gifts and gratuities policy, whose prohibitions were inconsistent with the travel, entertainment and gifts received by the former traders, the former executives and the senior executive.

Best Execution. The SEC found that the Adviser breached its duty under Section 206(2) of the Advisers Act to seek best execution on behalf of its clients, including the Funds, by allowing the receipt of travel, entertainment and gifts from certain broker-dealers, and certain traders' family and romantic relationships to play a role in the broker selection process for client transactions. The SEC concluded that this resulted in a substantial possibility of higher execution costs, but did not find that it had in fact resulted in higher execution costs or other financial harm.

Conflicts of Interest. The SEC found that the Adviser violated Section 206(2) of the Advisers Act by failing to disclose the material conflicts of interest created by its personnel's receipt of travel, entertainment and gifts from certain broker-dealers and certain equity traders' family and romantic relationships with broker-dealer personnel. (Section 206(2) prohibits an investment adviser from, directly or indirectly engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. Negligence is sufficient for a Section 206(2) violation; scienter is not required.)

False and Misleading Disclosures. The SEC found that the Adviser's former head of equity trading had made false disclosures to the Funds' trustees when he failed to mention travel, entertainment and gifts provided by certain broker-dealers to Adviser personnel and certain equity traders' family and romantic relationships among the factors in the broker selection process that he described to the trustees in presentations on that topic. In addition, the Adviser's former head of equity trading represented to the Fund's trustees that broker-dealers competed for Fund brokerage transactions based on specified execution considerations, without mentioning that broker-dealers also competed for business by providing travel, entertainment and gifts to the Adviser's traders or on the basis of family or romantic relationships between the Adviser's traders and broker-dealer personnel. The foregoing omissions were found to be violations of Section 206(2) of the Advisers Act. Similar omissions by the Adviser in

public disclosure documents, such as the Adviser's Form ADV and the Funds' prospectuses and statements of additional information, were the basis for SEC findings that the Adviser had made materially false and misleading disclosures in violation of Sections 204, 206 and 207 of the Advisers Act, Rule 204-1 under the Advisers Act and Section 34(b) of the 1940 Act.

Recordkeeping. The SEC found that the Adviser had failed to comply with the 1940 Act's recordkeeping requirements under Section 204 (which governs recordkeeping generally), and specifically Rule 204-2(a)(7) (written communications) and Rule 204-2(g) (electronic recordkeeping). Specifically, the Adviser failed to make and keep true, accurate current originals or copies of messages sent over an electronic messaging network that the Adviser's traders used to communicate with brokers, as required by Rule 204-2(a)(7)(iii), which applies to written communications sent or received by a registered adviser relating to the placing or execution of any order to purchase and/or sell a security. The Adviser's records were incomplete and inaccurate because when retrieved from the network provider, with which the Adviser had contracted for storage services, the messages did not include the names of users who had terminated their employment with the Adviser or the relevant broker-dealer.

Remedial Action. In reaching its settlement with the Adviser, the SEC noted the Adviser's actions following its discovery of the activities giving rise to the SEC's investigation. The Adviser disciplined approximately 2 dozen equity traders and other employees based on information it gathered regarding the receipt of travel, entertainment and gifts from broker-dealers. The Adviser adopted additional standards of conduct for all its employees, implemented a requirement of management approval for all private jet travel, further clarified its rules on permissible business entertainment and instituted a requirement that all employees report the receipt of any business entertainment exceeding $250 in value to the Adviser's ethics office. The Adviser also adopted a policy requiring traders to notify their managers and the ethics office promptly if certain family members became employed in certain specified positions by any broker-dealer with which the Adviser does business. The Adviser reorganized management of its equity trading operations, introducing a new level in management oversight between the head of equity trading and the traders. The Adviser also increased its ethics office's funding and staffing. As a condition of the settlement order, the Adviser is required to retain an independent consultant to conduct a comprehensive review of the Adviser's policies and procedures designed to prevent violations of Section 17(e)(1) of the 1940 Act, among other related matters.

Disgorgement and Penalties. The senior executive, the former executive and former equity trader respondents were each required to agree to cooperate with future related SEC investigative, administrative or judicial activities or proceedings and to disgorge the value of gifts, travel and entertainment they received, with interest. In addition, the former executive and former equity trader respondents were required to pay civil money penalties of $25,000 and $10,000 respectively. The Adviser's settlement requires it to pay a civil money penalty of $8 million (which may not reduce the amount it has committed to pay its clients under its December 2006 undertakings).

Further Proceedings. The proceedings the SEC has brought against the Adviser's former head of equity trading and nine former equity traders will be heard before an administrative law judge, who must issue a decision within 300 days from the date the SEC serves the order on the respondents. The allegations in the order instituting proceedings against these individuals generally parallel those in the settlement orders.

➢ Treasury/FRB Address Sovereign Wealth Fund Issues

Treasury. The US Treasury announced that it had agreed to overarching principles with the governments of Abu Dhabi and Singapore and their respective sovereign wealth funds ("SWFs"), ADIA and GIC. The parties generally agreed with the "best practices" initiatives being undertaken by the International Monetary Fund ("IMF") and the Organization for Economic Cooperation and Development ("OECD"), and hoped that the IMF and OECD could build upon the following basic principles (the IMF has stated a draft of the principles may be available this August):

- For SWFs
  - Investment decisions based solely on commercial (as opposed to geopolitical) grounds
  - Greater disclosure as to purpose, investment objectives and financial information
  - Strong internal governance structures, controls and risk management systems
  - Compete fairly and comply with host country rules
- For Countries receiving SWF investment
  - Do not erect protectionist barriers
  - Provide publicly available, predictable investment frameworks
  - Do not discriminate among investors
  - Do not impose intrusive restrictions, and limit rules based on national security to genuine concerns

FRB. Separately, Scott Alvarez, General Counsel of the FRB, spoke to a Subcommittee of the House of Representatives on the legal framework for SWF investment in banking institutions located in the US. He stated that in the past several months SWFs have made direct investments totaling more than $24 billion. Mr. Alvarez then discussed the general rules (which also apply to SWFs) applicable to investments by entities in US banks and bank holding companies ("BHCs").

Mr. Alvarez notes that the FRB generally has not found control if an entity owns less than ten percent of the voting shares of a bank or BHC, and the SWFs have to date generally stayed below these thresholds. He further highlights that although SWFs are potentially subject to the registration and ongoing requirements of the Bank Holding Company Act ("BHC Act"), the FRB has long held that the BHC Act does not apply (regardless of the size of the investment) to direct investments by foreign governments. Moreover, if a SWF controlled a foreign bank and the bank sought to establish branch or agency in the US now, that also would subject to FRB jurisdiction by virtue of the International Banking Act ("IBA"). However, while SWFs do have significant (i.e., above 10%) interests in a number of foreign banks, all those with offices in the US established those offices before the IBA was amended to provide the FRB this enhanced jurisdiction in 1991.

➢ FRB Publishes Legal Interpretive Letter Concerning Margin Status of Auction Rate Preferred Securities under Regulation T

The FRB published a legal interpretive letter (the "Letter"), which concludes that an auction rate preferred security, in general, is classified as a "nonmargin, nonexempted security" under Regulation T, and, therefore, a customer must maintain margin equal to 100 percent of the current market value of the security. Consequently, according to the Letter, an auction rate preferred security is likely to have no loan value at a U.S. broker-dealer, unless used as collateral for nonpurpose credit (*i.e.*, for a purpose other than buying, carrying, or trading in securities).

Regulation T ("Credit by Brokers and Dealers," 12 C.F.R. Part 220) regulates extensions of credit by brokers and dealers and imposes, among other things, initial margin requirements and payment rules on certain securities transactions. Regulation T generally provides for the classification of securities into one of three categories: margin, nonmargin or exempted. U.S. broker-dealers are not permitted to extend credit against nonmargin securities, unless the loan is a nonpurpose loan. Brokers and dealers are permitted to extend credit of up to 50 percent loan value against margin equity securities and may extend "good faith" credit against non-equity and exempted securities.

According to the Letter, in order to avoid being classified as nonmargin, auction rate securities issued as preferred stock must either satisfy one of the clauses found in the definition of "margin security" or else must be issued by an "exempted securities mutual fund." The Letter stresses that auction rate preferred

securities generally do not enjoy margin status because, to the FRB's knowledge, no auction rate preferred security (i) is registered or has unlisted trading privileges on a national securities exchange; (ii) is a debt security convertible into a margin security; or (iii) is issued by an open-end investment company or unit investment trust registered under section 8 of the Investment Company Act of 1940. (Satisfaction of any of the foregoing would satisfy the definition of a margin security.) The Letter states that an auction rate preferred security is unlikely to satisfy the definition of "foreign margin stock" which also satisfies the definition of a margin security. To qualify as "foreign margin stock," a foreign equity security must either have (i) a "ready market" as set forth in SEC Rule 15c3-1, or (ii) a "no-action" position issued by the SEC. In order to satisfy Regulation T's definition of an "exempted securities mutual fund," a closed-end investment company must have at least 95 percent of its assets continuously invested in exempted securities. Auction rate preferred securities issued by such closed-end investment companies (however unlikely) would be entitled to "good faith" margining.

The Letter highlights the difference in margin status between auction rate securities issued in the form of debt versus those issued in the form of equity (as discussed above), noting that municipalities that access the auction rate market (as opposed to corporations) do so only through debt offerings. Such securities constitute "non-equity" securities and thus would meet the definition of a "margin security" under clause (3) of section 220.2 of Regulation T ("any non-equity security"). As mentioned, Regulation T allows "good faith" margining for both non-equity and exempted securities.

➢ SEC Proposes New Rule on Naked Short Sales

The SEC issued a formal release proposing a new rule under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), intended to address failures to deliver securities sold short that have been associated with "naked" short selling. In a naked short sale, a seller sells securities short without having them available for delivery and intentionally fails to deliver them within the standard three-day settlement cycle. The SEC believes that naked short selling is detrimental to the markets and can have a negative effect on shareholders, potentially depriving them of the benefits of securities ownership, such as the ability to vote and lend the securities held. In the SEC's view, naked short sales also may create a misleading impression of the market for an issuer's securities. Past SEC efforts to prevent naked short selling have included instituting the "locate" requirement contained in Regulation SHO under the Exchange Act. Under the locate requirement, broker-dealers that execute short sales must either make arrangements to borrow the security sold short or to have reasonable grounds to believe that the security can be borrowed in time to make timely delivery. While naked short selling as part of a manipulative scheme is already illegal under current law, the SEC believes that the proposed rule will focus the attention of market participants on such activities. The proposed rule is designed to highlight the specific liability of persons that deceive specified persons about their ability or intention to deliver securities in time for settlement.

Proposed Rule 10b-21 would forbid "any person to submit an order to sell a security if such person deceives a broker or a dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due." Scienter would be a necessary element for a violation of the proposed rule. A seller would violate the proposed rule if it represented that it had an identifiable source of borrowable securities, but (a) never contacted the source, (b) did contact the source and learned that the source did not have sufficient shares for timely delivery or (c) contacted the course, which confirmed the availability of the securities, but did not instruct the source to deliver them. The rule would also apply to a seller that deceives a broker-dealer, participant of a registered clearing agency or purchaser about its ownership of the securities being sold (*e.g.*, the seller that knows or recklessly disregards that the security being sold cannot, or cannot reasonably be expected to be in the broker-dealer's physical possession by the date delivery is due), and subsequently fails to deliver them. Broker-dealers acting for their own account would be subject to the rule. However, broker-dealers engaged in bona fide market making activity would be exempt from the rule (just as market makers are exempt from the requirement of Regulation SHO that they locate securities to borrow before selling short). A seller relying in good faith on a broker-dealer's "Easy to Borrow" list to comply with

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Regulation SHO's locate requirement would not be liable under the rule. Broker-dealer customers that sell shares held in a margin account would also be exempt from the rule (because the SEC believes that it would be reasonable for them to assume that they have the ability to deliver the securities even though the broker-dealer may have, in fact, loaned them out). Comments on the proposal are due by May 20, 2008.

Other Item of Note

➢ FASB Issues Additional Standards for Disclosures about Derivative Instruments and Hedging Activities

The Financial Accounting Standards Board issued FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, which amends FASB Statement No. 133 to require enhanced disclosures about derivative instruments and hedging activities in order to better reflect their effects on an entity's financial position, financial performance and cash flows. The new disclosure requirements are effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008.