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SEC Goes Back to the Drawing Board Following Invalidation of Hedge Fund Rule

By Gareth T. Evans

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In testimony before Congress last month, Securities and Exchange Commission Chairman Christopher Cox said that the SEC has been “forced back to the drawing board” following the D.C. Circuit’s invalidation of the SEC’s hedge fund rule in *Goldstein v. SEC*.¹ Cox now seeks new rules restricting the sale of hedge funds to retail investors and imposing additional anti-fraud provisions on hedge fund advisers. Whether such rules are really necessary should be the subject of considerable debate, however. In addition, Cox will need to proceed carefully to avoid the rulemaking mistakes that doomed the hedge fund rule and, just weeks earlier, the mutual fund independent director rule.

In the immediate future, Cox must clean up the mess that invalidation of the hedge fund rule has left for advisers who registered under the rule. The court’s decision not only invalidated the requirement that hedge fund advisers register with the SEC, but it also had the side-effect of invalidating exemptions from various regulatory requirements that would otherwise apply to registered investment advisers. Hoping to prevent a tide of deregistrations, Cox has directed the SEC staff to take “emergency action” to restore the exemptions and transitional provisions that were included in the hedge fund rule.² Without such action, many of the approximately 2,500 hedge fund advisers who registered with the SEC before the *Goldstein* decision could find themselves in violation of those requirements when the court issues its final mandate in mid-August.

The Hedge Fund Rule

Through the hedge fund rule, adopted in December 2004, the SEC sought to bring hedge fund advisers within the requirements of the Investment Advisers Act. The Advisers Act requires non-exempt investment advisers to register with the SEC and prohibits them from engaging in fraudulent and deceptive activities.³ Hedge fund advisers generally meet the Advisers Act’s definition of “investment adviser.”⁴ But they are usually exempt from registration under the private adviser exemption, which applies to advisers with fewer than fifteen “clients.”⁵ The Advisers Act does not define “client,” but before enacting the hedge fund rule the SEC had interpreted it to mean the funds themselves,

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SEC Update: More 404 Rules, Soft Dollars Safe Harbor, and Investment Fraud Against Seniors

By Peter H. Schwartz and Katelin R. Oakley

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Additional 404 Rulemaking Proposed

On July 11, the Securities and Exchange Commission published a concept release to solicit public feedback on the topic of providing additional guidance about the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.¹ According to the SEC, any such guidance will likely be in the form of a new rule regarding management's assessment of the effectiveness of internal control over financial reporting, with a focus on assisting smaller public companies in developing and implementing cost effective assessment and compliance procedures. The release specifically notes the conclusions of the SEC's Advisory Committee on Smaller Public Companies, which identified three main differences between smaller and larger public companies that hampered Section 404 compliance efforts smaller companies, namely:

- limited ability to segregate conflicting duties;
- higher risk of management override; and
- limited ability to maintain a static business process.

More broadly, the SEC indicated that the feedback it had received regarding implementation suggested that issuers were struggling to effectively identify risks to reliable financial reporting and to implement efficient, entity-level controls. In order to target these issues, the new guidance will likely address:

- the objectives for internal controls;
- identification of related risks;
- development of targeted controls (including key and entity-level controls);
- evaluation of control deficiencies; and
- creation of appropriate and cost effective documentation.

Comments and responses with regard to this concept release are due September 18, 2006.

SEC Issues Interpretive Release Narrowing the Scope of Soft Dollars Safe Harbor

On July 18, the SEC issued an interpretive release providing guidance on the scope of the soft dollars safe harbor contained in Section 28(e) of the Securities Exchange Act of 1934.²

"Soft dollars," a term mostly avoided by the release, refers to money managers' use of client brokerage commissions to pay for research and other services. Section 28(e) allows the use of soft dollars paid to a broker-dealer for effecting a securities transaction if the money manager determines in good faith that the amount of the commission is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

The initiative is not the first time that the SEC has issued guidance on soft dollars. The last of several releases interpreting "brokerage and research services" under Section 28(e) was issued in 1986,³ and in 1998, the agency published a staff report on soft dollar practices.⁴ In 2001, the SEC issued an interpretation stating that a riskless principal transaction's commission-equivalent, that is, the difference between the execution price and the price the customer paid, counts as a commission for purposes of the safe harbor.⁵ The SEC also has brought enforcement actions in this area.⁶

Much of the guidance in the interpretive release is the same as in the proposed interpretive release published in October.⁷ According to the final interpretive release, "brokerage and research services" must:

- be either eligible research or eligible brokerage;
- provide lawful and appropriate assistance to the money manager in the performance of its investment decision-making responsibilities; and
- be reasonable in cost in light of the value provided.

"Research services" are restricted to "advice," "analyses," and "reports," within the meaning of Section 28(e). Therefore, physical items, such as computer hardware, which do not reflect the expression of reasoning or knowledge relating to the subject matter identified in the statute, are outside the safe harbor, as are mass-marketed publications. "Brokerage services" are restricted to those products and services that relate to the execution of the trade from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account. Money managers must "make a reasonable allocation between eligible and ineligible uses with respect to mixed-use items" and document the allocation. The release also reiterates money managers' statutory obligation to make a "good faith" determination that the commissions paid are reasonable in relation to the value of the brokerage and research services obtained.

The interpretive release departs from the proposed interpretive release regarding third-party research and commission-sharing arrangements. The release notes the benefit to investors of money managers being able to functionally separate trade execution from access to valuable research. The release states that the broker-dealer “effects” the trade if the broker-dealer executes, clears, or settles the trade, or performs one of four other “core functions” and allocates the other functions to other broker-dealers. The proposal had required that all four functions be performed by the introducing broker-dealer. The four functions are:

- taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities);
- making and/or maintaining records relating to customer trades required by SEC and exchange rules, including blotters and memoranda of orders;
- monitoring and responding to customer comments about the trading process; and
- generally monitoring trades and settlements.

The release also states that broker-dealers “provide” the research if they prepare the research, are financially obligated to pay for the research, or their research arrangements meet certain other requirements intended to require that client commissions are used only for eligible brokerage and research.

The interpretive release will be immediately effective upon its publication in the Federal Register. However, market participants may continue to rely on the SEC’s prior interpretations until six months after publication. The SEC notes that it also is considering whether at a later time to propose requirements for disclosure and recordkeeping of client commission arrangements.

SEC Summit Addresses Investment Fraud Against Seniors

On July 17, the SEC convened its first ever “Seniors Summit” to address investment fraud perpetrated against older Americans and the significant impact that it may have on the aging “baby boomer” generation.⁸ The content of the summit presentations and panel discussion was focused on investor education and enforcement activities of the participating organizations, including the National Association of Securities Dealers (NASD), the North American

Securities Administrators Association and the New York Stock Exchange.

On the forefront of enforcement activity was the “free lunch” seminar, which SEC Chairman Christopher Cox indicated would be increasingly examined for evidence of product misrepresentation and unsuitability.⁹

The results of a fraud study conducted by the NASD Investor Education Foundation were also presented at the summit. The study results showed, among other things, that fraud victims are in fact more likely to be financially literate than non-victims, and based on that finding, recommended that fraud prevention programs should increasingly focus on educating seniors about persuasion tactics and strategies to avoid such tactics.

Notes

1. SEC Rel. No. 34-54122 (Jul. 11, 2006), available at <http://www.sec.gov/rules/concept/2006/34-54122.pdf>.
2. SEC Rel. No. 34-54165 (Jul. 18, 2006), available at <http://www.sec.gov/rules/interp/2006/34-54165.pdf>.
3. SEC Rel. No. 34-23170 (Apr. 23, 1986), 51 FR 16004, 16011 (Apr. 30, 1986) (“1986 Release”).
4. See Office of Compliance Inspections and Examination, U.S. Securities and Exchange Commission, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998) (“1998 OCIE Report”), available at <http://www.sec.gov/news/studies/softdolr.htm>.
5. SEC Rel. No. 34-45194 (Dec. 27, 2001), available at <http://www.sec.gov/rules/interp/34-45194.htm>.
6. See, e.g., Dawson-Samberg Capital Management, Inc. and Judith A. Mack, Advisers Act Rel. No. 1889 (Aug. 3, 2000); Marvin & Palmer Associates, Inc., et al., Advisers Act Rel. No. 1841 (Sept. 30, 1999); Fleet Investment Advisors, Inc., Advisers Act Release No. 1821, 70 SEC Docket 1217 (Sept. 9, 1999); Republic New York Sec. Corp. and James Edward Sweeney, Rel. No. 34-41036, 53 SEC 1283 (Feb. 10, 1999); *SEC v. Sweeney Capital Management, Inc.*, Lit. Rel. No. 15664 (Mar. 10, 1998), 1999 U.S. Dist. LEXIS 22298 (1999) (order granting permanent injunction and other relief); Renaissance Capital Advisers, Inc., Advisers Act Rel. No. 1688 (Dec. 22, 1997); Oakwood Counselors, Inc., Advisers Act Rel. No. 1614, (Feb. 11, 1997); S Squared Technology Corp., Advisers Act Rel. No. 1575 (Aug. 7, 1996); *SEC v. Galleon Capital Mgmt.*, Lit. Rel. No. 14315, (Nov. 1, 1994).
7. SEC Rel. No. 34-52635 (Oct. 19, 2005), available at <http://www.sec.gov/rules/final/34-52602.pdf>.
8. SEC Rel. No. 2006-109 (July 10, 2006), available at <http://www.sec.gov/news/press/2006/2006-109.htm>.
9. See e.g. Lit. Rel. No. 19761 (July 14, 2006), available at <http://www.sec.gov/litigation/litreleases/2006/lr19761.htm>.