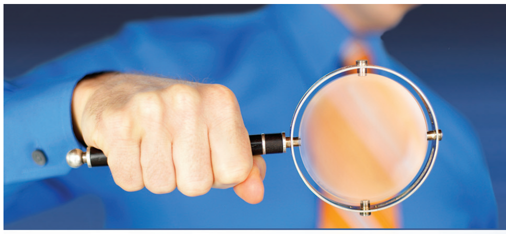

■ INVESTMENT MANAGEMENT UPDATE

Legal News™

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Legal News is part of our ongoing commitment to providing up-to-the minute information about pressing concerns or industry issues affecting our clients and our colleagues.

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Legal News: Investment Management Update is available on a monthly basis to provide articles of interest affecting investment advisers, hedge funds, and mutual funds.

Enforcement Matters

Advisory Firm Owner Charged With Misleading Clients About CMO Risk

The U.S. Securities and Exchange Commission (SEC) recently filed a lawsuit in U.S. District Court for the Northern District of Florida against Donald W. Reinhard for making material misrepresentations to clients of Mr. Reinhard's investment advisory firm about the risks connected with investing in collateralized mortgage obligations (CMOs). (See *SEC v. Reinhard*, N.D. Fla., Case 4:7-CV-00529, 12/13/07.)

The SEC in its complaint alleged that Mr. Reinhard, through his investment advisory firm, made material misstatements and admissions to his clients in connection with the offering of CMOs. Mr. Reinhard allegedly misrepresented the safety of investing in such products. In addition, the SEC complaint alleges that Mr. Reinhard failed to inform his clients of a lawsuit filed against him by the Florida Insurance Department in connection with the CMO investments, and that as market values of the CMO investments fell, Mr. Reinhard engaged in various fraudulent actions meant to hide the decline in value of such investments from his clients. The SEC alleges that Mr. Reinhard's clients and hedge fund investors lost at least $6 million due to the alleged violations.

The SEC is asking the court for injunctive relief, disgorgement, and civil-money penalties.

Adviser Charged With Fraud Involving Insured Investment Program

A registered investment adviser, National Investment Advisers, Inc. (NIA), and its principal, Douglas A. Jimerson, were the subject of a recent SEC administrative action based upon conduct involving guaranteeing investors against loss of principal. (See also http://www.sec.gov/litigation/admin/2007/34-57056.pdf.)

In the action, the SEC alleged that NIA and Mr. Jimerson offered investment programs that provided a guaranty to investors against loss of principal as long as the investors maintained their assets under NIA's management for a certain period of time. The SEC determined that the investment programs lacked the promised insurance. In addition, the SEC alleged that the investment advisory firm failed to disclose material information to its clients regarding the advisory firm's financial condition and failed to maintain certain books and records as required under the Investment Advisers Act of 1940.

Administrative Action Against Adviser's Principal for Fraudulent Statements in Connection With Application to Register

In a recent action, the SEC revoked the investment adviser registration of Henry Disraeli for alleged violations of Sections 203 and 207 of the Investment Advisers Act of 1940 in connection with the filing of an SEC application for investment adviser registration, though Mr. Disraeli's firm failed to qualify for such registration. The SEC alleged that Mr. Disraeli included certain material misstatements and omissions in the registration application. (See also http://www.sec.gov/litigation/opinions/2007/33-8880.pdf)

The SEC revoked the investment adviser registration, barred Mr. Disraeli, its principal, from association with any investment adviser, broker, or dealer, and imposed an $85,000 civil fine and disgorgement of $84,300.

Administrative Action Against Investment Adviser/Broker-Dealer for "Illegal Cherry-Picking" Scheme

The SEC recently reported the issuance of an order instituting public administrative proceedings under the Securities and Exchange Act of 1934 and the Investment Advisers Act of 1940 against Ken and Wendy Brown, who controlled K.W. Brown & Company, 21st Century Advisors, Inc., and K.W. Brown Investments, Inc. — all entities registered with the SEC as either investment advisers or broker-dealers; broker-dealer Michael Cimilluca was the registered representative. (See also http://www.sec.gov/litigation/admin/2008/34-57101.pdf.)

The SEC order is based upon the permanent injunction entered by a District Court against these respondents for violating various provisions under the federal securities laws based on the District Court's findings that such respondents engaged in an "illegal cherry-picking scheme."

The order by the SEC's Division of Enforcement alleges that during the period of September 2002 through at least June 2006, the respondents knowingly or recklessly engaged in the illegal cherry-picking scheme that earned such respondents $4.5 million, with losses of $9 million being passed on to unsuspecting advisory clients.

The District Court had entered an injunction against the respondents that permanently enjoined them from committing future violations of certain federal securities laws. The District Court also held the respondents jointly and severally liable for disgorgement of more than $4.7 million in ill-gotten gains. The District Court also imposed civil penalties of $4.5 million on the corporate defendants, and collectively $250,000 on Ken Brown and Michael Cimilluca, and $100,000 on Wendy Brown.

U.S. Department of Labor Sues Advisers to Pension Plan

Co-advisers of a Michigan pension plan were sued by the U.S. Department of Labor for alleged violations of their fiduciary duties under the Employee Retirement Income Security Act (ERISA) in connection with the sale of real estate held by an employee pension plan.

The Department of Labor alleged in its complaint filed in the U.S. District Court for the Eastern District of Michigan on December 28, 2007 (Case No. 2:07-CV15519), that Fifth Third Bank and Carrie Milestone Advisors, LLC violated their fiduciary obligations to their client, Operating Engineers Local 324 Pension in Troy, Michigan, by abruptly selling investment property held by the plan when they informed the plan they would be managing this real estate asset as a long-term investment. The complaint states that the advisors' fiduciary violations caused the plan to sell a $28-million property for $4.5 million. The Department of Labor asked the Court to prevent the defendants from acting as ERISA fiduciaries in the future and to order compensation to the plan for its losses.

Certain SEC Charges Against Hedge Fund and Its Manager Are Dismissed

On January 2, 2008, charges by the SEC were dismissed by the U.S. District Court for the Southern District of New York (Court) against hedge fund manager Edwin Lyon IV and his Gryphon Funds with respect to alleged violations of securities registration requirements in connection with short-sale transactions involving private investments in public equities (PIPE). (See *SEC v. Lyon*, S.D.N.Y., No., 06 Civ. 14338). (See also http://www.sec.gov/litigation/complaints/2006/comp19942.pdf.)

In its suit, the SEC claimed that Mr. Lyon and Gryphon Funds, a series of on-shore and off-shore hedge funds, participated in PIPE transactions involving the issuance of unregistered securities in publicly traded companies during the period of 2001 to 2004.

Once the PIPE shares are issued, they are considered restricted securities and cannot be publicly traded until the issuer files a registration application under the Securities Act of 1933 and the SEC declares that application effective. During the period that a registration statement is pending before the SEC, purchasers of PIPE shares often hedge their investments by selling short the same issuer's publicly traded securities. The Court said that Mr. Lyon and the Gryphon Fund entities hedged almost all of their PIPE investments by executing short sales that fully hedged or hedged as much as possible their PIPE positions.

When Mr. Lyon and the Gryphon entities shorted the issuer's publicly traded stock, no resale registration statement was effective for the corresponding PIPE shares, and there was no registration exemption available for those shares. The Court stated that Mr. Lyon and the Gryphon entities covered their short positions until the SEC declared the registration statement effective for the PIPE resale and then used the formally restricted PIPE shares to close out the short positions. The defendants accomplished this, according to the Court, by delivering the PIPE shares to their trading account or by executing sales and repurchases with brokers. The SEC alleged that such sales were "wash sales" and "matched orders" to ensure delivery of the requisite shares to the trading accounts of Mr. Lyon and the Gryphon entities.

The SEC filed a lawsuit against Mr. Lyon and the Gryphon entities in connection with these transactions, alleging that the defendants engaged in insider trading and securities registration violations. While the Court declined the defendants' motion to dismiss the insider trading allegations, it did dismiss the allegations of violations of the securities registration requirements. In so ruling, the Court noted that the SEC alleged that the defendants violated the securities registration provisions when they took a short position in a PIPE issuer's publicly traded securities when no PIPE resale registration was in effect and then covered their short position with PIPE shares after the effective date of the registration statement. The defendants' response to the SEC's allegations was that the delivery of once-restricted PIPE shares to close the short positions did not convert the underlying short sale into a sale of PIPE shares.

The Court disagreed with the SEC's assertion that what an investor uses to close down his short position determines what security was actually sold when the short sale was executed. The Court found this characterization of a short sale inaccurate and not reflective of what actually occurs in the market. The Court maintained that the buyer on the other side of that hypothetical short sale received common stock. Accordingly, from the Court's perspective, a short sale of a security constitutes a sale of that security. The Court concluded that how an investor subsequently chooses to satisfy the deficit in his trading account does not alter the nature of that sale.

In addition, the Court concluded that the SEC's characterization of a short sale did not advance the purposes of the securities registration requirements under the Securities Act of 1933, which protects investors by requiring publication of material information necessary to make informed investment decisions. In the relevant short-sale transactions, the buyers contracted to purchase the publicly traded shares of the PIPE issuers. The SEC did not allege that these securities failed to comply with the securities registration requirements, and the complaint did not explain how the means by which a short position is closed alters the information that must be disclosed to the buyer. The Court concluded that the buyers were presumably in possession of all the information to which they were entitled and that would be provided through securities registration.

On January 15, 2008, the SEC filed a motion with the Court asking it to reconsider and amend its decision. The SEC in its most recent motion alleges, among other things, that the Court mistakenly held the SEC to standards set for private actions, rather than those applicable to government regulators.

Non-Enforcement Matters

NASAA Announces Best Practices and Common Deficiencies of Investment Advisers

The North American Securities Administrators Association (NASAA) recently announced the results of examinations conducted of state-registered advisers during 2007. (See also http://nasaa.org/nasaa_newsroom/)
As a result of those examinations, which covered 418 state-registered advisers, of which 104 were affiliated with a broker-dealer, located in 43 jurisdictions including certain Canadian provinces, 2,100 deficiencies were found in 13 categories. Those categories included: books and records; financials; registration; Form ADV, Form U-4, IA Reps, and Form ADV delivery; fees; advertising (including ads, Web sites, business cards, and seminars); privacy notices; supervisory procedures and compliance policies;

investment activities; adherence to investment policy; fairness and conflicts; performance reporting; custody; and use of solicitors.

Based upon the deficiencies found, NASAA proposed the following best practices for investment advisers to avoid being cited for such deficiencies:

- Review and revise Form ADV and disclosure brochure annually to reflect current and accurate information
- Review and update all contracts
- Prepare and maintain all recorded records, including financial records
- Prepare and maintain client profiles
- Prepare a written manual outlining compliance and supervisory procedures that are relevant to the type of business
- Prepare and distribute a privacy policy initially and annually
- Keep accurate financials; file timely with each state jurisdiction as required; maintain a surety bond if required
- Calculate and document fees correctly in accordance with contracts and Form ADV
- Review all advertisements, including Web site and performance advertising for accuracy
- Implement appropriate custody safeguards, if applicable
- Review solicitor agreements, disclosure, and delivery procedures

SEC No-Action Letter Granted in Connection With Custody of Client Assets

SEC staff recommends no enforcement action against investment adviser who promptly forwarded client assets.

The SEC issued a no-action letter setting forth an acceptable procedure by which an investment adviser may forward client assets inadvertently received by the investment adviser, rather than returning the assets to a third-party sender. (See also http://www.sec.gov/divisions/investment/noaction/2007/iaa092007.pdf.) The letter was requested by The Investment Adviser Association to establish that an investment adviser may forward client assets to the client or a qualified custodian without being deemed to violate Section 206(4) of the Investment Advisers Act of 1940 or Rule 206(4)-2 thereunder (Custody Rule).

The Custody Rule could be interpreted to require an investment adviser to return to sender any client assets inadvertently received by the investment adviser from a third party (i.e., not from the client). In its request for a no-action letter, the Investment Adviser Association stated that returning client assets to the third-party sender could cause the client to experience unnecessary delays in receiving the assets and could cause the client unnecessary risk of losses.

The no-action letter related specifically to the following types of client assets inadvertently received by an investment adviser: (a) tax refunds; (b) class action settlement assets; and (c) stock certificates or dividend checks. The Office of the Chief Counsel, Division of Investment Management, which issued the letter, stated that it would not recommend enforcement action under the Custody Rule against an investment adviser who forwarded client assets to the client (or a qualified custodian) within five days after inadvertently receiving such assets from a third party.

The SEC no-action letter, however, indicated that if it was not rare for a particular investment adviser to receive client assets inadvertently, the investment adviser would be expected to implement written procedures for (a) promptly identifying client assets inadvertently received, (b) promptly identifying the client to whom the assets belong, (c) forwarding the assets to the client (or qualified custodian) within five days after receiving such assets, (d) returning to sender any client assets not forwarded to the client, and (e) keeping records of client assets received and forwarded or returned.

Court Rules on Statute of Limitation Period With Respect to Claim Under Investment Advisers Act of 1940

Securities Act statute of limitations applied to claim under Investment Advisers Act.

A cause of action arising out of a contract with an investment adviser that allegedly violated the Investment Advisers Act of 1940 (Advisers Act) was time-barred three years after the plaintiffs signed the contract, according to the U.S. District Court for the Northern District of Ohio (the Court), in *Kleinman v. Oak Assoc. Ltd.* (Fed. Sec. L. Rep. P 94,430, N.D.Ohio, July 16, 2007 (NO. 5:07CV0698)).

The plaintiffs sought rescission and restitution after losing about 65 percent of the value of their investment accounts, basing their claim on an allegedly illegal hedging clause in the contract they signed with their investment adviser. The Court held that a claim for rescission of contract that was based upon the content of the contract accrued when the contract was signed.

The Court, relying on precedent from the Second and Sixth Circuits, applied the limitations period from the 1933 and 1934 Securities Acts (i.e., one year after discovery/three years after injury) because the Investment Advisers Act does not have its own limitations period. The Court acknowledged that some courts have applied a longer limitations period from the Sarbanes-Oxley Act of 2002 in Investment Advisers Act cases, but not in the Sixth Circuit and only in cases involving fraud.

SEC Director of Investment Management Charts 2008 Initiatives

Buddy Donahue, SEC Director of the Division of Investment Management, reviewed the Division's initiative for 2008 while speaking at the Investment Company Institute's 2007 Securities Law and Developments Conference in Washington, D.C.

According to Mr. Donahue, during 2008, the Division intends to make recommendations to the full Commission regarding Rule 12b-1 reforms under the Investment Company Act of 1940. The SEC has received more than 1,400 comment letters responding to the SEC's request for public comment on this one issue. About 1,000 of those letters were sent by financial planners and registered representatives of broker-dealers who oppose substantive reform of the rule. Some comment letters received from industry members provided some support for reform, including the name of the fee and requiring additional disclosure. Additionally in 2008, the Division will focus on reform of the investment adviser books and records requirements as well as reforms to books and records requirements of mutual funds under the Investment Company Act of 1940. (See also http://www.sec.gov/news/speech/2007/spch120607ajd.htm.)