INVESTMENT MANAGEMENT UPDATE

Legal News℠

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Legal News: Investment Management Update 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.

Non-Enforcement Matters

SEC Announces CCOutreach Regional Seminars

The U.S. Securities and Exchange Commission (SEC) has opened registration for 25 regional seminars to help mutual fund and investment adviser chief compliance officers to improve their effectiveness. Dates, locations, and registration instructions for regional seminars are available on the SEC Web site at http://www.sec.gov/info/ccoutreach.htm.

The regional seminars will be held in April, May, and June 2008 in various cities. They will focus on compliance areas that SEC examiners frequently find to be deficient during examinations of investment advisers and investment companies.

At the seminars, SEC examiners will discuss deficiencies, how the SEC identifies them, and corrective actions funds and advisers have taken to address them. The CCOutreach Program was formed to promote open communication and coordination on mutual fund, investment adviser, and broker-dealer compliance issues.

SEC Proposed Amendments to Privacy Regulation

The SEC decided March 4, 2008 to propose amendments to Regulation S-P regarding privacy obligations for entities it regulates.

The proposed amendments would provide broker-dealers and registered investment advisers with more detailed standards for information security programs to safeguard information and respond to information security breeches. The proposed amendments also would provide new exceptions to permit a limited transfer of information when representatives move from one broker-dealer or registered investment adviser to another.

SEC Names New Associate Regional Director for Examinations in Chicago

On March 27, 2008 the SEC announced the appointment of Jane Jarco as an Associate Regional Director for Examinations in its Chicago regional office.

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In her new position, Ms. Jarco will over see the SEC's examinations of registered investment advisers and investment companies in Kentucky, Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, Ohio, and Wisconsin. Ms. Jarco will lead a staff of approximately 70 accountants and examiners in conducting compliance examinations and compliance outreach programs for investment advisers, investment companies, and transfer agents.

SEC Examiners Focus on Several Practices of Dually Registered Broker-Dealers and Investment Advisers

Andrew Donohue, Director of the SEC Division of Investment Management spoke on March 21, 2008 at the IA Compliance Best Practices Summit in Washington, D.C. about the focus of SEC inspectors examining firms that are registered dually as broker-dealers and investment advisers. In particular, Mr. Donohue referred to managed accounts, soft dollars, principal trades, and new investment products. Mr. Donohue explained, "As a regulator, the Commission strives to keep pace with developments in the market place and to maintain regulations that both allow beneficial industry innovation and ensure that, regardless of such changes, interests of investors are protected."

Mr. Donahue spoke about the "top regulatory initiatives that the Investment Management staff is working on." First, he encouraged comments on the proposed changes to Form ADV Part II, which is intended to make disclosures by investment advisers easier for clients to understand and use. Next, Mr. Donohue discussed the RAND Report, delivered to the SEC in December 2007, on the current state of the retail investment adviser and broker-dealer industries. He said the SEC will be using the RAND Report to evaluate whether regulation under the Investment Advisers Act needs to be adjusted to reflect changes in the industry.

Mr. Donahue discussed the Financial Planning Association (FPA) decision of the Court of Appeals for the D.C. Circuit which, as of October 1, 2007, caused broker-dealers offering fee-based brokerage accounts to become subject to the Investment Advisers Act with respect to those accounts. "In the aftermath of the FPA decision," Mr. Donahue said, "there are a few matters that you may see examiners focusing on if your firm isn't dual registered. They may look into how your firm is conducting principal trades and what compliance procedures are in place to ensure that those trades are in the client's best interest. Examiners also may be looking at how firms advise clients about what type of account is appropriate for them."

Mr. Donohue said that another area that interests the SEC is the rapid development of managed accounts. According to Mr. Donohue, managed accounts create "challenges" for compliance personnel and the firm's regulators. "First, separation of those providing the foundational advice or investment models or those with discretion to determine the trades and asset allocation requires careful disclosure to ensure that clients understand how the advice is provided and where the decision making is centered. Second, firms providing managed accounts should be attuned to how they are meeting their best expectation obligations. If client trades will be placed with the managed accounts sponsor, the adviser should be comfortable that this arrangement achieves best execution and that the client is informed of this arrangement and why it achieves best execution." Mr. Donohue also expressed concerns about whether firms are complying with rule 3a-4 of the Investment Company Act, which allows managed accounts to operate outside the jurisdiction of the Investment Company Act.

Mr. Donohue spoke of changing practices in the industry regarding commission fees and commissions and said that in light of these changes in the marketplace, the Division of Investment Management recognized the need to provide additional guidance to assist mutual fund boards in their oversight responsibilities with respect to soft dollars. Finally, he spoke about derivatives and new investment products, stressing that "before determining to advise clients to invest in any new investment product, it is critical that an investment advisory firm is confident that it has the resources in place to appropriately administer those investments." Mr. Donohue said that, "the firm's back office functions should be

sufficiently robust to provide effective and timely service regarding these instruments, including when unexpected events occur that cause spikes in activity."

Throughout his remarks, Mr. Donohue emphasized the need for investment advisers to provide the SEC with comments and other feedback about how the SEC can best respond to the many rapid developments and innovations in the financial advice industry.

Investment Adviser Firm Disciplined by SEC With Regard to Accepting Gifts From Brokers

The SEC imposed remedial sanctions and a cease-and-desist order against Fidelity Management & Research Company and FMR Co., Inc. (together, Fidelity) with regard to gifts from brokers to two Fidelity executives and 10 traders on Fidelity's Boston domestic equity trading desk. See, *Fidelity Mgmt. & Research Co.,* SEC Admin. Proceeding File No. 3-12976, (Mar. 5, 2008).

The SEC found that the personnel involved accepted in the aggregate approximately $1.6 million worth of travel, entertainment, and gifts from brokerage firms that sought and obtained orders to buy or sell securities on behalf of Fidelity's advisory clients. According to the SEC, the brokerage firms each received millions of dollars in commission revenue for handling orders from Fidelity's advisory clients' accounts. The SEC found that Fidelity willfully violated Section 206(2) of the Investment Advisers Act by allowing gifts to employees to influence their selection of brokers, instead of seeking best execution for their clients' securities transactions, and by failing to disclose these conflicts of interest to their advisory clients.

Based on its findings, the SEC censured Fidelity, to cease and desist, and ordered Fidelity to pay a civil money penalty in the amount of $8 million.

Officer of Investment Adviser Barred for "Referral Fees" Paid to His Mother

The SEC disciplined Michael R. Donnell, vice president of Mercantile & Advisors, Inc. (Mercantile Advisors) for failing to disclose a conflict of interest arising from a sub-adviser's payment of substantial "referral fees" to Mr. Donnell's mother. See, *Michael R. Donnell,* SEC Admin. Proceeding File No. 3-12986 (Mar. 11, 2008).

Mercantile Advisors is a registered investment adviser that manages a "fund of hedge funds" investment company (Mercantile Fund) for which Mr. Donnell served as a vice president. Mr. Donnell influenced the decision to hire a sub-adviser of the Mercantile Fund who promised to pay a substantial portion of his sub-advisory fees to Mr. Donnell's mother as a "referral fee" if he was retained by the Mercantile Fund. Proposed payments created a conflict of interest that Mr. Donnell did not disclose to anyone at Mercantile Advisors or to the board of directors of the Mercantile Fund. Mr. Donnell's mother received about $78,000, which was more than one-third of the fees received by the sub-adviser.

The SEC barred Mr. Donnell from association with any investment adviser and ordered him to pay a civil money penalty in the amount of $50,000.

Federal Court Sanctions Former Connecticut Legislator for Aiding and Abetting Fraud

Former majority leader of the Connecticut State Senate, William A. DiBella, was sanctioned by a United States District Court for the District of Connecticut for his role in a fraudulent investment scheme. See, *SEC v. DiBella,* No. 3:04-CV.1342(EBB) (D. Conn. Mar. 14, 2008).

According to the judgment, the then treasurer of the State of Connecticut, Paul J. Sylvester, who had invested $75 million in state pension funds with a Washington, D.C.-based private equity firm, arranged for the firm to pay Mr. DiBella a percentage of the investment as compensation for work Mr. DiBella never performed. Mr. Sylvester increased by $25 million the amount of the pension fund invested with the Washington, D.C. firm solely to secure a larger fee for Mr. DiBella.

The court ordered Mr. DiBella to disgorge $375,500 and imposed a penalty on him of $110,000. The court did not enter a permanent injunction or an officer-and-director bar against Mr. DiBella.

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Registered Representative Barred for Market Timing of Mutual Funds

A U.S. District Court in Massachusetts imposed sanctions against Mark J. Bilotti, a former registered representative of the Boston branch office of Prudential Securities, for defrauding mutual fund companies and their shareholders to place market timing trades on behalf of his client. See, *SEC v. Druffner*, No. 1:03-CV-12154-NMG (D. Mass. Mar. 14, 2008).

The court found that Mr. Bilotti used numerous registered representative identification numbers and multiple accounts under fictitious names to cause mutual fund companies to accept trades that they otherwise would have identified as market timing trades and thus would have rejected. The court ordered Mr. Bilotti to pay a penalty of $20,000 and barred him from associating with any broker-dealer or investment adviser, with a right to reapply after three years.

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