INVESTMENT MANAGEMENT UPDATE

Legal News℠

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A Compilation of Enforcement and Non-Enforcement Actions – February 2009

Non-Enforcement Matters

Congress Considers Major New Reporting Requirements in Hedge Fund Transparency Act

As widely expected since the news broke of the Bernie Madoff scandal and reports of other hedge fund/Ponzi schemes, legislation has been introduced in order to bring some regulation over the operation of such investment entities. Under current law, most of these private funds operate outside of the registration requirements under federal and state securities laws.

Senators Charles Grassley (R-Iowa) and Carl Levin (D-Mich.) introduced the Hedge Fund Transparency Act (S. 344) (Bill) on January 29, 2009. The Bill would bring hedge funds and other "private investment funds" under the regulatory authority of the U.S. Securities and Exchange Commission (SEC) by amending the Investment Company Act of 1940 (Investment Company Act). Commentators already have criticized the Bill for lacking clarity with regard to potential new registration requirements under the Investment Advisers Act of 1940 (Advisers Act) and for its requirement to publish the names of investors.

Managers of private funds avoid registration requirements under the Advisers Act under Section 203(b)(3), which exempts from registration those managers who (a) do not represent themselves to the public as an investment manager and have fewer than 15 clients during the course of the preceding 12 months and (b) do not provide investment advice to a fund registered under the Investment Company Act. Because the Bill would shift many of those funds from the jurisdiction of the Advisers Act to that of the Investment Company Act, albeit in the form of an exemption discussed below, it is unclear whether investment advisers would lose their registration exemption under Section 203(b)(3). Clarification may be required in this area.

Under the Bill, so-called "large investment companies" (i.e., funds with assets under management of $50 million or more) must register with the SEC as an investment company under the Investment Company Act, unless they qualify for an exemption. However, even if a large investment company is exempt from registration, it must disclose to the SEC and to the public:

1. The names and addresses of its investors as well as its minimum investment commitment
2. The names and addresses of its accountant and broker
3. An explanation of the ownership structure
4. Any affiliation with other financial institutions
5. The fund's current value of assets under management

Commentators have criticized the requirement to publicize investors' names and addresses. Neither the Bill nor its sponsors have explained the policy rationale for this requirement.

To date, the Bill has been referred to committee, has no additional sponsors, and has no proposed amendments. Notwithstanding the seeming lack of interest in the Bill among senators, many beltway insiders suspect the Bill may become law in some form.

Congress Likely to Require Investment Advisers to Use Independent Custodian

Both the Senate Committee on Banking, Housing, and Urban Affairs and the House Financial Services Committee (via its Subcommittee on Capital Markets) recently held hearings regarding the increase in the number of alleged Ponzi schemes. Experts and members of Congress latched on to one simple regulatory reform proposed by Columbia Law School Professor John C. Coffee Jr.: requiring hedge funds and alternative investments created by investment advisers to use an independent custodian to hold the investors' funds in a separate account, as mutual funds do.

According to Professor Coffee, Ponzi schemes occur in hedge funds and other alternative investments but not in mutual funds. The regulatory difference, per Professor Coffee, is that mutual funds must use an independent custodian under the Investment Company Act, which provides sufficient oversight to prevent Ponzi schemes. Conversely, the Advisers Act, which regulates investment advisers, allows an investment adviser to self-clear transactions through an affiliated broker-dealer, a loophole Professor Coffee referred to as an "illusory rule." Professor Coffee's recommendation was echoed by industry consultant Leon Metzger, who also serves as a visiting professor at Columbia University, New York University, and Yale University, where he teaches hedge fund management. The Investment Advisers

Association has already endorsed this regulatory reform.

Enforcement Matters

Investment Adviser Flees, Faces Civil and Criminal Charges

When a partner of his requested that an independent accountant audit their funds' books, investment adviser Arthur Nadel, 76, had a strange response: he disappeared. The SEC subsequently filed civil injunctive action against Mr. Nadel, two investment management companies, and six hedge funds for which Mr. Nadel acted as the principal investment adviser. Shortly after the SEC filed its action, and 13 days after he first disappeared, Mr. Nadel resurfaced and turned himself in to authorities.

According to the SEC, Mr. Nadel sent offering materials representing that three of his funds had $342 million in assets, when in fact they only had about $1 million in assets, and that several of his funds had monthly returns of 11 percent to 12 percent, when in fact they had negative returns. Investors asked for $50 million of their funds back, far in excess of the actual assets of $1 million. The U.S. District Court for the Middle District of Florida granted the SEC's request to freeze the assets of the funds and to appoint a receiver. The SEC additionally seeks disgorgement and civil monetary penalties.

Mr. Nadel also faces criminal charges for his alleged fraud. Bloomberg reports Mr. Nadel was transferred to New York to face his federal criminal charges, which are further complicated by his 13-day disappearing act.

Investment Adviser to Pay Penalty for Failure to Send Section 19(a) Notices

Gabelli Funds, LLC (Gabelli) is an investment adviser that managed two closed-end funds: Gabelli Utility Trust and Gabelli Convertible and Income Securities Fund, Inc. (collectively with Gabelli Utility Trust, the Funds). During 2002 – 2003, the Funds made at least 31 payments to shareholders that were funded in part from shareholder capital and capital gains. Under Section 19(a) of the Investment Company Act, if any portion of any payment to shareholders arises from a source other than the fund's net income, the Funds must send a notice to shareholders to that effect. Gabelli failed to send Section 19(a) notices to the shareholders with any of the 31 payments that were funded, at least in part, by shareholder capital and capital gains.

The SEC instituted an enforcement action against Gabelli, in its role as investment adviser of the Funds. Gabelli, without admitting or denying responsibility, settled the action for $450,000.

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Contacts

Terry D. Nelson
Madison, Wisconsin
608.258.4215
tnelson@foley.com

Joseph D. Shumow
Madison, Wisconsin
608.258.4329
jshumow@foley.com

Peter D. Fetzer
Milwaukee, Wisconsin
414.297.5596
pfetzer@foley.com

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