K&L GATES

Welcome to K&L Gates Annual Investment Management Conference 2012

27th June 2012

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

K&L GATES

U.S. Hot Topics

27 June 2012

Susan Gault-Brown – Partner, Washington, D.C.
Cary J. Meer – Partner, Washington, D.C.

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

OVERVIEW

- Jumpstart Our Business Startups Act (“JOBS Act”)
- Commodity Futures Trading Commission (“CFTC”) Developments
- Form PF
- Forms CPO-PQR and CTA-PR
- State and Local Government Pay-to-Play Issues
- Change to Definition of “Qualified Client”

JOBS ACT

JOBS Act

The JOBS Act requires:

- The SEC to amend Rule 506 of Regulation D (by 5 July 2012) to eliminate the prohibition on general solicitation and general advertising as a condition of the safe harbor exemption from registration, provided that all purchasers are "accredited investors"
  - Includes use of websites and other media
  - Must take reasonable steps (by methods to be specified by the SEC) to verify purchasers are "accredited investors"
  - Amendment applies to all Federal securities laws and so it appears that private funds relying on exemptions in Sections 3(c)(1) and 3(c)(7) of Investment Company Act of 1940 ("1940 Act") would be covered
    - Not clear with respect to exemptions from registration under CFTC Regulations 4.13(a)(3) and 4.7

JOBS Act (cont'd)

Although general advertising and general solicitation will be permitted for sales made only to accredited investors:

- Investment advisers must still comply with the Investment Advisers Act of 1940 ("Advisers Act") rules regulating advertising
- Broker-dealers that are FINRA members may be required to comply with FINRA/NASD rules concerning communications with the public
  - New FINRA Rules 2210 and 2212-2215 reduce number of categories of communication, which may affect responsibilities of broker-dealers with respect to the approval of communications
- Advisers seeking to market through general solicitation will need to amend offering documents and policies and procedures
- Regulations must be adopted before this change is effective

JOBS Act (cont'd)

- JOBS Act creates opportunity for Section 3(c)(7) funds to admit a larger number of investors
  - Increased threshold for registration under the Securities Exchange Act of 1934 ("Exchange Act") up to 1,999 record holders (excluding holders pursuant to certain employee compensation plans)
    - Generally, previously limited to 500 to avoid becoming public company under Exchange Act
    - Would still be required to register if fund held by 500 or more record holders that are not "accredited investors"
- This change is currently effective

JOBS Act (cont'd)

- Certain persons will not be subject to broker-dealer registration requirements of the Exchange Act with respect to offers and sales in compliance with Rule 506 of Regulation D:
  - A person that maintains a platform that permits the offer, sale, purchase or negotiation of or with respect to securities, or permits general solicitations or similar activities by issuers of such securities, whether online, in person or through any other means
  - A person or associated person that co-invests in such securities or
  - A person or associated person that provides "ancillary services" such as due diligence and creation of standardized documentation

JOBS Act (cont'd)

- The exemption is conditioned upon:
  - The person and each associated person not receiving compensation in connection with the purchase or sale of the security
  - The person and each associated person not holding investor funds or securities in connection with the purchase or sale of the security and
  - Such person and each associated persons not being subject to "bad boy" provisions of the Exchange Act
- This provision appears to allow third parties to provide various services in Rule 506 offerings through websites and other means and not be required to register as broker-dealers
  - May still have Securities Act of 1933 ("Securities Act") compliance issues under Section 5 if sell to any non-accredited investors

CFTC DEVELOPMENTS –
RESCISSION OF
REGULATION 4.13(a)(4)

Rescinded Exemption for Pools with Highly Sophisticated Investors

- On 8 February 2012, the CFTC rescinded Regulation 4.13(a)(4), which contained a broad exemption from most of the requirements of the Commodity Exchange Act ("CEA") applicable to commodity pool operators ("CPOs")
- Regulation 4.13(a)(4) generally required investors in the commodity pool to meet the "qualified purchaser standard" or be "Non-United States persons"
- Compliance date is 31 December 2012 for existing pools and 24 April 2012 for new pools (may be extended)
  - Additional compliance period may be provided for inclusion of swaps

Rescinded Exemption for Pools with Highly Sophisticated Investors (cont'd)

- Regulation 4.13(a)(4) did not contain any limit on the amount of a pool's trading in commodity interests
- Regulation 4.13(a)(4) required:
  - a filing claiming the exemption to be made with the National Futures Association ("NFA")
  - that fund investors receive disclosure stating that the CPO relies on the exemption
  - that the investors meet a certain level of sophistication

Rescinded Exemption for Pools with Highly Sophisticated Investors: Uncertain Futures

- As a result of the rescission of Regulation 4.13(a)(4), many private fund managers will be forced to either comply with Regulation 4.13(a)(3), register as a CPO (in addition to being registered with the SEC), or exit the commodity interest markets
- We are going to discuss:
  - What is a CPO and a commodity trading advisor ("CTA")?
  - Available exemptions
  - Registration
  - Reliance on CFTC Regulation 4.7

CFTC DEVELOPMENTS –
DEFINITIONS OF CPO AND CTA

Commodity Pool Definition

- Commodity Pool: the statutory term for a fund or other pooled vehicle that invests in futures contracts (including security futures), options on futures contracts, leverage contracts, retail forex and/or other retail commodity transactions (collectively "commodity interests")
- Even indirectly through another pool – *e.g.*, a fund-of-funds
- When the CFTC and SEC finalize regulations further defining the terms "swap" and "security-based swap," investing in swaps will also make a pooled investment vehicle a commodity pool
  - Swaps involve an agreement, contract or transaction based upon an exchange of payments tied to a notional amount of an asset, index or rate

Commodity Pool Definition (cont'd)

- Swaps also include options on physical commodities, so-called "event" contracts, and "mixed" swaps
- Security-based swaps, generally swaps on a single security or a narrow-based index, are not swaps and not included – contrast with security futures
  - Special rule for self-developed broad-based security index where component securities may be changed
- For currency-related instruments, if there is an exchange of currencies, the instrument will likely be exempt from swap definition
  - However, if settlement is in a single currency like dollars, such as in the case of "non-deliverable forwards," the instrument will likely be classified as a swap

CPO vs. CTA

- The CEA regulates the operator of a commodity pool (the CPO), as opposed to the pool itself
- Each commodity pool has at least one CPO and one CTA, although this may be the same entity
- Each commodity pool may also have multiple CPOs and/or CTAs

Definition of CPO

- CPO is someone who operates a commodity pool and who solicits investors to invest in that pool
  - often the managing member or general partner
    - an SPV that acts as general partner may delegate management functions to a registered CPO and be relieved of CPO registration under certain conditions
  - in a corporate structure (like a Cayman Islands exempted company), most likely the directors unless delegation of management functions is made to the investment manager
- Title VII of Dodd-Frank amended the definition of CPO to, among other things, include swaps
- The CFTC, through a series of orders, has delayed the effective date of the Dodd-Frank changes to the definition of CPO
- Currently, the effective date will be the earlier of 16 July 2012 or the effective date of the regulations adopted by the CFTC and the SEC further defining the term “swap” (likely to be further postponed)

Definition of CTA

- CTA is someone who provides trading advice with respect to commodity interests
  - in a fund that has no separate investment adviser, the general partner/managing member is both CPO and CTA
  - in a corporate structure, the directors are usually the CPOs unless delegation is made to the adviser, and the adviser is the CTA
  - in a separate account, the investment adviser is the CTA; there is no CPO

CFTC DEVELOPMENTS – CPO EXEMPTION IN REGULATION 4.13(a)(3)

Regulation 4.13(a)(3) Conditions

- Pool interests exempt from Securities Act registration
- No marketing to the public in the United States or as a vehicle for trading commodity interests
- Investors must be “accredited investors,” family trusts, “knowledgeable employees,” QEPs, certain persons associated with the CPO and “Non-United States persons”

Regulation 4.13(a)(3) Conditions (cont'd)

- Regulation 4.13(a)(3) requires that the pool trade only a *de minimis* amount of commodity interest positions, whether entered into for *bona fide* hedging purposes or otherwise, specifically:
  - the aggregate initial margin, premiums, and required minimum security deposit for retail forex transactions required to establish such positions cannot be more than 5% of the liquidation value of the pool's portfolio after taking into account unrealized profits and losses; or
  - the aggregate net notional value of such positions cannot exceed 100% of the liquidation value of the pool's portfolio after taking into account unrealized profits and losses
  - under the net notional test, can net futures contracts on the same underlying commodity across markets and can net swaps cleared on the same derivatives clearing organization

CFTC DEVELOPMENTS – CTA EXEMPTIONS

CTA Exemptions

- Under CFTC Regulation 4.14(a)(8), certain persons may be exempt from registration as CTAs and from complying with the CFTC's CTA disclosure and recordkeeping requirements
- Such persons include persons who are:
  - registered as investment advisers under the Advisers Act
  - excluded from the definition of "investment adviser" pursuant to Sections 202(a)(2) (certain banks and trust companies) or 202(a)(11) of the Advisers Act
  - U.S. state-registered investment advisers or
  - investment advisers that are exempt from federal and state registration

CTA Exemptions (cont'd)

- However, to qualify for this exemption, the investment adviser must comply with the following requirements:
  - advice must be furnished only to certain entities excluded from the commodity pool definition
    - "qualifying entities" and entities excluded from the commodity pool definition under Regulation 4.5 (*i.e.,* non-contributory, governmental and church plans),
    - pools that are organized and operated outside of the United States and have mostly Non-United States person investors, and
    - Regulation 4.13(a)(3) pools (no longer Regulation 4.13(a)(4) pools)
  - advice must be "solely incidental" to investment adviser's business
  - the investment adviser must not otherwise hold itself out as a CTA
  - Regulation 4.14(a)(8) also contains certain notice filing requirements and requires the retention of certain records, and persons who rely upon the exemption are subject to special calls by CFTC staff

CTA Exemptions (cont'd)

- Under CEA Section 4m(3), persons who are registered as investment advisers under the Advisers Act whose business does not consist primarily of acting as CTAs, and who do not act as CTAs to any investment trust, syndicate, or similar form of enterprise that is engaged primarily in trading in any commodity interest, are exempt from registration as CTAs
- This exemption, if applicable, also exempts the CTA from the CFTC's disclosure, reporting and recordkeeping requirements
- Broader range of commodity interests are covered
- If a CTA holds itself out to the public as being primarily engaged in advising on commodity interests or investing, reinvesting, owning, holding or trading them, it cannot rely on this exemption

CTA Exemptions (cont'd)

- Section 4m(1) of the CEA exempts from registration a CTA who provides commodity interest trading advice to 15 or fewer persons within the preceding 12 months and who does not hold itself out to the public as a CTA
  - CFTC adopted Regulation 4.14(a)(10) in 2003 to provide that any entity advised by a CTA that receives commodity interest trading advice based on the entity's investment objectives, rather than on the individual investment objectives of its investors, would count as only one "person" for purposes of determining eligibility for the exclusion from registration under Section 4m(1) of the CEA
- This exemption, if applicable, also exempts the CTA from the CFTC's CTA disclosure, reporting and recordkeeping requirements
- However, if a CTA holds itself out to the public as a CTA, this exemption does not apply, regardless of how many persons the CTA advises
- Can combine Regulation 4.14(a)(8) with either CEA Sections 4m(1) or 4m(3) – Interpretive Letter 05-13

CFTC DEVELOPMENTS –
REGULATION 4.7

Exemption for Persons Who Operate Pools Composed Solely of "QEPs"

- Regulation 4.7(b) provides an exemption from almost all the disclosure, reporting, and recordkeeping requirements otherwise applicable to registered CPOs
- However, this exemption is available only to a registered CPO, and only with respect to a pool composed solely of persons that the CPO "reasonably believes" are QEPs
- Furthermore, the pool must be sold in an offering exempt from the registration requirements of the Securities Act pursuant to Section 4(2) (for example, under Rule 506 of Regulation D) or Regulation S, or by a bank registered as a CPO with respect to a collective trust fund exempt from registration under Section 3(a)(2) of the Securities Act
- These pools may not be marketed to the public

Exemption for Persons Who Operate Pools Composed Solely of "QEPs" (cont'd)

- The definition of QEP is contained in Regulation 4.7(a)(2) and (a)(3)
  - Regulation 4.7(a)(2) identifies persons who do not need to meet the "Portfolio Requirement" to be QEPs (certain institutional investors)
  - Regulation 4.7(a)(3) identifies persons who must meet the "Portfolio Requirement"
- Because "qualified purchasers," "knowledgeable employees" and "Non-United States persons" are defined as QEPs without having to meet the "Portfolio Requirement," the eligibility requirements for Section 3(c)(7) of the 1940 Act and CFTC Regulation 4.7(b) funds are almost the same
- For other investors, generally must be accredited investors <u>and</u> have at least $2 million in securities of unaffiliated issuers

Exemption for Persons Who Operate Pools Composed Solely of "QEPs" (cont'd)

- CPOs who operate under this exemption have:
  - No specific disclosure document requirements other than a legend and the requirement that the PPM include all disclosures necessary to make the information contained therein, in context, not misleading
  - Limited periodic reporting requirements
  - Limited recordkeeping requirements
  - Notice filing requirements

Exemption for Persons Who Provide Advice to QEPs

- Regulation 4.7(c) provides an exemption from almost all the disclosure and recordkeeping requirements otherwise applicable to registered CTAs
- However, this exemption is available only to registered CTAs and only with respect to commodity interest trading advice provided to persons that the CTA "reasonably believes" are QEPs as defined in CFTC Regulation 4.7(a)(2-3)
- This exemption has its own limited disclosure requirements, recordkeeping requirements and notice filing requirements

CFTC DEVELOPMENTS –
REGISTRATION

Registration as CPO and/or CTA

- The CPO/CTA and its associated persons ("APs") must register as such under the CEA
- The CPO/CTA must also become a member of the NFA and its APs must become associate members of NFA
- NFA handles registration processing on behalf of the CFTC
- Applicants for registration as a CPO/CTA and membership in NFA must file Form 7-R and must submit a Form 8-R for each AP and natural person principal

APs & Principals: Definitions and Responsibilities

- If an entity is registered as a CPO or CTA, its "principals" and "associated persons" must be identified
- Who is a "principal"?
  - anyone with controlling influence, such as directors and officers
  - anyone with certain titles (regardless of ownership or controlling influence), including Director, President, CEO, COO, CCO, CFO for corporations, LLCs and LPs, general partner for LPs and manager and managing member for LLCs and LLPs
  - any natural person who owns 10% or more of the voting securities or contributed 10% or more of the capital
  - any entity that owns 10% of shares or contributed 10% or more of the capital
  - any person in charge of a principal business unit, division or function subject to CFTC regulation
- Consequences of being a "principal"?
  - unlike "AP" status, being listed as a "principal" does not entail any test-taking requirement but does require that each natural person "principal" file a Form 8-R with a fingerprint card for purposes of fitness screening

APs & Principals: Definitions and Responsibilities (cont'd)

- Who is an "AP"?
  - Natural person involved in soliciting funds, securities or property for participation in a commodity pool or opening a discretionary commodity interest trading account
  - As well as supervisors of such persons, even if those supervisors do not personally solicit
  - Does not have to be employed solely by the CPO/CTA; may have multiple sponsors
    - Each sponsor must accept joint and several liability
  - Someone may be both a principal and an AP

APs & Principals: Definitions and Responsibilities (cont'd)

Consequences of being an "AP"?

- Registration on Form 8-R
- Fingerprint card
- Ethics training required by CFTC rules
- Oversight requirements
- Series 3 exam
- Exam waivers are available in limited circumstances
- Easier test (Series 32) for persons registered with the FSA

CPO/CTA Compliance Obligations

Disclosure Document

- For the most part, requires similar information to what would be included in a PPM
- Past performance disclosure rules
  - if pool has less than a 3-year operating history, performance information must be supplied for other persons and entities (in addition to performance information for the offered pool), including the performance of other pools and managed accounts operated or traded by the CPO/CTA and the trading manager of the offered pool
  - CFTC past performance disclosure rules may be in conflict with the SEC's rules
  - must be distributed to each prospective pool participant/client
  - must be filed with the NFA, pre-cleared by the NFA and updated every 9 months

CPO/CTA Compliance Obligations (cont'd)

Reporting to Both NFA and Investors

- CPOs must furnish to each pool participant certain prescribed reports

Recordkeeping

- A CPO or CTA must keep, at its main business office, accurate books and records regarding each pool/client account it operates/advises
- Records are subject to inspection by the CFTC, the NFA, and the U.S. Department of Justice

K&L GATES

NFA By-Law 1101

"Self-policing" mechanism that requires that registered CPOs and CTAs only transact business with persons who are:

- NFA Members (FCMs, introducing brokers ("IBs"), CPOs, CTAs) or
- exempt from registration

Impacts private fund managers primarily in four ways:

- affects their due diligence process with underlying managers
- affects their due diligence process with their own investors/clients
- affects their FCM and IB relationships
- affects their use of solicitors

K&L GATES

Due Diligence on Underlying Managers

- Is the manager trading futures, options on futures, leverage contracts, retail forex and/or (in 2012) swaps? If yes, then:
  - identify the CPO(s) and the CTA(s)
  - determine whether the CPO(s) and CTA(s) are registered or exempt from registration
  - if exempt, on what basis
  - check the NFA website (www.nfa.futures.org) to confirm that appropriate filings have been made
  - check manager’s CFTC/NFA compliance procedures
  - keep back-up
- It is theoretically possible that some underlying managers may also be “major swap participants,” which is a new registration category post-Dodd-Frank (rules are pending adoption)

Other Compliance Obligations

- Self-examination checklist
- Annual questionnaires
- Ethics training
- Quarterly reporting to NFA
- Advertising
- Large trader/swaps reporting
- Bunching
- Customer complaints
- Disaster recovery plan
- Subject to examination by CFTC, NFA and Department of Justice

CFTC DEVELOPMENTS –
TRANSITION AND COMPLIANCE
ISSUES

Transition and Compliance Issues

Waiting for Responses to Frequently Asked Questions, Extension and Harmonization Relief

- Who is the CPO?
- New funds
- Transition period for inclusion of swaps
- Clarification of notional value for swaps
- Netting of instruments
- 120 days for audited financial statements
- Location of books and records

Steps to Take Now

- Determine if funds can comply with either 5% or 100% tests
- Stress test portfolio/market disruptions
- If choose to rely on Regulation 4.13(a)(3), develop appropriate monitoring procedures
- If determine that cannot or do not want to rely on Regulation 4.13(a)(3):
  - Determine who your APs are
  - Either help them get ready to take Series 3 examination or determine whether an examination waiver may be available
- Revise compliance procedures to comply with both CFTC and NFA rules
- Review marketing materials for compliance with NFA rules

FORM PF

General Form PF Requirements

A Form PF must be filed by all advisers that:

- Are registered or required to be registered under the Advisers Act
- Must also file Form PF if are registered or required to register with the SEC and are also registered or required to register as a CPO/CTA
- Advise one or more "private funds" – issuers exempt from registration under Sections 3(c)(1) or 3(c)(7) of the 1940 Act
- Manage at least $150 million "regulatory assets under management" attributable to private funds as of end of most recent fiscal year
- May report commodity pools on Form PF even if not private funds

General Form PF Requirements (cont'd)

"Regulatory Assets Under Management"

- Same as Form ADV
- "Regulatory AUM" = gross of outstanding indebtedness and other accrued but unpaid liabilities

Series/Classes

- Two or more series/classes of interests, each valued based on separate investment portfolios, should each be regarded as a private fund
- Does not apply to side pocket or similar arrangements (*including in vehicles such as SPVs*), which should be aggregated with same series/class portfolio strategy

General Form PF Requirements (cont'd)

Large Private Fund Adviser Thresholds: Reporting requirements are dependent on what type of funds they advise:

- Hedge Funds = at least $1.5 billion in aggregate Regulatory AUM attributable to private hedge funds as of the end of any month in the prior fiscal quarter
- Liquidity Funds = at least $1 billion in aggregate Regulatory AUM attributable to liquidity funds and registered money market funds as of the end of any month in the prior fiscal quarter
- Private Equity Funds = at least $2 billion in aggregate Regulatory AUM attributable to private equity funds as of the end of any month in the prior fiscal quarter
- Aggregate parallel funds, dependent parallel managed accounts and master-feeder funds for all reporting thresholds
- Can exclude Regulatory AUM of related persons that are operated independently

Reporting Categories

Hedge Fund = any private fund having any one of three common characteristics of a hedge fund:

- A performance fee/allocation that takes into account unrealized gains
- The ability to engage in “high leverage” **or**
- The ability to engage in short selling (except for short selling that hedges currency exposure or manages duration)
- May also report commodity pools that are not private funds – should be treated as hedge funds, but not included when determining reporting thresholds

Exclusions = vehicles established for the purpose of issuing asset-backed securities

Reporting Categories (cont'd)

"High Leverage" = borrowing by a fund

- In excess of half of NAV (including committed capital) OR
- Gross notional exposure in excess of twice the fund's NAV (including committed capital)

Note: A private fund is not a hedge fund solely because organizational documents fail to prohibit borrowing or incurring derivative exposures in excess of the specified amounts or from engaging in short selling, as long as: (1) fund does not engage in these practices; and (2) reasonable investor would understand from fund offering documents that the fund will not engage in these practices. However, if the fund documents allow such practices, the private fund would still be a hedge fund; the SEC is concerned with potential use, not actual or contemplated use

Reporting Categories (cont'd)

- Liquidity Fund = any private fund that seeks to generate income by investing in short-term obligations in order to maintain a stable NAV per unit or minimize principal volatility for investors
- Private Equity Fund = any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course

Reporting Categories (cont'd)

- Hedge Fund AUM = the portion of the adviser's Regulatory AUM that is attributable to hedge funds it advises
- Liquidity Fund AUM = the portion of the adviser's Regulatory AUM that is attributable to liquidity funds it advises (including liquidity funds that are also hedge funds)
- Private Equity Fund AUM = the portion of the adviser's Regulatory AUM that is attributable to private equity funds it advises

Specific Issues - Reporting

General Guidance: If an adviser filed Form ADV Section 7.B.1 with respect to a private fund and is required to file Form PF, **that adviser must include the assets in that fund for reporting threshold purposes**

- Related Persons (Form ADV, Schedule D, Section 7.A) can all report on one Form PF
- Affiliated Sub-Advisers
  - Advisers filing separate ADVs
  - Filing/relying advisers - filing adviser should include the relying adviser's assets
- Unaffiliated Sub-Advisers

Specific Issues - Reporting (cont'd)

Note to General Guidance: Where two advisers who are "related persons" manage a fund (*e.g.*, a sub-advised fund) and one adviser reports on fund, other adviser does not have to report on fund, but still needs to include that fund's assets in its reporting threshold calculation and, if met, it must still file Form PF

Exception to General Guidance: If an adviser that filed Form ADV Section 7.B.1 with respect to a private fund is NOT required to file Form PF and one or more other advisers to that fund are required to file Form PF, other adviser(s) must include the assets of that private fund for reporting threshold purposes

Specific Issues - Reporting (cont'd)

Investments in Other Private Funds

- Generally: disregard a private fund's investments in other private funds
- Must do so consistently (e.g., do not include disregarded investments in net asset value used for determining whether the fund is a "hedge fund")
- However, do not exclude liabilities of the private fund, even if incurred in connection with an investment in other private funds, for threshold calculation and for fund reporting purposes

Specific Issues – Reporting – Funds-of-Funds

Funds-of-Funds Advisers: (Complete Section 1b only for each private fund that meets the following requirements):

- Adviser to a private fund that invests substantially all of its assets in equity of private funds that adviser does not advise AND
- Aside from private fund investments, holds only cash and cash equivalents and instruments acquired for hedging currency exposure
- For all other purposes – disregard the fund (other than question 10)
  - E.g.: do not include assets or liabilities in aggregate info
  - E.g.: do not include as a qualifying hedge fund

General Form PF Requirements - Form PF Overview

Section 1:

- Section 1a - information regarding adviser’s identity and status as a large hedge fund or liquidity fund adviser
- Section 1b information about each private fund
  - Regulatory AUM and net assets aggregated by types of private funds
  - Certain information for each reporting fund (including a break-down of Level 1, 2 and 3 assets and types of investors)
  - Performance for each reporting fund, gross and net
- Section 1c information about the adviser’s hedge funds
  - Description of strategy
  - Percentage of funds’ assets managed using high-frequency trading strategies
  - Significant counterparty exposures (including identity of counterparties)
  - Trading and clearing practices
  - Funds’ activities outside securities and derivatives markets

General Form PF Requirements - Form PF Overview (cont'd)

Section 2 (only for large private fund advisers):

- Section 2a - aggregate information about each hedge fund
  - Value of assets invested in different types of securities and commodities
  - Duration
  - Weighted average tenure or 10-year bond equivalent of fixed income holdings
  - Value of turnover in certain asset classes
  - Geographical breakdown of investments

General Form PF Requirements - Form PF Overview (cont'd)

Section 2: (Continued)

- Section 2b - additional information on large hedge funds (NAV of at least $500 million as of the last day of any month in the fiscal quarter prior to the most recently completed quarter; aggregate feeder funds, parallel funds and dependent parallel managed accounts)
  - Same information as Section 2a, but on a per fund basis and
  - Liquidity
  - Holdings of unencumbered cash
  - Concentration of positions
  - Fund's base currency
  - Collateral practices with counterparties
  - Risk metrics
  - Financing information
  - Investor information

General Form PF Requirements - Form PF Overview (cont'd)

Section 3 (only for large private fund advisers): Information about each large liquidity fund (required only by SEC; not CFTC)

- Method of computation of NAV and NAV as of month ends
- WAM/WAL – weighted average liquidity fund portfolio maturity with/without Rule 2a-7(d) exceptions (applicable to money market funds)
- Liquidity – daily, weekly, greater than 397 days
- Product exposures and portfolio concentrations
- Financing information
- Investor concentration and liquidity

General Form PF Requirements - Form PF Overview (cont'd)

Section 4 (only for large private fund advisers): Information about each large private equity fund

- Financing and investments
- Information on controlled portfolio companies
- Geographical breakdown of investments
- Information on principal co-investment in portfolio companies

Initial Filing Deadlines

Based on Data as of 30 June 2012

- If as of last day of fiscal quarter most recently completed prior to 15 June 2012, adviser had:
  - at least $5 billion in combined assets under management attributable to liquidity funds and registered money market funds, file within 15 days of deadline (by 15 July 2012)
  - at least $5 billion in assets under management attributable to hedge funds, file within 60 days of deadline (by 29 August 2012)
  - at least $5 billion in assets under management attributable to private equity funds, file within 120 days of deadline (by 28 October 2012 if fiscal year end is 30 June 2012; by 30 April 2013 if fiscal year end is 31 December 2012)

Based on Data as of 31 December 2012

All other advisers, including large private fund advisers under $5 billion AUM – file within 15, 60 and 120 days of filing deadline, as applicable

Subsequent Filing Deadlines

- Large private equity advisers must file within 120 days of end of adviser's fiscal year
- Large hedge fund advisers must file quarterly within 60 days of end of adviser's fiscal quarter
- Large liquidity fund advisers must file quarterly within 15 days of end of adviser's fiscal quarter
- With respect to annual filing for large hedge fund and liquidity fund advisers, must meet relevant quarterly deadline based on type of fund reported
- Others: within 120 days of adviser's fiscal year end

Confidentiality

- SEC does not intend to make public any Form PF information identifiable to any particular adviser or private fund
- SEC and CFTC precluded from being compelled to reveal any information except in limited circumstances
- Not subject to the Freedom of Information Act
- Information may be shared with other federal departments or agencies or self-regulatory organizations
- Any information may be used in an enforcement action against adviser

FORMS CPO-PQR AND CTA-PR

Forms CPO-PQR and CTA-PR

CFTC adopted Regulation 4.27(d) that, jointly with the SEC, establishes new reporting requirements with respect to private funds:

- Requires CPOs and CTAs to report certain information to the CFTC on Forms CPO-PQR and CTA-PR, respectively
- CPOs dually registered with the SEC and CFTC that file Sections 1 and 2 of Form PF, as applicable, must generally file Schedule A of Form CPO-PQR only
- Non-dually registered CPOs must file all relevant sections of Form CPO-PQR based on certain reporting thresholds
- All CTAs, regardless of SEC registration, will complete Form CTA-PR
- Both forms must be filed via NFA's EasyFile System

CPO-PQR Schedules, Thresholds, and Deadlines

Assets Under Management	Schedule A	Schedule B	Schedule C
Dually registered (at least $1.5 billion AUM)	Quarterly – 60 days (also filing Form PF)		
Dually registered (less than $1.5 billion AUM)	Annually – 90 days (also filing Form PF)		
Large CPO (at least $1.5 billion AUM)	Quarterly – 60 days (not filing Form PF)	Quarterly – 60 days (for each pool)	Quarterly – 60 days (for each “Large Pool”)
Mid-Sized CPO (at least $150 million AUM)	Annually – 90 days (not filing Form PF)	Annually – 90 days (for each pool)	
Small CPO (less than $150 million AUM)	Annually – 90 days (not filing Form PF)		

CPO-PQR Schedules, Thresholds, and Deadlines (cont'd)

- Filing requirements differ based on the aggregated gross pool assets under management ("Gross AUM") of a CPO – this differs from the SEC's "regulatory assets under management" for Form PF
- Even if a dually registered CPO files Form PF with the SEC, it may still need to file Schedules B and/or C if it has pools that were not captured on Form PF

CPO-PQR and Funds-of-Funds

The treatment of investments in other funds is consistent with the instructions adopted for Form PF

- CPO may generally exclude any pool assets invested in other unaffiliated pools but must do so consistently for purposes of both thresholds and answering questions
  - However, CPO must include assets invested in other unaffiliated pools in response to Schedule A, Question 10 (changes in AUM)
  - Further, CPO may report performance of the entire pool, and need not recalculate performance to exclude investments in other pools, in response to Schedule A, Question 11 (monthly rates of return)
- CPO that operates a pool that invests substantially all of its assets in other pools for which it is not the CPO, and otherwise holds only cash and cash equivalents and instruments acquired to hedge currency exposure, must complete only Schedule A for that pool

Form CTA-PR

- Only Schedule A of Form CTA-PR was adopted
- Schedule A requires all CTAs to provide basic information about the CTA's business and the pools for which it provides advice
- Form CTA-PR needs to be filed on an annual basis within 45 days after the end of the CTA's fiscal year
- Initial filing due on 14 February 2013 for most CTAs

STATE AND LOCAL GOVERNMENT
PAY-TO-PLAY ISSUES

SEC Pay-To-Play Rule

- On 1 July 2010, the SEC unanimously adopted Rule 206(4)-5
- The Rule became effective 13 September 2010, with compliance dates of 14 March 2011 and, in the case of the rules addressing third-party solicitors, 9 months after the compliance date for registration of municipal advisors
- The purpose of the Rule is to prevent registered investment advisers from obtaining governmental business by making, directly or indirectly, campaign contributions to elected federal, state, and local government officials

SEC Pay-To-Play (cont'd)

- Prohibition on accepting compensation from government sources for two years after making campaign contributions
- *De minimis* exception $350/$150
- Prohibition on using certain third-party solicitors
- Prohibition on "bundling" and soliciting campaign contributions

State Pay-To-Play Variations: In General

- Time Out, Political Contribution Provisions and Gift Restrictions
- Solicitor and Lobbyist Registration
- Practical Considerations

State Pay-To-Play Variations: Time Out and Political Contribution Provisions

- Example #1
  - In New Jersey, there is a two-year look-back for contributions to any candidate for governor or for a seat in the legislature, certain local officials and political parties that applies specifically to firms that provide investment management services to a New Jersey pension fund or annuity fund (however, there is an exception for contributions under $250 to a political party or a candidate for whom the contributor is entitled to vote)
- Example #2
  - Connecticut looks back to the beginning of the previous election cycle – a look back to January 2007 – with no *de minimis* exemption with respect to contributions to candidates for State Treasurer

State Pay-To-Play Variations – Who is Restricted From Contributing?

- Some state restrictions are more expansive than the SEC Pay-to-Play Rule and may apply to:
  - All employees
  - Affiliates
  - Third-party solicitors and marketers (not just covered employees and the adviser itself)

Types of Political Contributions and Gifts Restricted

- Many state statutes/rules are more restrictive than the SEC Rule:
  - Gifts
    - Trustees, investment officers and employees in a position of investment discretion over a state retirement system are often prohibited from soliciting or accepting *anything of value*, including reimbursement of expenses
    - In many states, violation of gift statutes is a crime for both the recipient <u>and</u> donor
    - Many states have *de minimis* (*i.e.*, less than $50; in some cases, less than $10) exceptions to gift prohibitions; some states have no *de minimis* exception
  - Contributions made for <u>any</u> purpose (not only for the purpose of influencing)

State Pay-To-Play - What Individuals in Government Entities are Restricted?

- New Jersey regulates contributions to any candidate for governor or for a seat in the legislature, certain local officials and political parties in New Jersey
- Connecticut restricts contributions to any exploratory, candidate or political committee established by, or supporting or authorized to support certain candidates for state office or a party committee (includes a state central committee as well as town committees)
- Maryland requires disclosure of contributions to any state employee, official and any campaign finance committee that promotes the success or defeat of a candidate, political party or **public question**

State and Municipal Solicitor and Placement Agent Restrictions

- Certain states prohibit paying any contingency fee in connection with investments by a public investment fund with an investment manager or in the manager's funds
- Prohibitions usually apply to payments of contingency fees to third-party placement agents and may also apply to contingency fees paid to employees
- Non-contingent performance bonuses to employees may be permitted, depending on the circumstances
- Violation of contingency fee prohibition could be a felony in certain states

State and Municipal Solicitor and Placement Agent Restrictions (cont'd)

- NYC Pay-to-Play law prohibits "private equity fund managers" from <u>using</u> (whether or not fees are paid) placement agents in connection with securing a commitment by a covered pension fund
- For all non-private equity fund investments in NYC, investment managers must disclose any placement agent fees paid in connection with securing commitments in such funds
- NYS's governor has recently announced a permanent ban on the use of all placement agents, including in connection with investments by its largest retirement system

State Lobbyist Registration Considerations

- Many states have adopted lobbying laws that require individuals and entities who work for third-party placement agents as well as certain employees of hedge fund managers, hedge funds, investment advisers and other investment managers to register with those states as lobbyists
- In these states, sales staff of third parties, as well as in-house sales and marketing personnel, are the most likely to be required to register
- Texas, Ohio and California are among the states requiring lobbyist registration for investment management professionals, in certain circumstances

State Lobbyist Registration Considerations (cont'd)

- **Examples of Activities Triggering Lobbyist Registration:**
  - Texas
    - Receiving compensation or making expenditures **over a certain threshold** in connection with direct communications with certain government officials to influence legislation or government action, including investment decisions
    - "Communication" with government officials can be merely for purposes of maintaining goodwill with government officials and does not have to be in the context of specific legislation or administrative action

State Lobbyist Registration Considerations (cont'd)

- Ohio
  - "Lobbyist," in connection with a state retirement system, is defined as a person or entity whose main purpose on a "regular and substantial basis" is to influence the system's decisions by direct communications with board members, investment officials or any employee whose position involves substantial and material exercise of investment discretion
- California
  - Any placement agent (finders, solicitors, marketers, consultants, brokers or other intermediaries), including internal sales or marketing personnel that influence state pension plan investments, must register as a lobbyist, with limited exceptions

State Lobbyist Registration Considerations (cont'd)

- Consequences of Registering as a Lobbyist
  - Ongoing reporting requirements for individual lobbyists and their employers
  - Ethics training
  - Prohibition on contingency fees (i.e., based on an award of an advisory contract or investment in a fund) in some states
  - Filing of written placement agent/lobbyist agreement (or summary of such an agreement if oral)
  - Payment of registration fees
  - Reporting of information such as compensation, lobbying expenditures, gifts and entertainment to public officials and/or political contributions

State Lobbyist Registration Considerations (cont'd)

- Consequences of Not Registering as a Lobbyist
  - Failure to comply with a state or municipal lobbying statute can result in a fine and, in some cases, rises to a misdemeanor
  - Potential "Bad Boy" Status
    - Pursuant to the Dodd-Frank Act, the SEC has proposed rules under Regulation D of the Securities Act that would disqualify certain bad actors from relying on the Rule 506 safe harbor exemption from Securities Act registration
    - A criminal conviction for failure to comply with state or local lobbying laws could be considered a "disqualifying event" for purposes of the SEC's proposed rules, resulting in treatment as a "bad boy" for purposes of the Regulation D Rule 506 exemption

Pay-to-Play – Practical Considerations

- Advisers should take affirmative steps to monitor and achieve compliance with the SEC Pay-to-Play Rule and the various state requirements concerning lobbyist registration, placement agent use, political contributions and gifts
- Review and update recordkeeping policies to comply with new requirements

Practical Considerations (cont'd)

- Prior to hiring new employees, require disclosure of all political contributions and gifts and entertainment provided to state and local government officials
- Update policies and procedures to require pre-clearance of all political contributions and gifts and entertainment
- Identify the permissible political contribution and gift and entertainment thresholds applicable to the adviser's business
  - Determine whether adviser's business is subject to more restrictive rules than the SEC Pay-to-Play Rule

Practical Considerations (cont'd)

- Do not approve any political contributions exceeding applicable thresholds
- Do not approve any gifts or entertainment above a *de minimis* amount
  - Depending on adviser's clientele, this might be $0
- Confirm that all placement agents engaged by the adviser for public funds business are registered (either as an investment adviser or broker-dealer)

Practical Considerations (cont'd)

- Before accepting an engagement with any government entity, determine what laws, policies and disclosures apply to such an engagement, and whether current pre-clearance requests for political contributions would preclude such investment
- Before marketing to a state or local plan, determine whether registration as a lobbyist and/or lobbyist employer is required
- Prior to engaging a placement agent to contact a particular state or local plan on your behalf, confirm that the use of placement agents or payment of fees to placement agents is not prohibited by law or by a plan's own policies

CHANGE TO DEFINITION OF “QUALIFIED CLIENT"

Change in Definition of "Qualified Client"

- A registered adviser is only able to accept performance-based compensation (such as a performance fee or incentive allocation) from "qualified clients"
  - Dodd-Frank increased dollar thresholds for determining qualified client status effective 22 May 2012
    - A natural person who or a company that immediately after making an investment has at least:
      - **Prior Definition: $750,000** under the management of the investment adviser
      - **New Definition: $1,000,000** under the management of the investment adviser

Change in Definition of Qualified Client (cont'd)

- A natural person who or a company that the investment adviser reasonably believes, immediately prior to selling shares to the person or company, either:
  - Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than:
    - **Prior Definition: $1.5 million** at the time of purchase
    - **New Definition: $2 million** at the time of purchase (excluding primary residence)
- Qualified client also includes:
  - a "qualified purchaser" under the 1940 Act
  - certain employees, officers and directors of the adviser

Definition of Qualified Client (cont'd)

- On or about 1 May 2016 and every five years thereafter, the SEC must adjust the numbers to take inflation into account
- Will base calculations on Personal Consumption Expenditures Chain-Type Price Index (or PCE Index) published by the Department of Commerce

Definition of Qualified Client (cont'd)

- Net Worth Threshold
  - Excludes the value of a person's primary residence
    - Second homes and investment properties may still be included
  - Includes amount of mortgage in excess of home's value only for purpose of <u>reducing</u> net worth
  - Includes any increase in the amount of secured debt within 60 days before entering into the advisory contract
    - Regardless of whether the home's value exceeds the mortgage amount

Definition of Qualified Client – Transition Provisions (cont'd)

- Advisers may maintain existing performance fee arrangements for:
  - Existing clients
  - Clients of previously exempt advisers
  - Transfers of ownership by gift or bequest
  - Transfers of ownership pursuant to a legal separation or divorce

Definition of Qualified Client – Transition Provisions (cont'd)

- Existing clients
  - Must have been qualified clients at the time the advisory contract was entered into or invested in fund, even if not qualified client under new standard
- Clients of previously exempt advisers
  - Apply to advisers who were previously exempt under Section 203 of the Advisers Act
  - Client account must have been established when the adviser was exempt

K&L GATES

Updates on Securities Laws and Developments in the Greater China Area, Hong Kong and Singapore

Tan Choo Lye
K&L Gates
Hong Kong & Singapore
852 2230 3528 / 65 6507 8100
choolye.tan@klgates.com

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

Global legal counsel in more than 40 fully integrated offices on four continents.

United States

Anchorage, Austin, Boston, Charleston, Charlotte, Chicago, Dallas, Fort Worth, Harrisburg, Los Angeles, Miami, Newark, New York, Orange County, Palo Alto, Pittsburgh, Portland, Raleigh, Research Triangle Park, San Diego, San Francisco, Seattle, Spokane, Washington, D.C.

South America

São Paulo

Europe

Berlin, Brussels, Frankfurt, London, Milan, Moscow, Paris, Warsaw

Middle East

Doha, Dubai

Asia

Beijing, Hong Kong, Shanghai, Singapore, Taipei, Tokyo

K&L Gates LLP

K&L GATES

Russia
Asia
Kazakhstan
Mongolia
Kyrgyzstan
Tajikistan
N. Korea
Japan
S. Korea
Afghanistan
China
Nepal
Buhtan
Pakistan
Taiwan
India
Burma
Bangladesh
Laos
Thailand
Vietnam
Philippines
Cambodia
Brunei
Malaysia
Singapore
Papua New Guinea
Indonesia

K&L Gates Asia Office Locations
Beijing
Tokyo
Shanghai
Taipei
Hong Kong
Singapore

2012 Trends

- Increasing restrictions
  - KYC, Anti-money laundering & Counter Terrorist Financing
  - Disclosure obligations
  - New investment fund regulations
  - Enforcement

- Consistency in regulations and meeting accepted market standards
  - G20 OTC reforms
  - High Frequency Trading
  - Passporting
  - Whistle-blowing

2012 Trends

- Resistance to US
  - FATCA
  - US investors

PRC

- QFLP
  - Qualified Foreign Limited Partner
  - Two types of licences
    - “management” enterprise
    - “investment” enterprise
  - Effect of National Development and Reform Commission notice of April 2012 – QFLP’s are NOT domestic funds
- QDLP
  - Qualified Domestic Limited Partner

PRC

- RQFII
  - Renminbi Qualified Foreign Institutional Investor
- Dim Sum Bonds

HONG KONG

- Anti-money laundering and Counter Terrorist Financing Guidelines
  - Effective 1 April 2012
- Know Your Client requirements
  - Professional investors
  - Suitability assessment
- Increased enforcement
  - Insider trading
  - Whistle-blowing

HONG KONG

- Increased disclosure requirements
  - Short reporting requirements

- Changes in taxation/fee structures

SINGAPORE

- New regime for capital markets services licences
  - Licensed non-retail fund management companies
  - Registered Exempt fund management companies

- New regulatory capital requirements for capital markets services licencees

JAPAN

- Increased enforcement and involvement by the Financial Services Agency
- Amendments to the Financial Instruments and Exchange Act

TAIWAN

- Securities and Futures Bureau amendments
  - Greater variety of investments in foreign securities by SITEs
  - Increased capacity to advise in respect of foreign securities by SICEs
  - Increased responsibility for master agents and distributors of offshore funds
- Capital Gains Tax

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- **G20 reform in respect of OTC Derivatives**
  - Hong Kong
    - Joint Consultation Paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong issued by Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) on 17 October 2011
    - Takes into account local market conditions and characteristics

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- To be enacted as law in the Securities and Futures Ordinance (SFO)
  - Oversight of OTC derivative action
  - HKMA will oversee authorized financial institutions (AIs)
  - Securities and Futures Commission will oversee persons other than authorized financial institutions

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- Key terms :-
  - OTC derivatives transactions will have to be reported to a trade repository
  - Standardised OTC derivatives transactions will have to be centrally cleared through a designated central counterparty
  - Initially, OTC derivatives transactions will not be required to be traded on an exchange or electronic trading platform.
  - Introduction of a new Type 11 regulated activity under SFO
  - Right of SFC to request disclosure of information from all other non-regulated parties
- Target effective date – likely to be Q4 2012

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- Singapore
  - Two consultation papers issued by the Monetary Authority of Singapore (MAS) on February 13, 2012
    - Consultation Paper on the "Proposed regulation of OTC derivatives"
    - Consultation paper on the "Transfer of regulatory oversight of commodity derivatives from IE to MAS', aiming to streamline current licensing and compliance requirements, and regulatory oversight of all commodity derivatives.
  - Key terms
    - Central clearing for all MAS-regulated financial institutions and non-FIs resident or having a presence in Singapore above a clearing threshold

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- Exemptions for central banks, governments, supranational organisations, small FI's, intra-group transactions with sufficient collateral
- Will initially cover SGD and USD interest rate swaps and Asian currency non-deliverable forwards
- Trade reporting

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- **High Frequency Trading**
  - Currently no regulations governing such trades in Asia
  - Currently only Japan has significant HFT volume in equities
  - Singapore – SGX Reach
  - Hong Kong - in the process of building a new co-location facility to support growth in HFT
  - Issue for HK and Singapore – Taxes and high stamp duties on share trades

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- **FATCA**
  - Hong Kong, Singapore, Taiwan, India, Malaysia and Australia pushing for exemptions
- **Regulation of financial sector remuneration**
- **Regulation of fund managers**

WHAT IS HAPPENING IN ASIA IN COMPARISON TO EUROPEAN REGULATIONS

- **Passporting – Asia’s version of UCITS**
  - Selective geographical areas in Asia rather than whole-Asia more likely
  - “China” passport
  - “ASEAN” passport

HOW WILL THIS IMPACT YOU?

- Increased compliance costs
- Highly-specialized skilled service providers
- Greater transparency & corporate governance
- Technology
- Accountability to investors
- Investors with leverage

CONSIDERATIONS FOR FUND-RAISERS AND INVESTORS IN ASIA

- Lack of sophistication/churning of funds
- Smaller sizes
  - US$50 to US$100 million
  - Very focused
- Focus on the right market for your product
- US investors
- Tailored Products
- Local contacts
- Costs
- Branding

Tan Choo Lye
Partner
Hong Kong & Singapore

K&L GATES

Breakout sessions

11:50 am – 12:35 pm

Session 1: Ways to attract Islamic compliant investors to funds and products (E4)

Session 2: U.S. registered funds update (Wren room)

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

K&L GATES

Breakout 1:

Ways to Attract Islamic Compliant Investors to Funds and Products

Jonathan Lawrence
27 June 2012

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

The demographics

26.4% of the global population will likely be Muslim by 2030

Currently 23% in 2012

Percentage of Muslims in Europe is around 5%

- Source: Deutsche Bank, Global Islamic Banking, November 2011

Islamic asset management industry

2010: 7.6% increase in assets; 23 new islamic funds; 46 funds liquidated

Large number of relatively small, equity-heavy funds

Focus on banking industry

Islamic fund universe: c. 100 fund managers, managing 765 global islamic mutual funds (versus c. 60,000 conventional funds)

- Source: Ernst & Young Islamic Funds & Investments Report

Islamic fund sizes

Just over half of Islamic funds <$50m under management

Almost 70% <$75m under management

Conventional funds of $22,000bn versus Islamic funds of $52.3bn

- Source: E&Y, Islamic Funds & Investment Report, 2010

Islamic fund composition

54% equities
17% money markets
15% mixed assets
7% real estate
5% seed capital
2% others

- Source: Maybank Islamic, 2009

What is Shariah?

A means of conducting business through a distinct set of rules designed to facilitate fairness

High correlation between Shariah compliant investing and socially responsible investing

Shariah terms

- *Halal* – that which is permitted or compliant
- *Haram* – that which is not permitted
- *Riba* – charging of interest
- *Gharar* – uncertainty/ambiguity
- *Maysir* – gambling; one party receives the other's loss
- *Sukuk* – Shariah compliant debt
- *Ijara* – Shariah compliant lease
- *Takaful* – Shariah compliant form of insurance
- *Mudaraba/Musharaka* – forms of partnership
- *Murabaha* – sale of commodity with the payment being deferred, the mechanism being used as a fixed income substitute

Industry prohibitions

- Gambling
- Pork production or consumption
- Adult Entertainment
- Conventional banking and finance
- Alcohol production or consumption
- Tobacco production or use

Where are Shariah rules codified?

Interpretations of the Qur'an from various Islamic schools of thought

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

The fact remains: Shariah mandates are not always consistently applied from Scholar to Scholar. Information is asymmetric, and Shariah Advisers and lawyers skilled in the area become useful to work through the counter-intuitive results

Islamic finance themes

Connection to underlying assets

Commercial risk taking by all parties (including financier)

Entrepreneurship

Returns linked to actual investment outcomes

Sharing profit and loss

Islamic asset management challenges

Scholars and schools of thought

Lack of standardisation

Transaction costs

Asset ownership by financier involves potential liability e.g. environmental, warranty claims

Insurance / *takaful*

Tax treatment

Ways to Attract Islamic Compliant Investors to Funds and Products

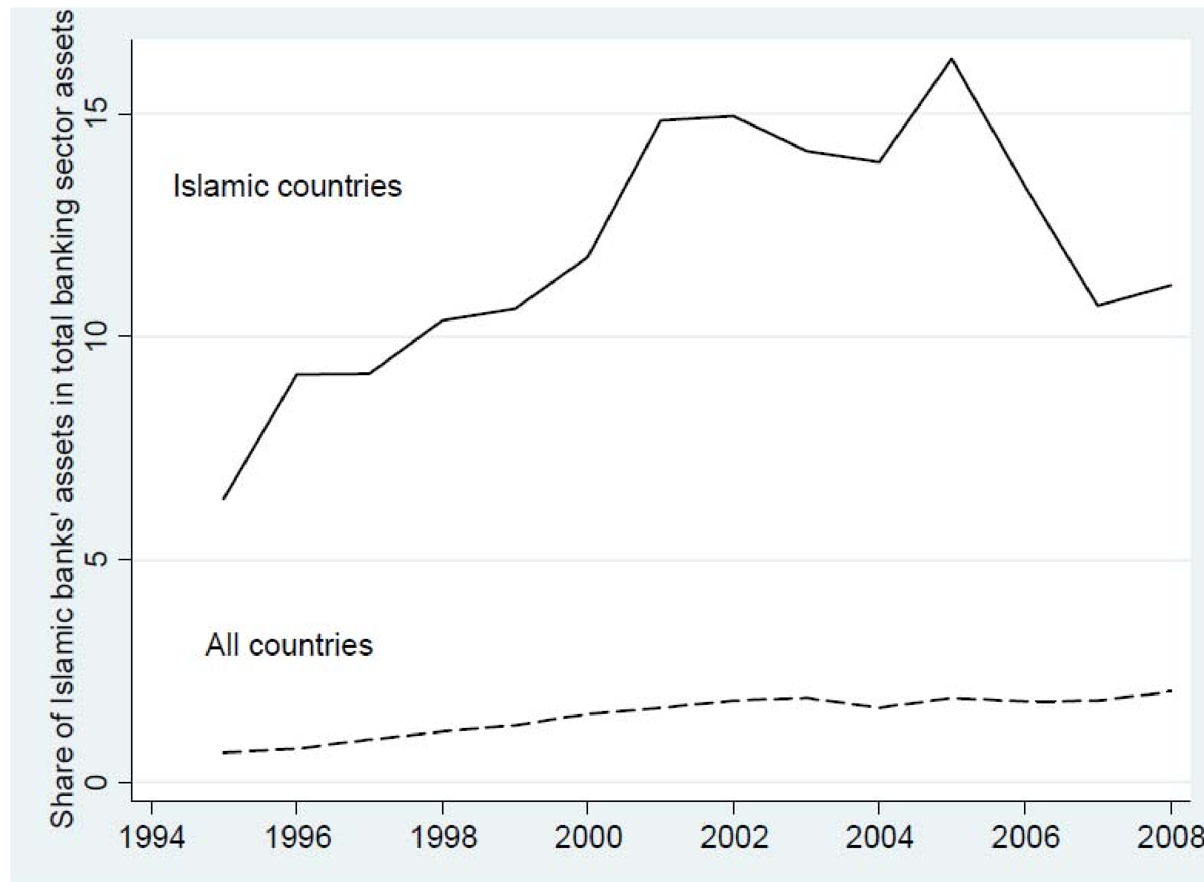
Fares Mourad, Head Islamic Finance
London 27th. June 2012

Numbers speak by themselves

- In 2010 about 23.4% of world's population are Muslims, and expected to reach 26.4% by 2030*
- In numbers, this means an increase from 1.6 billion to 2.2 billion*
- Muslims currently have a 7.7% share of global GDP which is expected to grow to 8.7% by end 2017
- 50% of the Islamic Banking is in the GCC, while GCC Muslims with a population of 38 million are a minority within the Muslim population.

Source: * The Economist, A waging crescent, 27th Jan 2011

Expansion of Islamic Banking 1995 - 2008



Source: World Bank, Policy Research working paper 55446

To attract, you need to know the motives

- Identity and faith
- Economic considerations

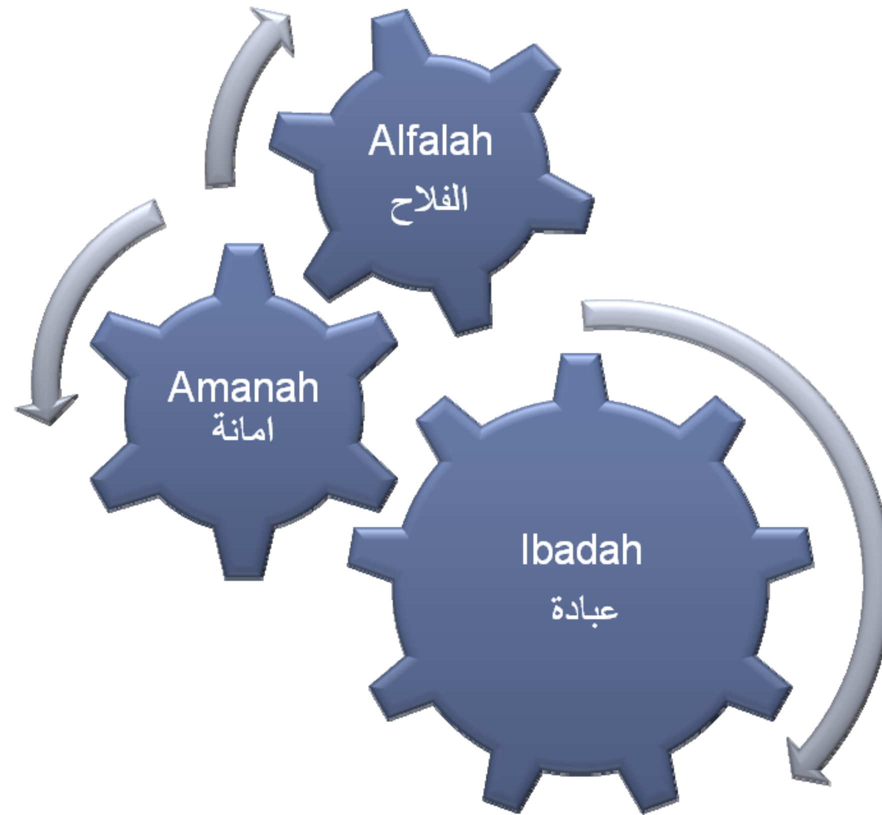
Competition on products

- Unless the product is unique, competing on products, is ultimately a competition on pricing
- it is better to create an added value to the client

Islamic Financial Planning / Estate and Succession Planning

Sustainable Swiss Private Banking since 1841.

Islamic world views on Financial Planning



Practical example I/III

- Abdullah, enquired about his Zakat obligation, the zakat awareness arose on the wake of his decision to perform the hajj. In addition to the recent preparatory hajj course that he has been attending, he found out that he has to pay back past dues (i.e. zakat not paid from his wealth in the past). Further, he believed that zakat is only obligatory during the month of Ramadan, namely zakat el fitr, which he never missed. of course his financial plans have not neglected the hajj requirements and have always been within the ambit of his savings and investment plan. To make this scenario more interesting, Abdullah has just divorced his wife of 25 years and is planning to remarry later in the year. His ex-wife is holding on the company directorship and has successfully claimed her rights to their matrimonial assets via the assistance of an established law firm.

Practical example II/III

- The plot thickens, The wife-to-be is also divorced with three children under her grace. with hindsight, Abdullah wants to plan his estate distribution firstly, to ensure his present children (his own flesh and blood) are provided for sufficiently from his wealth, and secondly to make sure that his present assets are not claimable by his future wife. Matrimonial assets would only be accumulated from the date of marriage onwards. Abdullah plans to transfer specific assets to be given to his wife-to-be via hibah (هبه) or living gift.

- to complicate things even more, Abdullah has only daughters, hence according to the laws of faraid, this is the case of missing independent agnate exposing the balance of the distribution to his living brothers or uncles or nephews.

- Thus a detailed Islamic Estate Plan is required to meet his goals, especially in the light of diverse locations of his assets. We already know that he has properties in UK,USA and Australia and his daughters are currently studying.

Practical example III/III

- Abdullah knows that the distribution of his estate is provided by faraid, however, he is not particularly sure of the rights of his soon-to-be-step children on his assets. Nor does he want to be unfair in providing for the needs of all his dependents, whether they are blood children or by marriage.

- thus he seeks full advice, on the matter including available options. Also planning ahead, he would like to explore the idea of waqf or charity in perpetuity as recommended in Islam.

- Last but not least, issues related to pension, health insurance…etc should be considered as well when planning.

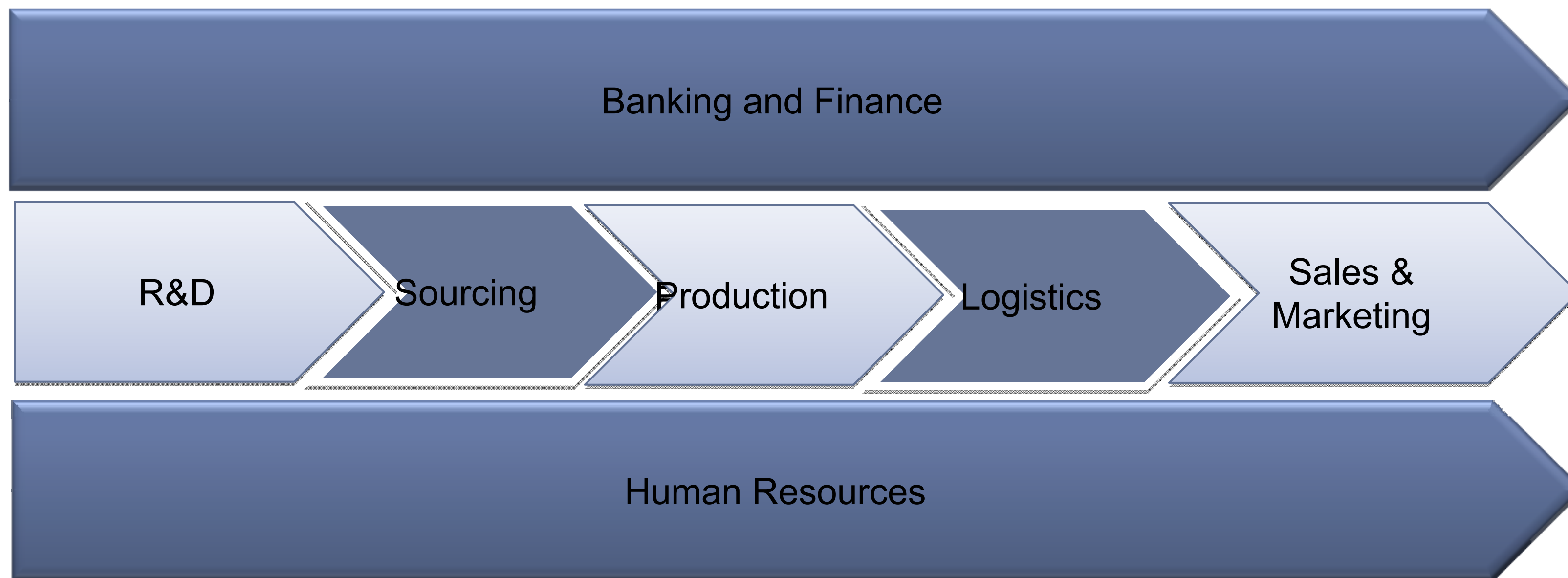
Islamic and Conventional Financial Planning

- Time horizon: the Muslim will live in the hereafter.
- Sharia is the guide in creating strategies to achieve life goals.
- Objective: Achieving Alfalah (الفلاح).

Business conversion

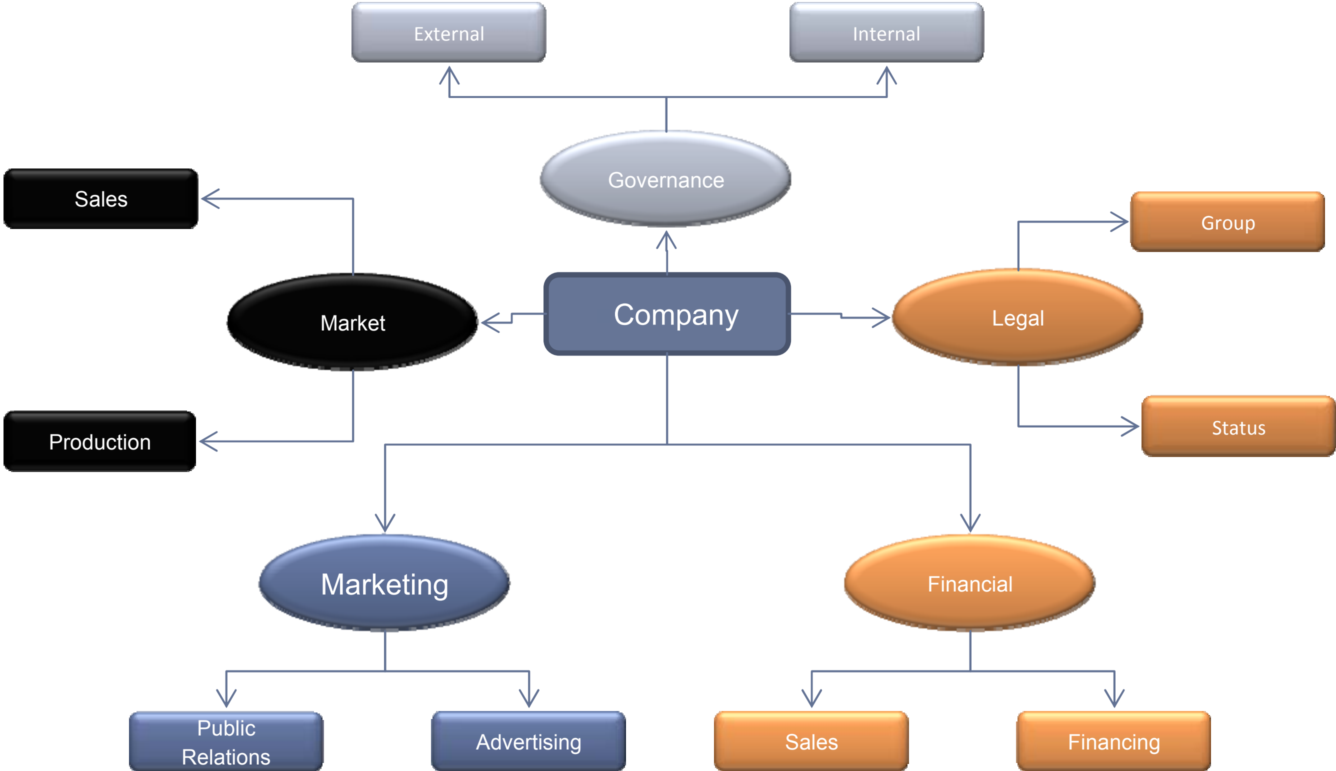
Sustainable Swiss Private Banking since 1841.

Conversion requires a holistic approach



Source: Bank Sarasin, A.T. Keaney

Corporate conversion means that a web of issues need to be considered



Source: Bank Sarasin

Purpose of conversion

If a company wishes to be Islamic, it cannot focus only on the business, but on making business right in the eyes of Allah.

Important notice

This marketing publication has been prepared by Bank Sarasin & Co. Ltd, Switzerland, (hereafter "BSC") for information purposes only. It contains selected information and does not purport to be complete. This document is based on publicly available information and data ("the Information") believed to be correct, accurate and complete. BSC has not verified and is unable to guarantee the accuracy and completeness of the Information contained herein. Possible errors or incompleteness of the Information do not constitute legal grounds (contractual or tacit) for liability, either with regard to direct, indirect or consequential damages. In particular, neither BSC nor its shareholders and employees shall be liable for the opinions, estimations and strategies contained in this document. The opinions expressed in this document, along with the quoted figures, data and forecasts, are subject to change without notice. A positive historical performance or simulation does not constitute any guarantee for a positive performance in the future. Discrepancies may emerge in respect of our own financial research or other publications of the Sarasin Group relating to the same financial instruments or issuers. It is impossible to rule out the possibility that a business connection may exist between a company which is the subject of research and a company within the Sarasin Group, from which a potential conflict of interest could result.

This document does not constitute either a request or offer, solicitation or recommendation to buy or sell investments or other specific financial instruments, products or services. It should not be considered as a substitute for individual advice and risk disclosure by a qualified financial, legal or tax advisor.

This document is intended for persons domiciled in countries where the Sarasin Group has a business presence. BSC does not accept any liability whatsoever for losses arising from the use of the Information (or parts thereof) contained in this document.

© Copyright Bank Sarasin & Co. Ltd. All rights reserved.

Bank Sarasin & Co. Ltd
Elisabethenstrasse 62
P.O.Box
CH -4002 Basel
Switzerland
Tel + 41 (0)61 277 77 77
Fax + 41 (0)61 272 02 05
www.sarasin.ch

K&L GATES

Breakout 2

US Registered Funds and their Investment Managers

Cliff Alexander
June 2012

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

MONEY MARKET FUNDS

- The Issues:
  - Are they *de facto* banks?
  - Are investors confused about "fixed $1.00 NAV?"
  - Do they present financial system risk?
- Potential Solutions:
  - Floating NAV
    - Retail funds
    - Institutional funds
  - Insurance
  - Reserves
- SEC Conundrum:
  - Political issue: How to get a majority of commissioners to agree on a solution
  - Legal Issue: How to satisfy the Administrative Procedures Act requirement of an empirical cost benefit analysis

CFTC RULE 4.5

- Background
  - CFTC Rule 4.5 exempted 1940 Act registered funds and other funds regulated by another regulatory authority
  - Over 30 1940 Act registered funds established offshore commodities fund subsidiaries for tax reasons
  - The CFTC on February 8, 2012 adopted amendments to Reg. 4.5 only as it applied to registered investment companies to require
    - Annual notices with the National Futures Association
    - Prohibition against marketing the fund as a commodities fund
    - Trading restriction

CFTC RULE 4.5 *(continued)*

- Two Alternative Trading Restrictions
  - Non-bona fide hedging positions may not exceed five percent of the “liquidation value” (generally NAV) of the portfolio; OR
  - Aggregate national value of non-bona fide hedging positions may not exceed 100 percent of the liquidation value of a portfolio
- Bona fide hedging generally is defined to include “risk reduction” strategies, but not “risk management”
- The Investment Company Institute and U.S. Chamber of Commerce have challenged the Reg. 4.5 amendments in a lawsuit, alleging failure to comply with the Administrative Procedures Act empirical cost benefit analysis requirements.

EXCESSIVE FEE LITIGATION

- Section 36(b) of the 1940 Act imposes on advisers (including subadvisers) and their affiliates a fiduciary duty with respect to fees they receive.
- Jones v. Harris
  - Only Supreme Court decision on Section 36(b) of 1940 Act
  - Reaffirmed Gartenberg standards
  - For a court to find a fee unreasonable and a violation of Section 36(b), it must conclude that the fee "is so disproportionately large that it bears no reasonable relationship to the services rendered …"
  - Six "Gartenberg Factors" that fund boards should consider
    - Nature extent and quality of services
    - Investment performance
    - Adviser costs and profitability
    - Fall out benefits received by an adviser
    - Economies of scale
    - Fees paid by comparable funds

EXCESSIVE FEE LITIGATION *(continued)*

- Gallus v. Ameriprise Financial
  - The Supreme Court in the Jones case held process is important. Courts should be very reluctant to second guess directors where the advisory agreement renewal process was good.
  - Where the process was poor, courts should take a closer look at the fees.
  - In the Gallus case, plaintiffs argued that Section 36(b) could be violated, even where the fee was reasonable, when the process was defective.
  - The Court disagreed, stating that "a process-based failure does not constitute an independent violation of Section 16(b)" and is only relevant in determining "the amount of deference to give the board's decision to approve the fee."

EXCESSIVE FEE LITIGATION *(continued)*

- Northern Lights Fund Trust Disclosure
  - Prospectus supplement dated June 8, 2012 stated they had received a "Wells Notice" indicating that the SEC staff was considering whether to recommend an enforcement action
  - The notice went to the fund "and certain of its current and former trustees and chief compliance officer."
  - The prospectus supplement states that "The Wells notice … relates primarily to the process by which certain investment advisory agreements" were approved and disclosed.
  - This proceeding emphasizes two important points:
    - Process is important
    - The SEC can sue if process is defective, even if shareholders cannot sue under Section 36(b) of the 1940 Act.

EXCESSIVE FEE LITIGATION *(continued)*

- Sub Adviser Lawsuits
  - Recent lawsuits have been filed against advisers who hire sub-advisers to manage portfolios
  - These complaints allege that advisers provided no services of value for the fees they received
  - Although the lawsuits are at early stages, one has been dismissed because the plaintiff redeemed all of his shares

FX TRADE EXECUTION

- Potential issues are what did the agreement provide and is there a fiduciary duty on the part of a custodian that override the terms of a custodian agreement where the custodian executes FX trades
- A complication exists where the custodian, or an affiliate, is trading FX for its own account
- A number of lawsuits were filed against State Street Bank and BNY Mellon
  - Some have been settled
  - Some portions of complaints have been dismissed
- BNY Mellon has argued that the cases should be thrown out because it made adequate disclosures of its practices and investment managers are sophisticated professionals who understood the terms of the agreements.

FX TRADE EXECUTION *(continued)*

- Mellon has changed some of its disclosure and changed its pricing to a fixed formula
- Reports indicate the cases were the result of whistleblower tips from former traders at State Street and BNY Mellon after the new rules took effect in August 2011
- The whistleblower rules were authorized by the Dodd-Frank Act and provide for payments of 10% - 30% of amounts recovered (over $1 million)

INVESTMENT ADVISOR SRO

- In the aftermath of the Madoff scandal, the Dodd-Frank Act commissioned an SEC study of examination and enforcement resources for advisers
- The study found that 58% of broker-dealers are examined but only 8% of advisers
- The SEC listed 3 options
  - User fees (paid to the SEC)
  - Authorizing FINRA to examine advisers
  - Creation of one or more SRO's

INVESTMENT ADVISOR SRO *(continued)*

- The Investment Adviser Oversight Act of 2012 (H.R. 4624) would authorize creation of one or more SROs
  - FINRA likely would be the SRO for advisers affiliated with broker-dealers
  - Some other firm likely would apply to be an alternative for other advisers
- Key exemptions
  - An adviser with one registered investment company client
  - An adviser with 90% of its managed assets represented by non-US residents and certain types of institution clients.

INVESTMENT ADVISOR SRO *(continued)*

- Institution clients whose assets qualify for the 90% test:
  - Qualified purchasers under 1940 Act
  - Charitable investment funds under SEC. 3(c)(10) of 1940 Act
  - Collective trust funds under SEC. 3(c)(11) of 1940 Act
  - Private funds
  - Mortgage REITS under Sec. 3(c)(5) of 1940 Act
  - Issuers of asset-backed securities under Rule 3a-7 issued under 1940 Act
  - Business development companies under SEC. 54 of 1940 Act
  - State-registered IAs
  - SEC-registered BDs
  - Employee security companies exempted under SEC. 6(b) of 1940 Act

K&L|GATES

K&L Gates LLP
1601 K Street NW
Washington, DC 20006-1600
T 202.778.9000 www.klgates.com

REGULATORY UPDATE FOR U.S. REGISTERED FUNDS AND THEIR ADVISERS

June 2012

Clifford J. Alexander
Cary J. Meer

RECENT LEGISLATIVE AND REGULATORY DEVELOPMENTS

A. Money Market Fund Reform

On May 11, 2012, SEC Commissioners Luis Aguilar, Troy Paredes and Daniel Gallagher issued a joint statement expressing their opposition to reforms proposed by the International Organization of Securities Commissions' ("IOSCO") report entitled "Consultation Report of the IOSCO Standing Committee 5 on Money Market Funds: Money Market Fund Systemic Risk Analysis and Reform Options," which was issued on April 27, 2012 ("Consultation Report"). The Consultation Report states that money market funds are subject to systemic risks and proposes several reforms, including a floating NAV and mandatory private insurance. The Commissioners' statement notes that the Consultation Report was published without the SEC's concurrence, and that the Commissioners felt it was "important to state for the record that the Consultation Report does not reflect the view and input of a majority of the Commission." In addition, the Commissioners stated that "a majority of the Commission expressed its unequivocal view that the Commission's representatives should oppose publication of the Consultation Report and that the Commission's representatives should urge IOSCO to withdraw it for further consideration and revision."

The Investment Company Institute ("ICI") wrote a comment letter to IOSCO regarding the Consultation Report on May 25, 2012. The comment letter notes that the SEC's 2010 money market reforms work as proven during the summer of 2011 when money market funds were able to meet large volumes of redemptions. The ICI states that money market reforms under the most consideration in the U.S. have serious flaws and would be detrimental to investors, the industry and issuers of short-term debt. The comment letter argues that money market reforms should be guided by two principles: (i) preserving key money market fund features, including ready liquidity and $1.00 per-share net asset value, that have made them attractive to investors, and (ii) encouraging competition and preserving investor choice by ensuring a robust global money market fund industry. In addition, a study released by the ICI on May 16, 2012 found that requiring money market fund sponsors to create capital buffers to protect against future losses could hurt the money market fund industry. The economics of capital buffers for money market fund sponsors would be unmanageable according to the study.

Recently, House Republicans have sought to delay new regulation for money market funds by introducing a requirement into a GOP-backed appropriations bill for the fiscal year beginning October 1, 2012 that would require the SEC to study its 2010 reforms to its rules. If the proposal becomes law, the SEC would have 90 days to complete its study after the passage of the 2013 fiscal budget.

B. Investor Adviser Oversight Act of 2012 Proposal

On April 25, 2012, House Financial Services Committee ("Committee") Chairman Spencer Bachus and Rep. Carolyn McCarthy, a member of the Committee, introduced legislation to create what they believe to be a more efficient and effective structure for oversight of the investment advisory industry ("Bachus-McCarthy Bill"). Chairman Bachus and Rep. McCarthy introduced the proposal in response to an SEC study finding that the agency lacks resources to adequately examine the nation's registered investment advisers. According to the proposal, the Bachus-McCarthy Bill would authorize one or more self-regulatory organizations ("SROs") for investment advisers funded by membership fees, similar to the Financial Industry Regulatory Authority ("FINRA") model in place for the oversight of the broker-dealer industry.

The Bachus-McCarthy Bill proposes an amendment to the Investment Advisers Act of 1940 ("Advisers Act") to provide for the creation of National Investment Adviser Associations ("NIAAs") to be registered with and overseen by the SEC. It also proposes requiring investment advisers that conduct business with retail customers to become members of a registered NIAA. Similar to the SEC's current oversight of SROs, the legislation would permit the SEC to approve, suspend or revoke an NIAA's registration, as well as censure an NIAA or impose limits on an NIAA's activities. Importantly for investment advisers to mutual funds, the Bachus-McCarthy Bill includes a provision that would exempt any investment adviser that has at least one registered investment company client from the requirement to become a member of an NIAA.

According to the Bachus-McCarthy Bill press release, 58% of broker-dealers were examined by the SEC in 2011, yet only 8% of investment advisers were examined during that same period. Chairman Bachus stated that "[t]he average SEC-registered investment adviser can expect to be examined less than once every 11 years. That lack of oversight, particularly in the aftermath of the Madoff scandal, is unacceptable…. Bad actors will naturally flow to the place where they are least likely to be examined. Therefore, it is essential that we augment and supplement the SEC's oversight to dramatically increase the examination rate for investment advisers with retail customers." Certain segments of the adviser industry are objecting to the bill because they believe it is intended to create a means to give FINRA oversight over investment advisers.

At a hearing for the bill held on June 6, 2012, consumer advocates' and industry trade groups' hopes that the SEC would receive increased funding in order to thwart an SRO were extinguished when Rep. McCarthy stated: "Would I like to get more money for the SEC? Yes, I would. But we are not going to get the money for the SEC; it's not going to happen." However, Rep. Maxine Waters stated that she is drafting legislation that would allow the SEC to collect additional user fees to fund investment adviser exams. On June 5, 2012, the House Financial Services General Government Appropriations Subcommittee provided the SEC with $1.37

billion for the fiscal year 2013, which is $195 million below President Obama's request and an amount that is insufficient to provide the SEC with the necessary funding to boost its oversight of investment advisers.

During the hearing no legislator was enthusiastic about the bill, but many saw it as a good starting point with questions and reservations about the bill's details. Critics of the bills stated that a new SRO would present investment advisers with a layer of expensive additional bureaucracy. A major topic of the hearing was the costs that small investment adviser firms would face if the bill was approved. Chairman Bachus noted that he would consider revising the bill so that small investment advisers would only pay a de minimus SRO membership fee. A committee vote on the bill is likely to be delayed until later in the summer as the bill's sponsors work with critics to modify the bill.

C. SEC Announces Members of New Investor Advisory Committee

On April 9, 2012, the SEC announced the formation of a new Investor Advisory Committee ("Committee") pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Section 911 of the Dodd-Frank Act mandates the establishment of the Committee to advise the SEC on regulatory priorities, the regulation of securities products, trading practices, fee structures, the effectiveness of disclosure, and initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace. Section 911 also requires that the Committee consist of members who represent, among other things, the interests of individual equity and debt investors, including investors in mutual funds, and who represent the interests of institutional investors, including the interests of registered investment companies. Members of the Committee represent a wide variety of interests, including senior citizens and other individual investors, mutual funds, pension funds, and state securities regulators, and include one independent trustee of a mutual fund complex.

D. Senate Finance Committee Hearings on Future of Tax-Exempt Status for Municipal Bonds

The ICI joined a number of organizations in sending a joint letter to Senate Finance Committee chairman Senator Max Baucus (D-Mont.) and to ranking member Senator Orrin Hatch (R-Utah), urging Congress to uphold the current tax-exempt status of municipal bonds. The possibility of municipal bonds losing their tax-exempt status was recently raised in President Obama's 2013 budget proposal, which contains a provision that would limit the extent to which high-income taxpayers ($250,000 for joint filers or $200,000 for single filers) could reduce their tax liability. This measure could negate an individual's ability to exclude "all itemized deductions; foreign excluded income; tax-exempt interest; employer sponsored health insurance; retirement contributions; and selected above-the-line deductions." The letter to Senators Baucus and Hatch emphasized the importance of tax-exempt bonds to state and local government financing initiatives.

E. Final ESOC Rule Regarding Systemically Important Financial Institutions

On April 3, 2012, the Financial Stability Oversight Council ("FSOC") issued a final rule and interpretive guidance regarding the authority of the Federal Reserve to supervise certain designated nonbank financial institutions. The final rule is very similar to the proposed rule issued in October 2011. The release accompanying the final rule discusses FSOC's process for analyzing whether a given company should be designated as a "systemically important financial institution" ("SIFI"). The ICI had submitted multiple comment letters advocating that asset management companies not be included in the final rule. While the release indicates that FSOC is still evaluating whether asset management companies pose a potential threat to the stability of the U.S. economy and whether it would be appropriate to develop additional guidance regarding potential metrics and thresholds relevant to determinations regarding asset managers, it also states that such companies will be evaluated under the new rule using the existing criteria.

The release outlines a three-step process by which FSOC will evaluate an entity's SIFI status. First, SIFI designation will apply to entities that have at least $50 billion in consolidated assets and meet one of five additional criteria related to the entity's derivatives activity and outstanding debt. Second, FSOC will analyze public information and regulatory sources to determine the potential threat that an entity poses to U.S. financial stability. Third, FSOC will issue formal notices to entities still under review, which may be accompanied by requests for additional information from the entity. Notably, with regard to the initial $50 billion threshold, the release states that, for purposes of evaluating whether investment funds are SIFIs, FSOC "may consider the aggregate risks imposed by separate funds that are managed by the same adviser, particularly if the funds' investments are identical or highly similar." In addition, the release indicates that, where appropriate, FSOC may consider assets under management when determining whether an asset manager meets the initial $50 billion threshold for consideration as a SIFI. In a report issued on May 11, 2012, Moody's Investors Service stated that over 100 asset managers and seven individual taxable money market funds would meet the initial $50 billion threshold if FSOC were to include such assets. The rule took effect on May 11, 2012.

F. SEC Examination Plan for New Private Fund Registrants

In a speech to the Private Equity International Private Fund Compliance Forum on May 2, 2012, Carlo di Florio, Director of the SEC's Office of Compliance Inspections and Examinations, discussed the SEC's plan for examinations of new private fund registrants. The plan will have three stages. The SEC will begin with an initial phase of industry outreach and education, with a focus on the SEC staff's expectations and perceived "high risk" areas. The second step will involve coordinated examinations of a significant percentage of new registrants, with further emphasis on high risk areas. Third, the SEC will publish a series of "after-action" reports, identifying key issues, risks and themes that were found in the examinations.

G. New SEC Derivatives Approach for Funds

On February 9, 2012, at the PLI Investment Management Institute 2012 program, Eileen Rominger, director of the SEC's Division of Investment Management ("Division"), discussed the Division's initiative to review the regulatory regime relating to the use of derivatives by registered investment companies and the comments received by the Division in response to the

concept release issued by the SEC in August 2011, which sought comment on a wide range of issues under the Investment Company Act of 1940 (the "1940 Act") raised by the use of derivatives by investment companies regulated under the 1940 Act ("Concept Release").

According to Ms. Rominger, among other comments, many commenters focused on the issue of leverage that funds incur when using derivatives. She noted that comments were mixed in this area, with some commenters suggesting that funds be given the ability to determine for themselves how and where to set their leverage limits in the context of derivatives, and others expressing concerns about the extent of derivatives use by some funds. She stated that the suggestion that funds be given the ability to determine for themselves how and where to set their leverage limits "is one of several that the Division is examining more closely as it begins to analyze the comments on the Concept Release." She further stated that there are certain questions that are at the base of any future efforts to "help ensure that the regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the [1940] Act," such as:

- Would this approach lead to excessive leverage and raise the concerns that led Congress to limit funds' leverage in the first place?
- How would a fund go about deciding on its derivatives leverage limits?
- Would there be a "race to the bottom" if leverage drives performance and performance drives sales of fund shares?
- Are fund trustees and chief compliance officers in a position to guard against abuses in this area? If they are, what tools do they have at their disposal and how would they use them?

Ms. Rominger also noted that the Concept Release did not exhaust the list of issues that relate to funds' use of derivatives, for example, custody-related issues and broader risk management concerns. She also stated that, although the Concept Release did not discuss every potential issue, such issues are receiving the Division's and the SEC's attention in other ways. As an example, she stated that the Division is continuously monitoring for funds that appear to have significant derivatives exposure in their financial statements, but have limited or no discussion in their annual reports of the effect of those derivatives on the funds' performance.

Ms. Rominger closed her remarks by stating that the Division is working toward a comprehensive, coordinated, and informed analysis on funds' use of derivatives. She did not provide a specific timetable for issuing guidance on this topic, citing the uncertain timing associated with the various rulemakings related to derivatives required under the Dodd-Frank Act. However, she acknowledged the need to act in a timely and expeditious manner, particularly in light of Division's moratorium on reviewing exemptive requests by exchange-traded funds that invest in derivatives.

H. SEC Proposed Rules to Help Prevent and Detect Identity Theft

On February 28, 2012, the SEC proposed a new rule that is intended to protect investors from identity theft by ensuring that broker-dealers, mutual funds, and other SEC-regulated entities create programs to detect, and respond appropriately to, "red flags." The SEC issued the proposal jointly with the Commodity Futures Trading Commission ("CFTC"). Section 1088 of the Dodd-Frank Act transferred authority over certain parts of the Fair Credit Reporting Act from the Federal Trade Commission ("FTC") to the SEC and CFTC for entities they regulate. The proposed rules are substantially similar to rules adopted in 2007 by the FTC and other federal financial regulatory agencies that previously were required to adopt such rules. The rule proposal would require SEC-regulated entities to adopt a written identity theft prevention program that would include reasonable policies and procedures designed to detect, prevent and mitigate identity theft in connection with certain existing accounts or the opening of new accounts. The comment period closed on May 7, 2012.

I. PCAOB's Proposed Mandatory Auditor Rotation

On March 22-23, 2012, the Public Company Accounting Oversight Board ("PCAOB") held two days of panel discussions regarding auditor independence and auditor rotation. In August 2011, the PCAOB had issued a concept release advocating for mandatory term limits for audit firms. The comment period on this concept release originally ended on December 14, 2011, but in early March the PCAOB reopened the comment period in anticipation of the panel discussions. The reopened comment period ended on April 22, 2012. To date, the PCAOB has received over six hundred comment letters on this release. While testifying during a recent House of Representatives Financial Services subcommittee hearing, PCAOB Chairman James Doty said that the PCAOB's consideration of auditor rotation is still in the very early stages and that the PCAOB may not take any action at all.

Many public companies oppose the idea of a mandatory rotation of audit firms because of the prospect of increased costs and the risk of increased accounting errors. In late March, U.S. Representative Michael Fitzpatrick (R-PA) proposed an amendment to the Sarbanes-Oxley Act that would specifically prevent the PCAOB from requiring auditor rotation.

J. Volcker Rule Not Expected to be Finalized by July Deadline

In testimony before the House Financial Services Committee on February 29, 2012, Federal Reserve Chairman Ben Bernanke stated that he does not believe that the Volcker Rule will be finalized by the July 21, 2012 implementation date set by the Dodd-Frank Act. The rule regulates proprietary trading and investment in and sponsorship of private equity and hedge funds by banking entities. Mr. Bernanke did not provide an exact timeframe for the completion of the rule. The rule was proposed on October 12, 2011, and Mr. Bernanke stated that approximately 17,000 comments were received before the comment period ended on January 13, 2012. Mr. Bernanke also stated that the Federal Reserve "will make sure that firms have an adequate period of time to adjust their systems" once the rule is finalized.

K. SEC Call for Increased Board Interaction with CCOs

On January 31, 2012, at the SEC's Compliance Outreach Program, Carlo di Florio, director of the Office of Compliance Inspections and Examinations (commonly known as "OCIE"), reportedly discussed the SEC's increased focus on the board's role in ensuring compliance with the securities laws and regulations. Mr. di Florio noted that directors perform a critical oversight function by monitoring management, ensuring there is an effective company culture and engaging "with all the critical constituents who represent the control environment." He also said that directors should make sure the board receives "independent information and perspective" on whether the company is managing risk and complying with the laws and regulations. Mr. di Florio also stated that the SEC has been "increasingly engaging senior management and the board in our examination and monitoring activities."

In a separate panel discussion, Bruce Karpati, co-chief of the SEC's asset management unit within the Division of Enforcement, pointed to the "siloization" in which compliance was not an integral part of a company's operations and that was partially to blame for the alleged wrongdoing involved in a recent settlement. He stated that compliance needs to be part of the process.

Separately, Norman Champ, deputy directory of OCIE, recently stated that OCIE wants to improve communication with fund advisors and is urging firms to take measures to help ease the examination process. According to Mr. Champ, this increased engagement will also include more frequent guidance on the SEC's compliance and risk concerns via risk alerts and sweep examination reports.

K&L GATES

OTC Derivative Developments in the U.S. and the E.U.

27th June 2012

James Stevens – COMAC Capital LLP
Kate Lamburn – Bank of America Merrill Lynch
Swen Werner – JP Morgan
Susan Gault Brown – K&L Gates LLP
Stephen H. Moller – K&L Gates LLP

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

K&L GATES

SEC and FSA Enforcement Developments Affecting Investment Managers

Cliff Alexander
Washington DC
+1 202 778 9068
clifford.alexander@klgates.com

Robert Hadley
London
020 7360 8166
robert.hadley@klgates.com

Elizabeth Robertson
London
020 7360 8255
elizabeth.robertson@klgates.com

www.klgates.com

June2012

Copyright © 2012 by K&L Gates LLP. All rights reserved.

FSA/FCA

- More effective approach to conduct regulation
- Credible Deterrence "Here to Stay"
  - Market Abuse Insider Dealing
  - Criminal Prosecution
  - Higher Fines
  - More Prohibitions
  - Senior Management "continuing focus"
- Innovation

The Multi-Million Pound Drop

£200 million

£66 million

US$6.5176 million

£8.75 million

£10.5 million

£33.32 million

The Chase

Christopher McQuoid
James Melbourne
Matthew Uberoi
Neel Uberoi
Malcolm Calvert
Anjam Ahmad
Neil Rollins
Christian Littlewood
Angie Littlewood
Helmy Omar Sa’aid
Rupinder Sidhu
James Sanders
Miranda Sanders
James Swallow
Bilal Shah
Truptesh Patel
Paresh Shah
Mitesh Shah
Neten Shah
Ali Mustafa
Pardip Saini
Thomas Amann
Christina Weckwerth
Jessica Mang
Richard Joseph

Insider Dealing/Inside Information

Insider Dealing

Greenlight/Einhorn

Punch Taverns plc

- Held 13.3% not a seller
- The Wall-Crossing Call 8 June 2009
- The Punch Call 9 June 2009
- Immediate Instruction to sell
  Sold about one-third holding
- 15 June 2009 Announcement. Share price falls 29.9%
  Greenlight avoided £5.8 million loss

Insider Dealing

Alexander Ten-Holter Greenlight UK Execution Trader and Compliance Officer

- Sell order call 9 June 2009
- If Greenlight signed an NDA management would tell it “secret bad things”
- About a week before stock “plummets” though that “might be a lie”

Insider Dealing

Greenlight/Einhorn - Alexander Ten-Holter

- Warning Signs
- Should have investigated further
    - The reasons for the sale before proceeding; and
    - after announcement (AT-H accepted)
    - any inside information on Punch Call
- Don’t like assumption that risk very low because of firm’s strict policies on market abuse and high standards

Statement of Principle 9 (SIF due skill, care and diligence)

Insider Dealing

Greenlight/Einhorn

Caspar Agnew, selling trader

- Failure to raise a suspicious transaction report after announced

Statement of Principle 2 (due skill, care and diligence)

Andrew Osborne, Punch's broker

- Market abuse, improper disclosure

Insider Dealing

Greenlight/Einhorn - Penalties

- DE - £3 million fine, £638,000 disgorgement of loss avoided on his holdings in the funds
- Greenlight - £3 million fine, £650,795 disgorgement of reduced performance and management fees avoided
- AT-H – Prohibition from Compliance oversight CF10 and money laundering reporting CF11, £130,000 fine
- CA - £65,000 fine
- AO - £350,000 fine

Insider Dealing

Greenlight/Einhorn- Issues

- Publicly accepted not deliberate or reckless. No intention
- Did not believe inside
- Can’t rely on others
- Management/broker call after refusing to be wall-crossed – “unusual”. Itself a red flag
- No reference to compliance/legal before sale

“*information … that makes you want to trade …*”

- Also no reference to Punch
- AO did not consult legal before the Punch call (though Punch had)

Takeaways

- Market abuse/insider dealing training
- Non-wall crossing not enough – a red flag in itself.
But still make clear!
- Honest belief not enough even for market abuse
- Further investigation – records
- Be alert for STRs retrospectively
- D&O Insurance

Inside Information

Nicholas Kyprios

- Not market abuse because price sensitive information was not in respect of a "qualifying investment"
  - Statement of Principle 2 – due skill, care and diligence
  - Statement of Principle 3 – proper standards of market conduct
  - £300,000 (£210,000 after 30% discount)

Inside Information

Ian Hannam
Global Co-Head UK Capital Markets

Market Abuse improper disclosure.
Honesty/integrity not in question.
No intention to commit. No expectation of trading.
No evidence of trading. Not deliberate. Not reckless.

Decision Notice - £450,000

Inside Information

Ian Hannam

Objections:

- Can’t “disclose” what recipient already knew.

  FSA disagrees. Repetition/source may lend credence/weight.
- Acted “in the proper course of … employment , profession or duties”.

  Acted for Heritage. FSA: Not enough. Obliged to consider risk and whether disclosure “necessary”.

Insider Dealing US Activity

SEC'S ASSET MANAGEMENT UNIT

Dedicated to investigating investment advisers, private hedge funds and registered funds

A principal focus is misuse of inside information

The SEC has brought over 60 insider trading cases since October 2009:

- Six are pending
- The SEC has won or settled the other 60

INSIDE INFORMATION

Trading by an officer, director, employee of a company or a person in a position of trust

Non-public information

Material information

RAJARATNAM CASE

A self-made billionaire hedge fund manager; worth $1.8 billion in 2009 (reported by the 236 richest in U.S.)

Galleon at its peak in 2008 had $7 billion in assets

After his arrest on October 16, 2009, investors fled and Galleon was liquidated in January 2010

Rajaratnam was accused of 14 counts of conspiracy and securities fraud by profiting from inside information on several public companies, including IBM, Intel Capital and Goldman Sachs

He was sentenced to 11 years and fined $10 million

The government had direct evidence – 45 wire taps of calls between Rajaratnam and tippers

Galleon employees, including a portfolio manager, also testified about getting inside information

RAJAT GUPTA CASE

Gupta was a director of both Goldman Sachs and Proctor and Gamble

He was accused of passing on inside information that he received in board meetings of both companies to Rajaratnam

Evidence was circumstantial; there was no direct wire tap evidence

Rajaratnam refused to wear a wire, even though he was promised a reduced sentence

RAJAT GUPTA CASE *(continued)*

Gupta was accused of tipping Rajaratnam about Goldman Sachs' earnings for two quarters and a September 2008 Berkshire Hathaway investment:

- Gupta was briefed during a Goldman Sachs board meeting on the Berkshire Hathaway investment
- Gupta called Rajaratnam a minute after the board meeting concluded
- Galleon bought 267,000 immediately after
- Rajaratnam was caught on a wiretap telling a Galleon trader that he heard "something good might happen to Goldman"

LESSONS TO BE LEARNT FROM ROGUE TRADER
AND EXCESSIVE PROPRIETARY TRADING CASES

MAJOR ROGUE TRADER CASES

Joseph Jett Kidder – Peabody & Co. (1994)

- Strategy involved exchanging U. S. Government "STRIPS" (Separate Trading of Registered Interest and Principal of Securities) for whole bonds
- Kidder system allowed Jett to input instructions and also select the settlement dates for transactions

MAJOR ROGUE TRADER CASES

Nick Leeson – Barings Bank (1995)

- Floor manager for Barings' trading on the Singapore International Monetary Exchange and the head of his office's settlement operations, which was responsible for that officer's accounting system
- Lost over £800million placing big bets on the Japanese yen utilising futures contracts

MAJOR ROGUE TRADER CASES

Toshihide Iguchi – Daiwa Bank (1995)

- Lost more than $1 billion through unauthorised trading in U.S. government bonds
- Covered up losses on his trades by selling securities held in customer custody accounts and falsifying records

Yasou Hamanaka – Sumitomo Corp (1996)

- Engaged in unauthorised metal trades for 10 years that ultimately generated $1.8 billion in losses
- Because his office had virtually complete autonomy, he was able to hide the losses through fictitious trades and falsified records

MAJOR ROGUE TRADER CASES

Chen Jiulin – China Aviation (2004)

- Bought oil futures contracts, betting that prices would continue to rise
- Prices instead fell, and losses totaling US $5.5 billion resulted

Four Traders – National Australia Bank (2004)

- Four traders on the NAB foreign exchange option trading desk decided that the US dollar would rise after a September 2003 meeting of G-7 ministers and went long the U.S. dollar utilising options, spots and forwards
- Instead, the dollar fell, resulting in losses of £360 million

MAJOR ROGUE TRADER CASES

Brian Hunter – Amaranth Advisors (2006)

- Hunter traded natural gas for a private hedge fund managed by Amaranth and in 2005, he made $1 billion by correctly betting that natural gas prices would rise after Hurricane Katrina hit the U.S. Gulf Coast
- After betting that natural gas prices would fall, the markets moved against their position and, in one month, the hedge fund lost $6 billion of its $9.6 billion in total net assets

Jerome Kerviel – Société Générale (2008)

- Reportedly began to acquire large unauthorised positions of futures contracts on European stock indices
- Initially, he bet the market would fall and later that it would rise, but he was wrong both times

J. P. MORGAN CHASE CASE (2012)

Does not appear to involve a rogue trader

Occurred while embedded U.S. banks examiners were on the premises

Involved disproportionately large transactions in a relatively small credit derivatives market

The department had been successful in prior years

Internal controls were revised in a way that allowed the strategy to increase risk exposure

SOME COMMON THREADS

Traders were relatively young

Traders became “superstars” over night

Traders had a high degree of autonomy

The traders and their supervisors resisted efforts to impose controls

Traders were able to enter orders or provide data with little or late independent review

SOME COMMON RED FLAGS

Unusually large profits by a trader from a supposedly conservative investment strategy

Big jump in a trader's profits from one year to another

Trader and/or supervisor resist financial controls

Frequent overrides of investment valuations

Large number of unsettled trades

K&L GATES

OFFICIAL RESPONSES

A number of governmental organisations responsible for financial institutions in the U.S. and Europe promptly issued responses to the Société Générale events

- The **Financial Services Authority** issued Market Watch No. 25 in March 2008, to encourage firms to contact the FSA if they had suspicions of unauthorised trading and identify possible systems and controls that firms "should consider" that may be effective for trading operations
- The **Financial Industry Regulatory Authority** issued Regulatory Notice 08-18 in April 2008**,** "to highlight sound practices for firms to consider" as they review their internal controls and risk management systems for trading activities
- The **Committee of European Banking Supervisors** on July 18, 2008, issued a report titled "Reactions to the Société Générale Loss Event: Results of the Stock-Take"

COMPLIANCE AND CONTROLS TIPS

Firms should foster a "culture of compliance"

Separation of duties should be strictly enforced

Exceptions to policies should be clearly justified and rarely given

Performance rewards should not be a one-way bet

Traders should not be permitted to utilise products or strategies that they or their supervisors do not understand

Firms should insist that employees take vacations

Policies and procedures should require that questions raised about trading activities be escalated

COMPLIANCE AND CONTROLS TIPS

IT-related controls should be designed to prevent traders from deleting or overriding entries in systems

Valuations of investment positions should not be overridden by traders without formal, independent approval

Automatic reporting and review of unusual patterns of cancelled or amended trades, overrides of valuations, trading limit breaches, fails to deliver and delays in confirmations and settlements of trades should be a required part of compliance programs

Policies and procedures designed to assure that new or complex instruments or strategies cannot be utilised without adequate knowledge, back office systems, risk management measures and compliance programs should be adopted

Clear and unambiguous lines of reporting and accountability should be established between a parent company and its overseas units

Senior Management

Senior Management

- Syed Hussain – Habib Bank
- Yohichi Kumagai – Mitsui
  - CF1 Director CF3 Chief Executive (Chairman/MD)
  - £170,433 (£119,303 after 30% discount)
  - Prohibition
  - Statements of Principle 5 and 7
  - Expansion into Europe
  - Recognised and resigned

Senior Management

James Pottage
UBS Wealth Management (UK) Limited

- CF3 Chief Executive (September 2006)
- CF8 Apportionment and Oversight
- Compliance incidents – Mr Pottage not personally involved
- Statement of Principle 7 – SIF must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function complies with the relevant requirements

Senior Management

James Pottage

FSA Case

Mr Pottage should have

- Carried out an adequate Initial Assessment
- Questioned assurances
- Carried out continuous monitoring and reacted better to “warning signals” (which included “two significant disasters” and indicated “serious flaws”/”fundamental deficiencies”)
- Implemented his Systematic Overhaul “sooner than he did”

Senior Management

James Pottage

Mr Pottage's Case

- Initiated the Systematic Overhaul July 2007
- All identified control failures led to remedial steps planned and implemented
- Decided early to strengthen compliance team
- No one in Risk, Audit, Compliance, local or Group, or FSA, suggested other steps necessary
- Monitoring weaknesses not obvious to CEO

Senior Management

James Pottage

APER 3.1.4G “An approved person will only be in breach of a Statement of Principle where he is personally culpable…[i.e.,] conduct was deliberate or standard of conduct was below that which would be reasonable in all the circumstances”

Senior Management

James Pottage

Tribunal held: Misconduct charge not supported by the evidence

- Not alleged conduct deliberate
- Not alleged that “matters went wrong” while CEO=failure to take reasonable care
- No authority to change governance/risk management frameworks
- Steps taken pre July 2007 were reasonable steps

Senior Management

James Pottage

- CEO “unique position of oversight” so expected to assess wider implications where a control failure appears.
- CEO disciplined on a Statement of Principle “where he is personally culpable, but not otherwise”.
- CEO not required to design, create, implement controls. An oversight role.
- Not obliged to do job of an appropriately appointed delegate.
- Approved person not required to “ensure” compliant systems and controls. Requirement is to “take reasonable steps”.

Anti-Money Laundering

Anti-Money Laundering

- Thematic Work at Banks – June 2011
- 2001 General Abacha
- High Risk Customers – not just PEPs
  - Enhanced Due Diligence – source of wealth/ funds
  - Enhanced monitoring
  - Analysis “skewed” in favour of acceptance
- Looking for improvements

Anti-Money Laundering

Coutts & Company

- December 2007 – November 2010
- £12.5 million (£8.75 million after 30% discount)
- Principle 3 – management and control

  SYSC 6.1.1R – counter financial crime risk

  SYSC 6.1.3R – assess, manage money laundering risk – comprehensive, proportionate
- JMLSG Guidance
- No actual money laundering

Anti-Money Laundering

Coutts & Company

- Expansion/remuneration
- High Risk Customers
- Identify PEPs and assess risk
- Insufficient customer due diligence
- “Legitimate rationale” for structures
- Controls when taking on high risk customers
- Insufficient scrutiny/challenge by AML team
- Level of Authority Reduced – Senior Management
- Monitoring and review

Anti-Money Laundering

Coutts & Company

- FSA found ‘deficiencies’ 73 of 103 high risk customer files
- Insufficient information on source of wealth and income generally
- Source of funds
- Acquire/act on risk information
- Keep up to date
- Review transactions

Anti-Money Laundering

Habib Bank AG

- December 2007- November 2010
- £750,000(£525,000 after 30% discount)
- Principle 3
  - SYSC 6.1.1R, 6.3.1R
  - SYSC 6.3.3R Regular assessment
  - SYSC 9.1.1R Sufficient records to monitor compliance
- No Actual Money Laundering
- Skilled Person's Report

Anti-Money Laundering

Habib Bank AG

- Procedure to assess risk
- High Risk Country List – Pakistan, Kenya
- Enhanced Due Diligence for higher risk customers
- Inadequate review of systems and controls
- Training/Records

Anti-Money Laundering

Mr Hussain (Habib Bank AG)

- CF11 - Money Laundering Reporting Officer
- £25,000 (£17,500 after 30% discount)
- Retired
- Statement of Principle 7 – SIF reasonable steps business complies with regulatory requirements
- Saw all Enhanced Due Diligence
- Identified deficiencies but did not follow up with training

Anti-Money Laundering

Shah v HSBC Private Bank (UK) Limited

- SARs to SOCA
- Implied term don’t have to act without SOCA consent
- No obligation to disclose and risk tipping off
- Not blanket protection – have a reasonable basis and document!

Systems and Controls

Systems and Controls

Enforcement

"to encourage the industry to strengthen its defences"

- Anti-Money Laundering
- Inside Information
- Anti-Bribery
- Client Money
- Rogue Trader Incidents
- Valuation
- Just Systems and Controls
  - Mitsui £4.78 million (£3.345 million after 30% discount)

US VALUATION CASE

The fund invested primarily in mortgage-backed securities, including collateralised "debt obligations"

The SEC alleged that a portfolio manager learned that one of the portfolio's issuers had filed for bankruptcy

The SEC also alleged:

- The portfolio manager did not report this fact to the adviser's valuation committee
- The fund overpriced its net asset value for a long period of time
- Due to the mispricing, the fund's performance was inflated
- The fund was reported to be a top performer but actually had a poor record

VALUATION CASE *(continued)*

In addition, the SEC alleged that the adviser selectively disclosed information to some investors, who redeemed at a higher NAV

The case was settled by the adviser; the SEC order stated that the $40 million penalty took into account remedial action and cooperation by the adviser

Systems and Controls

Martin Currie Investment Management Limited
Martin Currie Inc (UK Branch)

- January 2007 – November 2010
- Unlisted investments in China
- Fine £5 million (£3.5 million after 30% discount) (plus SEC)
- HK $64.3 million (£5.1 million) compensation
- Principle 2 – skill, care and diligence/
- Principle 3 – management and control
- Principle 8 – conflicts of interest
- COB 7.1.3R – Fair treatment for customers where conflict
- SYSC 3.1.3R – Appropriate systems and controls
- SYSC 3.2.6R – systems and controls for compliance/counter financial crime
- SYSC 6.1.1R – Procedures for compliance by agents
- SYSC 6.1.2R – Procedures to detect/minimise failures/risks

Systems and Controls

Martin Currie Investment Management Limited

Limited experience of unlisted securities

- Two funds – Fund A MCIML; Fund B MCI
- Investment management by same managers in Shanghai Office with full discretion
- Supervision/oversight
- Unlisted bonds – Fund A Company X
  Fund B Company Y
  Y subsidiary of X

Systems and Controls

Martin Currie Investment Management Limited

- Criticised due diligence/credit risk
- Described one Company X bonds as ‘cash’
- Breached Fund A limit for unlisted investments
  - Edinburgh aware late
  - Went ahead/did not disclose to Board
- Made worse by Fund A redemptions late 2008

Systems and Controls

Martin Currie Investment Management Limited

- Purpose of Company Y bond was to redeem company X bond held by Fund A
  - Inadequate management/disclosure of conflict
  - Eventually sold c.50% less
- No investment committee/early oversight of local management plans
- Inadequate disclosure to Fund B board – no informed consent
- Breached own conflict management policies
- Not addressed until more than a year later – when
  - Paid compensation to Fund B
  - New General Counsel role at board level
  - Ceased unlisted investment
  - Disciplined/reallocated responsibilities

International Enforcement Co-operation

International Enforcement Co-operation

- Martin Currie SEC fine US$8.3million
- Insider Dealing
  - Blue Index Criminal Insider Dealing SEC DoJ FBI
- Sanctions – RBS/Coutts
- Anti-Money Laundering FSA working with
  - ESA AML Committee
  - FATF
- Boiler Room Actions – Eurojust
  - 16 countries – Malta, Italy, Cyprus, Slovak Republic, Iceland
- Market Abuse Directive
  - ESMA to determine inter-regulator disputes
  - ESMA will collect and publish comparative data enforcement outcomes

International Enforcement Co-operation

- Section 169 FSMA
- Mutual Legal Assistance
- 2010/11 FSA 900 requests in, 50 requests out
- Extradition
- Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 (the “Gateway Regulations”)

K&L|GATES

K&L Gates LLP
1601 K Street NW
Washington, DC 20006-1600
T 202.778.9000 www.klgates.com

ENFORCEMENT UPDATE FOR U.S. REGISTERED FUNDS AND THEIR ADVISERS

June 2012

Clifford J. Alexander
Cary J. Meer

RECENT JUDICIAL ACTIONS AND ENFORCEMENT ACTIONS

A. ICI and U.S. Chamber of Commerce Lawsuit Challenging Recent CFTC Amendments

As we previously reported to you, on February 8, 2012, the Commodity Futures Trading Commission ("CFTC") adopted final amendments to Rule 4.5 under the Commodity Exchange Act ("CEA"), which provides an exclusion for operators of registered investment companies from regulation as commodity pool operators. Amended Rule 4.5 will require fund operators to either limit their funds' use of commodity interests, including commodity futures, options, retail forex contracts and swaps, or submit to dual regulation by the CFTC and the SEC.

On April 17, 2012, the ICI and the U.S. Chamber of Commerce ("Chamber") filed a complaint in the U.S. District Court for the District of Columbia ("District Court") challenging the CFTC's amended Rule 4.5 and related provisions ("Complaint"). The Complaint alleges that amended Rule 4.5 imposes redundant regulations on registered investment companies without satisfying the CFTC's obligation to weigh the costs and benefits of the amendments.

David Hirschmann, president and CEO of the Chamber's Center for Capital Markets Competitiveness, stated that "[t]he Chamber strongly supports smarter regulation that reduces systemic risk. Unfortunately, the CFTC's new rule looks more like regulation for regulation's sake…." Paul Schott Stevens, ICI president and CEO, stated that the "rule layers the CFTC's regulatory regime atop that already applied to funds by the [SEC] under all the major federal securities laws. The CFTC in its rulemaking process did not remotely justify such regulatory excess…."

The Complaint alleges that amended Rule 4.5 violates the CEA and the Administrative Procedure Act ("APA") on multiple grounds by failing to evaluate sufficiently the costs and benefits of amended Rule 4.5. The Complaint further alleges that the CFTC violated the APA on several counts, including its failure to provide credible evidence to support its decision to require the registration and regulation of operators or investment companies and consequently it "acted in a manner that was arbitrary, capricious,

and otherwise not in accordance with the law." The Complaint requests that the District Court declare amended Rule 4.5 and related provisions unlawful and enjoin the CFTC from implementing those amendments.

On May 18, 2012, the ICI and Chamber filed a motion for summary judgment ("Motion") in the District Court. The Motion asks the District Court to vacate amended Rule 4.5 and related provisions because the amendments are arbitrary, capricious and fail to comply with the CEA's cost-benefit provisions. The ICI has stated that it expects the CFTC to file a response to the Motion and cross-motion for summary judgment by the end of June.

B. Third Circuit Affirms District Court Decision in *Santomenno* Litigation

On April 16, 2012, the U.S. Court of Appeals for the Third Circuit affirmed a District Court judge's decision in *Santomenno v. John Hancock Life Ins. Co.* in which the plaintiff brought a suit against John Hancock Life Insurance Company (USA) and its affiliates ("John Hancock") alleging that John Hancock had charged certain retirement plans excessive fees for annuity insurance contracts offered to plan participants in violation of, among other laws, Section 36(b) of the Investment Company Act of 1940 ("1940 Act"). The District Court had dismissed the excessive fee claims under the 1940 Act because "only those maintaining an ownership interest in the funds in question could sue under the derivative suit provision . . . and the Participants are no longer investors in the funds in question." The Third Circuit agreed, holding that continued ownership by a plaintiff throughout the pendency of a litigation is required under Section 36(b) of the 1940 Act.

C. Recent Developments Regarding SEC Settlement with Citigroup

As previously reported to you, on March 15, 2012, a three-judge panel of the U.S. Court of Appeals for the Second Circuit suspended the effect of a district court judge's decision to turn down the SEC's settlement with Citigroup Global Markets Inc. in *Securities and Exchange Commission v. Citigroup Global Markets Inc.* until the Second Circuit has the opportunity to further review the case.

More recently, the House of Representatives Financial Services Committee held a hearing on May 17, 2012 to examine "neither admit nor deny" regulatory settlements that have come under scrutiny in the Citigroup case. Witnesses, which included SEC enforcement director Robert Khuzami, as well as officials from the Federal Reserve, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, testified that requiring admissions would hamper their ability to bring cases and drain agency resources. According to Mr. Khuzami, "[w]hile some assert admissions may provide marginally increased accountability, the fact is that requiring admissions as a condition of settlement would likely result in longer delays before victims are compensated, dilution of the deterrent impact of sanctions imposed because of the passage of time, and the expenditure of significant SEC resources that could instead be spent stopping the next fraud." Nevertheless, Representative Maxine Waters noted that she was concerned about the frequent use of these settlements, noting that the SEC "has a broader responsibility to enforce the rule of law."

D. SEC Charges Goldman, Sachs & Co. Lacked Adequate Policies and Procedures for Research "Huddles"

On April 12, 2012, the SEC issued an order instituting and reflecting settlement of proceedings charging that Goldman, Sachs & Co. ("Goldman") lacked adequate policies and

procedures to address the risk that the firm's analysts could share material, nonpublic information about upcoming research changes during weekly "huddles" with firm traders and subsequent discussions with a select group of top clients ("Order"). According to the Order, Goldman began holding weekly huddle meetings in each of its seven equity research sectors beginning in 2006. The huddle meetings allowed the firm's equity research analysts to meet with firm traders and sometimes sales personnel to discuss the analysts' "high-conviction" short-term trading ideas and other "market color" concerning stocks they covered, as well as the traders' views on the market. The majority of the traders who participated in the huddles dealt directly with the firm's customers and, for some portion of time, some of the firm's proprietary traders also participated in the huddles. Then in 2007, Goldman launched its Asymmetric Service Initiative ("ASI") with the goal of generating additional revenue for the firm by providing market commentary and trading ideas to a select group of hedge fund and investment management clients. Research analysts were instructed to prepare scripts regarding the ideas discussed at the huddles to be used when calling ASI clients.

The Order states that, during the relevant period, Goldman's policies generally prohibited analysts from discussing unpublished research with clients or anyone outside of their department, other than the firm's legal or compliance departments. The Order further states that the firm did not establish specific policies regarding the huddles; however, in January 2008, the firm issued an internal memorandum that stated that huddles were subject to the firm's existing policies and procedures. The Order discusses several areas where the firm's procedures and related training presentations lacked adequate detail concerning the dissemination of research. For example, the Order states that "Goldman's written policies and procedures failed to adequately define the difference between 'material statements' that required broad dissemination and 'short-term' trading ideas that did not."

The Order found that Goldman failed to establish, maintain and enforce adequate policies and procedures to prevent the misuse of material, nonpublic information regarding equity research in connection with the huddles and ASI. The Order also found that Goldman did not maintain and enforce adequate controls to monitor huddles and ensure that research analysts were not using the program to disclose material, nonpublic information concerning their research that traders or clients could misuse prior to it being disseminated to the public. In addition, the Order found that Goldman's surveillance of trading ahead of research changes was materially deficient in several ways and was not reasonably designed to identify potential instances when analysts prematurely disclosed material research changes to firm traders and clients.

Without admitting or denying the SEC's findings, Goldman accepted sanctions that included: (1) a censure; (2) a civil monetary penalty in the amount of $22 million; and (3) certain undertakings that include the conduct of a comprehensive review of the policies, procedures and practices that relate to the findings in the Order and adoption and maintenance of practices and written policies that are consistent with the findings of the Order and the recommendations resulting from the comprehensive review.

E. Court Rejects Reserve Management Company's Motion to Dismiss SEC Fraud Case; Developments Relating to Board Meeting Minutes

On March 29, 2012, a District Court judge issued an order denying the requests of Reserve Management Company ("RMC") and Bruce Bent, Sr., its co-founder, to dismiss a pending lawsuit by the SEC with respect to its management of The Reserve Primary Fund ("Reserve Fund"), a large money market fund that "broke the buck" on September 16, 2008

during the financial crisis. The judge also rejected an SEC request for a finding of liability. RMC had sought dismissal of the case based on "gaping holes" in the case against it, including the claim that any statements the Reserve Fund may have made were not material.

In addition, details of minutes of a mutual fund board meeting surfaced as a point of contention at the March 29, 2012 hearing. At issue was the accuracy of minutes of a September 15, 2008 Reserve Fund board meeting. The originally approved board meeting minutes stated that the board was advised at its September 15 meeting that $16.5 billion in redemption requests had been received that day, whereas two years later the board sought to amend these minutes to reflect that it was advised at that meeting that only $8 billion in redemptions were received that day. The defendants in this case were seeking discovery of whether the SEC staff pressured the board into altering the minutes, and the judge granted their request to pursue this line of inquiry.[1]

Mutual fund board meeting minutes also were a focus of comments at a recent industry conference. As reported in *Board IQ*, Bruce Karpati, a Co-Chief of the Asset Management Unit within the SEC's Division of Enforcement, stated that Enforcement Division staff members were "reviewing board meeting minutes to make sure directors perform their oversight duties, especially as they relate to valuation, conflicts of interest and fees."[2]

F. SEC Charges Scotland-Based Fund Manager for Violation of Fiduciary Duties

On May 10, 2012, the SEC announced a settled enforcement action against the UK-based Martin Currie group of institutional investment managers for fraudulently causing its U.S. mutual fund client, The China Fund Inc. ("China Fund"), to engage in a transaction for the purpose of rescuing a failing hedge fund client called the Martin Currie China Hedge Fund L.P. ("Hedge Fund"). According to the SEC's order ("Order"), the Hedge Fund had acquired a significant, largely illiquid interest in a Chinese company and required liquidity in order to meet increasing redemption requests from its investors. The SEC alleged that, in April 2009, Martin Currie, through its registered subsidiaries Martin Currie Inc. and Martin Currie Investment Management Ltd., directed the China Fund to make a $22.8 million investment in convertible bonds issued by a subsidiary of the Chinese company. The Chinese issuer then used the proceeds to redeem $10 million of its bonds held by the Hedge Fund at face value, thereby alleviating the Hedge Fund's liquidity concerns. In April 2011, the China Fund sold the bonds for about 50% of their face value, incurring a loss of $11.5 million.

The Order stated that Martin Currie officials were aware of the conflict of interest in the transaction and sought to obtain approval for the transaction from the China Fund's board of directors. In doing so, however, the Martin Currie officials allegedly failed to disclose that the proceeds of the China Fund's investment would be used to redeem the Hedge Fund's illiquid bonds. The SEC also alleged that Martin Currie failed to consider whether the investment was in the China Fund's best interest and failed to follow the China Fund's policies and procedures with respect to valuation of the bonds purchased.

---

1 *Ignites.com*, "SEC, Reserve Set for Summer Blockbuster Trial," April 17, 2012.

2 *Board IQ*, "Minutes Take On Renewed Importance Under SEC Scrutiny," March 13, 2012.

The SEC charged Martin Currie with violating antifraud, compliance, reporting and affiliated transaction provisions of the Advisers Act and the 1940 Act. Without admitting or denying the SEC's findings, Martin Currie agreed to accept censures and cease-and-desist orders against future violations and to pay a penalty of $8.3 million. In addition, on May 2, 2012, Martin Currie settled a related action brought by the United Kingdom's Financial Services Authority and agreed to pay a penalty of $5.6 million.

G. SEC Charges Oppenheimer Funds with Misleading Disclosure Regarding Derivatives Use

On June 6, 2012, the SEC announced a settled enforcement action against Oppenheimer Funds, Inc. ("Funds") and OppenheimerFunds Distributor, Inc. ("Distributor") regarding allegedly misleading disclosure about derivatives use in two bond funds that experienced major losses during the financial crisis. The SEC alleged that the asset manager used total return swaps to increase exposure to commercial mortgage-backed securities ("CMBS") in the Oppenheimer Core Bond Fund and Oppenheimer Champion Income Fund. During the financial crisis in September 2008, both funds' net asset value sharply declined due to the problems in the CMBS market. According to the SEC's order, the Funds and the Distributor provided false information regarding the funds' performance several times to wholesalers, its call center representatives and financial advisors. The SEC's order also focused on the routine disclosure provided by the Funds and the Distributor. For example, according to the SEC the Oppenheimer Champion Income Fund's 2008 prospectus did not adequately disclose that the fund assumed substantial leverage in its use of derivatives.

Without admitting or denying the SEC's findings, the Funds agreed to cease and desist from causing or committing any violations or future violations of Sections 17(a)(2) and (3) of the Securities Act of 1933 ("1933 Act"), Section 206(4) of the Advisers Act and Rules 206(4)-8(a)(1) and (2) thereunder, and Section 34(b) of the 1940 Act. In addition, the Funds agreed to pay a penalty of $35,366,896. The Distributor agreed to cease and desist from causing or committing any violations and any future violations of Sections 17(a)(2) and (3) of the 1933 Act. Finally, both the Funds and the Distributor were censured.

H. SEC Focus on Cases Related to Fund Valuation

On January 17, 2012, the SEC filed an order charging the former lead portfolio manager of the Evergreen Ultra Short Opportunities Fund ("Evergreen Fund") with liability for causing the Evergreen Fund's NAV to be "materially overstated" from at least March 2008 to June 2008. The SEC alleges in part that: in February 2008, the portfolio manager learned that a collateralized debt obligation ("CDO") owned by the Evergreen Fund had defaulted, and in March 2008 learned that the CDO would no longer make payments to the Evergreen Fund; the portfolio manager did not convey this information to the Evergreen Fund's valuation committee, which was responsible for calculating the value of Evergreen Fund holdings and of which she was a member; when the valuation committee learned of the default and payment stoppage in early June 2008, it reduced the aggregate value being assigned to the CDO from approximately $6.98 million to $0; and the Evergreen Fund subsequently liquidated.

The SEC alleges in the order that the portfolio manager's actions breached her fiduciary duty to the Evergreen Fund and violated several provisions of the Advisers Act, including not following the stated pricing procedures set forth by the Evergreen Fund's Board of Trustees. A public hearing to take evidence for the matter will be held before an SEC

administrative law judge within 60 days. Separately, the Evergreen Fund's investment adviser and its affiliated broker-dealer agreed to pay more than $40 million to settle related SEC charges in 2009.

In another action related to fund valuation, on January 17, 2012, the SEC issued an order based on a settlement in an administrative proceeding sanctioning UBS Global Asset Management ("UBS") for improperly pricing securities in three mutual funds managed by UBS ("UBS Funds"). The case resulted from a referral to the SEC enforcement staff from SEC compliance examiners who had conducted a routine examination of the firm. The SEC had alleged that UBS failed to value certain fixed-income securities held by the UBS Funds in accordance with the UBS Funds' fair valuation procedures and that this failure resulted in a misstatement of the NAVs of the UBS Funds during a two-week period.

The order notes that the UBS Funds' fair valuation procedures require that an UBS Fund value its securities at their transaction prices until the UBS Fund receives "a response to a price challenge based on [a] discrepancy identified in [a] price tolerance report, or [the firm makes] a fair value determination." According to the order, the UBS Funds' valuation committee, contrary to its fair valuation procedures, allegedly did not price the securities at fair value until more than two weeks after receiving price tolerance reports that pinpointed discrepancies between the purchase prices and valuations coming from pricing sources. The order states that a majority of the securities in question were valued at least 100% higher than their respective transaction prices due to the reliance by UBS on valuations provided by pricing services that apparently did not factor in the prices at which the UBS Funds had purchased the securities.

The SEC alleged that, by using the valuations provided instead of the transaction prices, UBS caused the UBS Funds to fail to follow their own written valuation procedures, which resulted in a violation of the 1940 Act. Without admitting or denying any of the findings, UBS agreed to pay $300,000 to settle the charges with the SEC and also consented to cease and desist from committing or causing such violations under the 1940 Act.

I. SEC Alleges Misuse of Social Media in Securities Fraud Case

On January 4, 2012, the SEC staff initiated an administrative proceeding alleging that Anthony Fields, an Illinois registered investment adviser, willfully violated numerous federal securities laws. Chief among the allegations is that Mr. Fields made fraudulent offers to sell fictitious securities through LinkedIn discussion boards and other social media websites. The SEC issued two alerts in connection with this case, highlighting the risks that investors and advisors face when using social media.

J. Eighth Circuit Affirms Ruling in Favor of Defendant Investment Adviser in *Gallus* Litigation

As previously reported to you, on April 5, 2010, the U.S. Supreme Court vacated the decision of the U.S. Court of Appeals for the Eighth Circuit in *Gallus v. Ameriprise Financial, Inc.* ("*Gallus*") and sent the case back to the Eighth Circuit for "further consideration in light of" *Jones v. Harris Associates, L.P.* ("*Jones*"). *Jones*, a Supreme Court decision issued on March 30, 2010, resolved a circuit court split on the appropriate standard for the review of actions brought pursuant to Section 36(b) of the 1940 Act to recover for shareholders allegedly excessive investment advisory fees. *Jones* concluded that the Second Circuit's 1982 decision in *Gartenberg v. Merrill Lynch Asset Management, Inc.*

("*Gartenberg*") "was correct in its basic formulation of what Section 36(b) requires: to face liability under Section 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

In *Gallus*, the district court had granted summary judgment in favor of the investment adviser, holding that no Section 36(b) violation had occurred because the adviser's fee "passed muster" under the standard articulated in *Gartenberg*. The appeals court reversed the district court's decision, concluding that the district court erred in refusing to consider alleged shortcomings in a comparison between the fees charged to the investment adviser's institutional clients and its mutual fund clients. In its opinion, the appeals court held that Section 36(b) "impose[d] on advisers a duty to be honest and transparent throughout the negotiation process" and stated that "the proper approach to Section 36(b) is one that looks to both the adviser's conduct during negotiation and the end result. Unscrupulous behavior with respect to either can constitute a breach of fiduciary duty." The appeals court then remanded the case to the district court with instructions to determine "whether [the adviser] purposefully omitted, disguised, or obfuscated information that it presented to the Board about the fee discrepancy between different types of clients."

Following a reconsideration of its prior decision in *Gallus* in light of the *Jones* decision, the Court of Appeals for the Eighth Circuit issued an opinion on March 30, 2012, affirming the district court's grant of summary judgment in favor of the defendant investment adviser. Applying *Jones*, the Eighth Circuit stated that "a process-based failure does not constitute an independent violation of Section 36(b)" and is relevant only in determining "the amount of deference to give the board's decision to approve the fee." Applying this standard, the appeals court found that the investment adviser in the *Gallus* case had not "apprised [the board] of all the relevant information regarding the fee discrepancy between the [investment adviser's] mutual fund and institutional clients" in connection with the contract approval and therefore that the board's decision was entitled to less deference. However, the court also found that this factor was not sufficient to establish that the fees were outside the range of arm's-length bargaining and that the plaintiffs otherwise had failed to provide sufficient other evidence to support their claim.

K. <u>Third Circuit Affirms District Court Decision in *Santomenno* Litigation</u>

On April 16, 2012, the U.S. Court of Appeals for the Third Circuit affirmed the District Court judge's decision in *Santomenno v. John Hancock Life Ins. Co.* in which the plaintiff brought a suit against John Hancock Life Insurance Company (USA) and its affiliates ("John Hancock") under the 1940 Act and the Employee Retirement Income Security Act of 1974 ("ERISA") for "allegedly charging their retirement plans excessive fees for annuity insurance contracts offered to plan participants." John Hancock filed a motion to dismiss the case, which the District Court granted. The District Court dismissed the excessive fee claims under the 1940 Act because "only those maintaining an ownership interest in the funds in question could sue under the derivative suit provision . . . and the Participants are no longer investors in the funds in question." The Third Circuit held that continued ownership by a plaintiff throughout the pendency of a litigation is required under Section 36(b) of the 1940 Act and that, if a plaintiff fails to meet the statutory standing requirement of Section 36(b), he cannot use Section 47(b) of the 1940 Act to circumvent it. The District Court had also held that pre-suit demand is required under ERISA. The Third

Circuit vacated this part of the decision and remanded the case for further proceedings with respect to this claim.

L. SEC Fines Adviser for Concealing Quantitative Model Errors

On February 3, 2011, the SEC issued an order against AXA Rosenberg Group LLC, AXA Rosenberg Investment Management LLC, and Barr Rosenberg Research Center LLC (collectively, "AXA Entities") related to concealing errors in their quantitative investment models to their clients.

The order found that the AXA Entities concealed an error in the computer code of the quantitative investment model used to manage client assets that caused approximately $217 million in losses. The order found that in June 2009, senior management at the AXA Entities learned of a material error in the model's code. The error, which was introduced into the model in April 2007, disabled one of the key components in the model for managing risk. The order found that, instead of disclosing and fixing the error immediately, a senior official directed others to keep quiet about the error and declined to fix the error at that time. While the error was eventually fixed for all portfolios, the order found that the AXA Entities made material misrepresentations and omissions concerning the error to clients since statements were made to clients about the model's capabilities at times after the error had been discovered. The order found that the AXA Entities failed to disclose the error and its impact on client performance, attributed the model's underperformance to market volatility rather than the error, and misrepresented the model's ability to control risks.

In addition, the order found that one of the AXA Entities did not have reasonable compliance procedures in place to ensure that the model would assess certain risk factors as intended since the coding process for the model represented a serious compliance risk for that entity because accurate coding is required for the model to function properly and as represented to clients. This finding has sparked considerable discussion in the industry, since it is in the nature of many quantitative portfolio managers to jealously guard the secrets of their computer programming. Some organizations are now considering how that secrecy can be combined with strong compliance oversight.

Without admitting or denying the SEC's findings, the AXA Entities consented to the entry of the order that requires them to cease and desist from committing or causing any violations and any future violations of certain securities laws; censures them; and orders them jointly and severally to pay the $25 million penalty. The order also requires the AXA Entities to comply with certain undertakings, including a payment of approximately $217 million to reimburse clients. The undertakings also include reorganization of compliance functions and the hiring of an independent compliance consultant to conduct a comprehensive review of the overall supervisory and compliance policies and procedures – specifically the disclosure, recordkeeping and reporting processes for the quantitative investment model.

M. SEC and Charles Schwab Reach Settlement

On January 11, 2011, the SEC announced that it had settled a federal court case and related enforcement action against Charles Schwab Investment Management and Charles Schwab & Co., Inc. (collectively, "Charles Schwab") in which the SEC alleged in part that Charles Schwab misled its investors regarding the risks of investing in the Schwab YieldPlus Fund ("Schwab Fund"). The Schwab Fund is an ultra-short bond fund that suffered a significant decline in assets during the credit crisis of 2007-2008. According to the SEC

order announcing the settlement, Charles Schwab allegedly: (1) offered and sold the Schwab Fund as a cash alternative without adequately disclosing the differences between the Schwab Fund and the cash investments with which it was compared; (2) deviated from the Schwab Fund's concentration policy by investing more than 25% of the Schwab Fund's assets in non-agency mortgage-backed securities without obtaining a shareholder vote; (3) made inaccurate statements concerning the Schwab Fund while its net asset value declined; and (4) failed to establish and implement internal controls reasonably designed to prevent the misuse of material nonpublic information. Charles Schwab agreed to pay $118.9 million to settle these allegations.

The SEC also charged two senior executives of Charles Schwab with misleading investors, one on allegations that she made misleading statements about the extent of investor redemptions from the Schwab Fund and the second on allegations that he "authored, reviewed and approved" misleading statements in marketing materials regarding the Schwab Fund's maturity structure. These cases have not settled and are pending in federal court.

N. District Court Applies *Jones v. Harris* in Excessive Fee Case

On December 10, 2010, in one of the first excessive fee cases to be decided since the Supreme Court's decision in *Jones v. Harris ("Jones")*, the U.S. District Court for the District of Minnesota ("District Court") in *Gallus v. American Express Financial Corporation ("Gallus")* relied on *Jones* to reinstate its 2007 order granting summary judgment to the defendant investment advisers. The Gallus plaintiffs are shareholders of mutual funds advised by the defendants. In 2007, the District Court granted the defendants' motion for summary judgment after weighing the evidence under the *Gartenberg* factors. The U.S. Court of Appeals for the Eighth Circuit ("Eighth Circuit") reversed the District Court's ruling, holding that "*Gartenberg* demonstrates one way in which a fund adviser can breach its fiduciary duty, but it is not the only way" and that the District Court should have considered other possible violations of Section 36(b) of the 1940 Act, including the discrepancies between fees charged to the defendants' mutual fund and other institutional clients.

Within days of issuing its decision in *Jones*, the Supreme Court granted the defendants' request to accept an appeal of this case, vacated the Eighth Circuit's opinion and remanded the case to the Eighth Circuit for further consideration in light of *Jones*. The Eighth Circuit then remanded the case to the District Court. In its ensuing opinion, the District Court stated that in "*Jones*, the Supreme Court adopted the *Gartenberg* framework and reasoning that this Court used in reaching its summary judgment opinion. And, in its order reversing this Court, the Eighth Circuit specifically noted that this Court properly applied the *Gartenberg* factors."

O. SEC Files Enforcement Cases against Adviser Firms Solely for Violations of the Compliance Rule

On November 28, 2011, the SEC filed enforcement cases against three investment advisers for failing to adopt or implement compliance procedures designed to prevent securities law violations. The SEC Division of Enforcement's Asset Management Unit prepared the cases as part of an initiative with SEC examiners to ensure investment advisers were complying with Rule 206(4)-7 under the Advisers Act, which requires advisers, among other actions, to adopt and implement written compliance policies and procedures.

In two of the cases, the SEC alleged that the advisers did not satisfy the compliance requirements even though SEC examiners had warned them of deficiencies during prior examinations. In the third case, the SEC found that, even though the adviser had adopted compliance policies and procedures, they were not fully implemented. In an SEC press release, Carlo di Florio, Director of the Office of Compliance Inspections and Examinations, stated, "[w]hen SEC examiners identify compliance deficiencies, firms are expected to remediate them. The Commission will take enforcement action against registrants that fail to do so." The press release states that investigations related to the Asset Management Unit's compliance program initiative are continuing.

P. Morgan Stanley Investment Management Settles with SEC in Connection with Sub-Advisory Fee Arrangement

On November 16, 2011, the SEC issued an order finding that Morgan Stanley Investment Management ("MSIM"), among other violations, failed to disclose to a mutual fund's board of directors (the "Board") material information used by the Board in its approval of an ongoing sub-advisory fee arrangement. Section 15(c) of the 1940 Act requires investment advisers, such as MSIM, to provide mutual fund boards with information that is reasonably necessary to evaluate the terms of any contract needing Board approval. In this case, the SEC found that the information provided to the Board by MSIM did not meet the requirements of Section 15(c), which resulted in the Board approving annually from 1996 to 2007 a sub-advisory contract for advice, research and other services that were not provided.

The SEC found that MSIM "failed to adopt and implement procedures governing its oversight of [the sub-adviser's] services and its representations and provision of information to the Board in connection with the investment advisory contract renewal process." The SEC also found that MSIM had no written procedures governing its oversight of sub-advisers and had no procedure in place to review work done by sub-advisers. Without admitting or denying any findings, MSIM agreed to repay the mutual fund $1.845 million for the sub-adviser's fees and pay a $1.5 million penalty. MSIM also agreed to implement policies and procedures specifically governing the Section 15(c) contract renewal process and its oversight of service providers.

Q. D.C. Circuit Court Vacates the SEC's Proxy Access Rule; SEC Will Not Challenge Decision

On July 22, 2011, the U.S. Court of Appeals for the District of Columbia issued an opinion vacating the proxy access rule adopted last year by the SEC, holding that the SEC "acted arbitrarily and capriciously for having failed …. adequately to assess the economic effects" of the rule. As reported to you previously, the rule would have allowed shareholders of public companies, including mutual funds, to have their director nominees added to the company's proxy materials under certain circumstances. Although the SEC adopted the rule in August 2010, the agency stayed its effectiveness pending the outcome of this case.

The court determined that "the [SEC] inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters." The court agreed with the petitioners that "the [SEC]'s prediction that directors might choose not to oppose shareholder nominees had no basis beyond mere speculation." In this regard, the court stated that, while "a board, consistent with its fiduciary duties, might forgo expending

resources to oppose a shareholder nominee," the SEC "presented no evidence that such forbearance is ever seen in practice." The court agreed with the petitioners' argument that the SEC had "relied upon insufficient empirical data when it concluded that [the proxy access rule] will improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees." Additionally, the court stated that the SEC had "discounted the costs" of the rule, "but not the benefits – as a mere artifact of the state law right of shareholders to elect directors." The court also expressed the view that the SEC had acted arbitrarily by "ducking serious evaluation of the costs that could be imposed upon companies from use of the rule by shareholders representing special interests, particularly union and government pension funds."

With respect to investment companies, the court agreed with the petitioners (and with positions taken by the ICI and the Independent Directors Council) that the SEC had not adequately addressed whether the regulatory requirements of the 1940 Act reduced the need for, and thus the benefit of, proxy access for investment company shareholders, and whether "the rule would impose greater costs upon investment companies by disrupting the structure of their governance." The court cited the SEC's failure to respond to concerns that the rule "will impose greater costs upon investment companies by disrupting their unitary and cluster board structures with the introduction of shareholder-nominated directors who sit on the board of a single fund, thereby requiring multiple, separate board meetings and making governance less efficient." The court also cited the SEC's failure to address the probability that "the rule will be of no net benefit as applied to investment companies." In this regard, the court noted that the SEC did not consider that the less frequent use of the rule by investment company shareholders would reduce the expected benefits of the rule. The court also noted that the SEC's assertion that confidentiality agreements for shareholder-nominated directors could meaningfully reduce the costs was unsupported and unresponsive to investment company claims because these individuals would have no fiduciary duties to other funds in a complex.

The court concluded its opinion by addressing the SEC's observation that "any increased costs and decreased efficiency of an investment company's board as a result of the fund complex no longer having a unitary or cluster board" would occur only if a shareholder nominee is elected to the board. The court responded that "this rationale is tantamount to saying the saving grace of the rule is that it will not entail costs if it is not used or at least not used successfully to elect a director. That is an unutterably mindless reason for applying the rule to investment companies."

On September 6, 2011, the SEC stated that it would not challenge the decision by the court. In announcing this decision, SEC Chairman Mary L. Schapiro stated that she wanted "to be sure that we carefully consider and learn from the [c]ourt's objections as we determine the best path forward." She indicated that she still believed that "providing a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies is in the best interest of investors and our markets" and noted that the staff was continuing to review the decision and the comments received on the overturned rule.

R. <u>SEC Fines Morgan Keegan & Company and Morgan Asset Management</u>

On June 22, 2011, the SEC, FINRA and certain state regulators announced that Morgan Keegan & Company and Morgan Asset Management (collectively, "Morgan Keegan") agreed to settle charges related to valuation of subprime mortgage-backed

securities. Two Morgan Keegan employees also agreed to pay penalties for their alleged misconduct.

The SEC alleged that Morgan Keegan failed to appropriately follow pricing procedures for certain Morgan Keegan investment companies during a period in 2007. In addition, the SEC found that a former portfolio manager instructed Morgan Keegan's fund accounting department to make "price adjustments" to the fair values of certain portfolio securities, which did not reflect lower values for those same securities provided by other broker-dealers as part of the pricing process, and often lacked a reasonable basis. The SEC further found that the former portfolio manager screened and influenced the price confirmations obtained from at least one broker-dealer. According to the SEC, through his actions, the former portfolio manager fraudulently prevented a reduction in the value of securities held in the funds that should otherwise have occurred as a result of the deterioration in the subprime securities market in the first half of 2007. The SEC noted that his actions were not disclosed to the boards of directors of the funds involved. In the view of the SEC, this misconduct occurred in the context of a failure by Morgan Keegan to follow the policies and procedures adopted by the funds' boards of directors to fair value the funds' portfolio securities.

Under the settlement, Morgan Keegan agreed to pay $25 million in disgorgement and interest and a $75 million penalty to the SEC to benefit affected investors. Morgan Keegan also agreed to pay $100 million into a state fund that will be distributed to investors. In addition, the firms agreed not to be involved in the pricing of fair valued securities on behalf of any registered investment company for three years. The former portfolio manager agreed to pay $500,000 in penalties and be barred from the securities industry; the Morgan Keegan comptroller agreed to pay a penalty of $50,000, to a suspension from association with securities industry members for 12 months and to denial of the privilege of practicing before the SEC as an accountant. None of the respondents admitted or denied the SEC's allegations.

K&L GATES

AIFMD Update

27 June 2012

Martin Cornish, Partner, London
Philip Morgan, Partner, London

www.klgates.com

Copyright © 2012 by K&L Gates LLP. All rights reserved.

Introduction

- How do AIFMD, MiFID and UCITS interact?
- What are the next milestones?
- A few miscellaneous timing considerations.
- What is going on with Level 2?
- What strategies should managers be considering?
- Avoiding/minimising AIFMD impact.
- What should managers be doing now?

How do AIFMD, MiFID and UCITS interact?

- Activities of ‘external’ AIFM limited by AIFMD (Article 6), similar to the approach under UCITS:
  - portfolio/risk management of AIF;
  - other functions in the course of the above – administration; marketing; related advice;
  - separate account management*;
  - investment advice*;
  - safe keeping and administration re. shares/units in CISs*;
  - reception and transmission of orders re. financial investments*
- NOT, e.g., dealing on own account or execution of orders on behalf of clients in MiFID terminology.
- May also be authorised to manage UCITS under UCITS IV: in this case duel AIFMD/UCITS regulation.

How do AIFMD, MiFID and UCITS interact?

- Thus MiFID firm or UCITS management firm that is an AIFM will need to transition from MiFID authorisation to AIFMD or AIFMD/UCITS authorisation.
- However non-core services (see asterisked services on previous slide) still subject to MiFID minimum capital requirements; organisational requirements (e.g., conflict management; personal transactions; outsourcing of critical functions; responsibilities of senior management; record keeping and investment research) and conduct of business requirements (e.g. fair, clear and not misleading communications; inducements, retail client agreements, suitability/appropriateness tests).

How do AIFMD, MiFID and UCITS interact?

- MiFID firm outside the scope of AIFMD will remain a MiFID firm (but note the position of small AIFMs!), although subject to AIFMD in relation to the marketing of AIFs.

In terms of prudential categories the FSA envisages:

- internal AIFMs (AIFMD);
- external AIFMs (AIFMD);
- AIFM investment firms (AIFMD/MiFID);
- UCITS AIFM firms (UCITS/AIFMD);
- UCITS AIFM investment firms (UCITS/AIFMD/MiFID).

How do AIFMD, MiFID and UCITS interact?

- UK is considering how to implement ‘minimum registration regime’ for small AIFMs. Options under consideration are:-
  - Fully applying AIFMD to all small AIFMs (albeit in a “proportionate” way); or
  - Applying a lighter regime selectively to some small AIFMs.
- Many small AIFMs already subject to MiFID regulation, but not all (e.g. small internally-managed investment trust), and there are additional obligations under AIFMD – e.g. depositary, use of leverage, private equity provisions.

How do AIFMD, MiFID and UCITS interact?

- Under second approach, could more-or-less replicate the status quo.
- It seems that the UK is not considering applying the minimal registration regime to all small AIFMs, as is allowed under AIFMD, to the extent such small AIFMs are currently regulated under MiFID – i.e. they don’t want anyone that is currently FSA authorised to cease to require that authorisation – this is gold plating. Other gold plating seems likely – e.g. approved persons regime.

How do AIFMD, MiFID and UCITS interact?

- NB – small AIFM subject to minimal registration regime allowed under AIFMD could delegate to a non-AIFM that must be FSA authorised under MiFID – odd anomaly.

What are the next milestones?

- adoption of EU Commission's implementing measures – i.e. level 2 (possibly July, possibly later);
- FSA Consultation Paper re. transposition in the UK (Q3 or Q4 2012) – NB possible new FSA Sourcebook – FUND (UCITS and AIFMD);
- HM Treasury Consultation Paper re. transposition in the UK (Q3 or Q4 2012);
- equivalent documents re. transposition in other EU jurisdictions – and any proposals regarding amendments to private placement exemptions;

What are the next milestones?

- offering of depositary services (presumably soon after completion of level 2);
- FCA hopes to be in a position to receive AIFM applications for authorisation from Q2 2013 – it will be necessary to be an authorised AIFM to benefit from the EU passport from 22 July 2013.

A few miscellaneous timing considerations

- AIFMs which perform activities under AIFMD pre-22 July 2013 are required to apply for authorisation before 22 July 2014 (A.61(1)).
- Query what happens in the interim – it appears that to some extent national authorities may have discretion as to how much of AIFMD must be applied ahead of an AIFM becoming formally authorised.
- FSA/HM Treasury have not yet offered hints as to how they may interpret this transitional provision
- May leave the door open for some flexibility in the local implementation timetable.

A few miscellaneous timing considerations

- The rule that EU AIFs must have their depositary established in the home Member State of the AIF is suspended for four years. We understand that Maltese lobbying contributed to this position.
- AIFM managing closed-ended AIF pre 22 July 2013 that do not make additional investments after that date may continue to manage the AIF without authorisation. Query – exact meaning of additional investments?
- AIFM managing closed-ended AIF whose subscription periods closed pre 22 July 2011 and have a life expiring on or before 22 July 2016 are exempt other than annual reporting requirements and private equity – specific provisions (A.26-30). Query – effect of possible term extensions?

What is going on with level 2?

- The EU Commission has made a few key changes to the ESMA recommendations in first and second drafts of their implementing measures.
- AIMA (amongst others) has made representations on certain problematic provisions but now reports to us that the Commission is not taking further external representations or being open as to the process of finalising level 2.
- It appears that politics is continuing to influence what are supposed to be technical considerations.

What is going on with level 2?

- Key outstanding issues (at least from the point of view of the asset management industry) include:
    - Delegation – meaning of ‘letter box entity’. ESMA – AIFM must retain the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with delegation; AIFM also must have power to perform senior management functions, especially re. implementation of investment policies etc.

What is going on with level 2?

EU Commission adds:

1. AIFM retains contractual rights to inquire, inspect, have access or give instructions to delegates and the exercise of such rights is practically possible;
2. the totality of the individually delegated tasks do not substantially exceed the tasks remaining with the AIFM.

What is going on with level 2?

- Delegation – consequences of additional tests –
  - many UCITS managers fail on last limb;
  - confuses everyday tasks with ultimate legal authority;
  - undermines ability to delegate (e.g. in international strategies; impact on U.S. managers with UK offices);
  - lose benefit of dual-authorised UCITS/AIFM management companies – i.e. AIFM could not delegate day to day portfolio and risk management as UCITS management company is permitted to do (e.g. to a MiFID manager).

What is going on with level 2?

- Delegation – Commission has introduced new uncertainty as to the required local regulation of AIFM delegates who perform portfolio management and/or risk management – Article 20(1)(c) – must be authorised or registered for the purposes of asset management and subject to supervision. ESMA recommendation, rejected by EU Commission) was that the required authorisation is “based on local criteria”, and that the effective supervision is by an “independent competent authority”.

What is going on with level 2?

- Depositaries – EU Commission has omitted ESMA recommendation that it be made clear that fund assets provided as collateral under a title transfer collateral arrangement or a security financial collateral arrangement under which control or possession of the financial instruments is transferred from the fund or depositary to the collateral-taker are excluded from the financial instruments required to be held in custody by the depositary under AIFMD. Potentially highly significant for the maintenance of existing mechanisms for taking collateral.

What is going on with level 2?

- Third Country Co-operation Arrangements – EU Commission seems to require that these are legally binding, which will make them very difficult to conclude. We understand that regulators have been using a form of non-binding IOSCO memorandum of understanding. This could have a very substantial impact on the operation of the third country regime under AIFMD.
- Method of calculating leverage – we understand that the Commission may be conceding that an "Advanced Approach" for calculating leverage may be necessary/appropriate in certain cases.

What strategies should managers be considering?

- AIFMD in force from 1 July 2013
- Doing nothing not an option for EU AIFM and perhaps a risky option for non-EU AIFM
- Two basic AIFMD Strategies:
  - Avoiding/minimising AIFMD impact
  - Utilising the passport from 2013

Strategy options

Broadly:

1. EU Investment Managers

- Must apply for an AIFM permission early 2013 – subject to transitional provisions
- Only EU AIFM can initially obtain the benefit of the passport and only in respect of EU funds – until at least 2015
- EU AIFM can manage non-EU funds; and market non-EU funds within Europe; but will be subject to reporting and other rules with respect to such non-EU funds (but no depositary or annual report if not marketed within the EU)
- Marketing non-EU funds within the EU assumes reliance on current private placement rules or reverse solicitation

Strategy options

2. Non-EU Investment Managers

- Non-EU managers will need to set up EU AIFM ***and*** an EU Fund by July 2013 if they want the passport before 2015; or
- Could employ 3rd party EU AIFM to act as AIFM of EU Funds under a fee sharing arrangement; or
- Employ 3rd party EU AIFM to act as AIFM of EU Funds and sub-delegate back to the non-EU manager – but NB requirement that AIFM not a 'letter-box'

How do Non-EU managers get the passport?

(2. Non-EU Investment Managers cont.)

- EU fund could be mere feeder fund to Cayman/other funds but such funds will not have passport rights pre-2015
- Doing nothing implies reliance on current private placement regime and/or reverse solicitation
- From 2015, non-EU AIFM of EU and non-EU AIFs may be able to obtain a passport subject to ESMA advice and satisfaction of various conditions by the non-EU AIFM, the funds and their depositaries

Avoiding/minimising AIFMD impact – why?

- Limited benefits of passport for some AIFM – e.g. if mainly/exclusively target non-EU investors
- Cost of compliance unknown but extends to operational costs of EU and non-EU AIFs as well as compliance and other costs for the AIFM and could be significant
- Depository costs estimates at 1-2% of AUM
- EU AIFM will be subject to most AIFMD rules even if they only manage non-EU AIF and do not market in the EU

Avoiding/minimising AIFMD impact – why?

- If EU AIFM market in the EU, their non-EU AIF must comply with AIFMD req'ts
- Time to market likely to be delayed due to FSA consent to each fund launch

Avoiding/minimising AIFMD impact – why?

Detailed Compliance Examples: Depositary req'ts:

- EU funds must have a depository with wide ranging powers and obligations extending well beyond being a mere custodian including specific duties such as oversight of AIFM, limits on delegation and 'strict' responsibility for loss
- Even non-EU AIFs managed and marketed within the EU by EU AIFM must have a service provider providing the depositary function, albeit not subject to the onerous depositary liability provisions/limits on delegation etc.

Avoiding/minimising AIFMD impact – why?

(*Depositary req'ts – Cont.*):

Other Req'ts:

- Capital requirements (increased from €50,000 to €125,000 or 0.02% if AUM >€250m)
- Limits on permitted activities of AIFM
- Remuneration rules
- Provision of information on all AIFs

K&L GATES

Avoiding/minimising AIFMD impact – why?

- Limits on sub-delegation and including cooperation agreements with 3rd country delegates
- Leverage rules
- Professional indemnity and insurance req'ts
- Obligations to investors – e.g. req't to 'treat all investors fairly'
- 3rd country rules (including depositary requirements)

Avoiding/minimising AIFMD impact – why?

- Due diligence req'ts concerning investments
- Written policies to ensure investment policies are carried out in accordance with investment objectives, risk parameters etc
- Assess 'all relevant legal, fiscal, financial or other value-affecting factors, human and material resources as well as strategies including exit strategies'
- AIFM responsible for valuations

Avoiding/minimising AIFMD impact – why?

- AIFM responsible for overall management of AIF – not just investment management
- Including provision of subscription and redemption information to investors, selection of counterparties, including PBs, all of which must be regulated, ensuring daily reports by PBs to depositaries
- Separation of risk management from other functions
- Must set maximum levels on leverage and use/reuse of collateral
- Liquidity management req'ts and stress tests and alignment with redemption policy
- Securitisation rules

Avoiding/minimising AIFMD impact – why?

- Aggregate AUM <€100m or <€500m if unleveraged and closed ended for 5 years
- Self managed funds
- Put the AIFM outside the EU
- AIFMD envisages a single AIFM for each fund – i.e. an overall manager with responsibility for overall management
- “Managing” defined as “at least” investment management and risk management
- Restrict EU activities to advice, research etc?

Avoiding/minimising AIFMD impact – why?

- NB must not be a 'letter-box entity':
- Must retain necessary expertise and resources
- Must have power to take key decisions
- Offer managed accounts only
- Offer structured products – bonds, notes, insurance contracts, linked deposit accounts

What should managers be doing now?

- Examine current and future marketing strategies – countries, methods (direct, through intermediaries)
- Examine number of EU investors in existing funds
- Do they have EU AIFMs?
- What will the depositary req'ts be for existing funds – EU/non-EU
- Will depositaries be interested in acting/what will their costs be, where must they be located?
- Are my funds of sufficient size to be of interest to depositaries/will costs be unacceptable to investors

What should managers be doing now?

- Do managers have existing offshore operations – e.g. Hong Kong/Singapore/Jersey/Guernsey etc?
- Are they undertaking portfolio management or merely marketing, research, advisory or other services
- Could I/should I move portfolio and risk managers offshore so that AIFM is outside the EU?
- What local licensing/other permissions would managers need to consider in offshore jurisdictions
- Tax?

What should managers be doing now?

- If EU funds are small, consider closing them down/merge with other funds
- Merge with other managers to obtain critical mass/reduce operating costs?
- Find 3rd parties willing to act as AIFM (onshore or offshore) – outsourced type arrangement
- Find 3rd parties willing to offer structured products

K&L GATES

Martin W Cornish
Partner
London
Tel: +44.20.7360.8162
martin.cornish@klgates.com

Philip Morgan
Partner
London
Tel: +44.20.7360.8123
philip.morgan@klgates.com

Alice Bell
Assistant
London
Tel: +44 207 360 8304
Alice.bell@klgates.com

Cynthia Ma
Senior Associate
London
Tel: +44.(0).20.7360.8115
Cynthia.ma@klgates.com

Oliver Pilkington
Senior Associate
London
Tel: +44.20.7360.8145
Oliver.pilkington@klgates.com

Elizabeth Winder
Associate
London
Tel: +44 207 360 8126
Elizabeth.winder@klgates.com