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From the Editors

In response to the current multi-faceted financial crisis, governments have shown that they are prepared to take extreme steps to avert economic meltdown. In addition to short-term emergency measures, there is a growing readiness to bring tighter regulation to bear on financial services businesses going forward. This historic reshaping of global financial markets poses unprecedented challenges to an investment management industry struggling to make sense of the new world order.

In the space of a few days, the U.S. Treasury Department ("Treasury") announced a plan to take over the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), offered a temporary government guaranty of money market fund holdings, and put forward a proposal to buy $700 billion of devalued mortgages and mortgage-related securities from financial institutions. In addition, the U.S. Federal Reserve ("Fed") announced that it would provide American International Group, Inc. ("AIG") with an unprecedented $85 billion, two-year loan in return for a 79.9% equity stake in AIG.

This historic reshaping of global financial markets poses unprecedented challenges to an investment management industry struggling to make sense of the new world order.

Across the Atlantic, the UK government has disapplied merger regulations to allow the merger of UK high street giants Lloyds TSB and HBOS. And, the UK's Financial Services Authority was the first of a number of international regulators to implement restrictions on short selling.

The multi-jurisdictional efforts to stem short selling raise complex questions for funds that operate globally. In addition to the United States and the UK,

authorities in jurisdictions including Australia, Belgium, Canada, France, Germany, Ireland, Luxembourg, the Netherlands, Portugal, Spain, Switzerland, and Taiwan have announced comparable regulatory actions. For more information on developments in international short selling regulation, see *DechertOnPoint*, Issue 25 (September 2008), available at www.dechert.com/library/FS_25_09-08_International_Short_Selling_Regulation.pdf. For our responses to some of the questions we are being asked most frequently with respect to the steps taken by the U.S. Securities and Exchange Commission ("SEC"), see *DechertOnPoint*, Issue 26 (September 2008), available at www.dechert.com/library/FS_26__09-08_Frequently_Asked_Questions_About_Recent_SEC_Orders.pdf.

These are one-off, short-term measures but it seems certain that governments will have a heavier hand in financial market regulation over the longer term as well.

The very nature of investment banking has been shaken by the Fed's move on September 21 to permit Wall Street's last two independent investment banks, Morgan Stanley and Goldman Sachs, to become bank holding companies, which will be subject to new capital requirements and federal banking regulatory oversight.

Further, on September 23, SEC Chairman Christopher Cox called for the regulation of credit default swaps. The prior day, New York Governor David Patterson announced that, in January 2009, the state will begin to regulate some credit default swaps as insurance.

In addition to the regulatory actions taken by the SEC, the agency announced on September 19 that it was expanding its ongoing investigation into possible market manipulation in the securities of certain financial institutions. The announcement further indicated that the SEC had approved a formal order of investigation allowing its enforcement staff to obtain documents and testimony by subpoena.

This issue of our quarterly report includes articles analyzing the U.S. and UK short sales bans and the Treasury's plan for Fannie Mae and Freddie Mac. Looking at the role of government in the financial sector from another perspective, we consider sovereign wealth funds as a source of capital for troubled financial institutions.

In addition to these more in-depth articles on current developments, the following is a summary of some recent developments as we go to press.

Emergency Economic Stabilization Act of 2008

The U.S. Congress is considering the $700 billion Emergency Economic Stabilization Act of 2008 (the "Act"). The House of Representatives defeated the Act on September 29, 2008. The Senate passed a revised Act on October 1, 2008 and the House is expected to consider and vote upon the revised Act by the end of the same week.

Providing Support to Money Market Funds

On September 19, 2008, U.S. money market mutual funds received a boost from the Treasury, which took the dramatic step of offering a temporary government guarantee of money market funds. The Treasury took action after a money market fund, the Reserve Primary Fund, announced that it was freezing withdrawals after its net asset value per share fell below $1—known as "breaking the buck."

The Treasury's guarantee program (the "Treasury Guarantee Program" or the "Program") will insure the holdings of any publicly offered money market mutual fund managed in compliance with Rule 2a-7, including funds offered to retail and to institutional customers. The Treasury Guarantee Program would cover both taxable and tax-exempt money market funds. Under the Program, guarantee amounts for investors would not be capped—by contrast to the Federal Deposit Insurance Corporation's limit on insurance of ordinary bank deposits to $100,000 per depositor (proposed to be increased to $250,000 under the Senate's revised Act).

Though sweeping, the Treasury Guarantee Program has limitations. First, the Program will only provide coverage to money market fund shareholders for amounts held by them in such funds as of the close of business on September 19, 2008. Second, the Program will only last for a limited period of time not to exceed one year. The initial term of the Program is three months, which may be extended by the Secretary of the Treasury. Participation in the Program is voluntary, so a fund must elect to participate and must pay premiums to do so.

The Federal Reserve also took additional action to support money market funds, adopting an Interim Final Rule expanding an emergency lending program aimed at fostering liquidity in the asset-backed commercial paper market. Under this expanded program, banks are allowed to purchase asset-backed commercial paper ("ABCP") from money market funds and pledge the purchased ABCP as collateral for loans from the Fed window. Importantly, those loans would be non-recourse to the bank. The Rule also exempted ABCP held by state banks and bank holding companies under the program from applicable leverage and risk-based capital rules. These moves by the Fed were intended to mitigate temporary stresses faced by money market funds by encouraging banks to purchase ABCP from money market funds.

For more information on the Treasury Guarantee Program and the Federal Reserve's ABCP lending program, see "New Money Market Fund Stabilization Measures," *DechertOnPoint*, Issue 28 (September 2008), available at www.dechert.com/library/FS_28_09-30-08.pdf.

Unwinding Lehman Counterparty Trades

Previous Lehman counterparties, including a number of funds, are facing a complicated morass of legal issues following the collapse of the bank. Although a U.S. bankruptcy judge approved the sale of certain of Lehman's

U.S. operations to the UK's Barclays PLC on September 20, information as to the distribution of the remainder of its assets and—of more concern—the client account balances held as custodian, remains unknown at the time of writing. Among other matters, this raises potential systemic issues.

In addition to defaulted trades, many of Lehman's custody and prime broking services operated through Lehman Brothers International (Europe) in London, which is currently in administration and there is continuing uncertainty as to where, and under what rules, client assets were actually held, and how quickly they can be returned.

Money Funds Seek Relief from the SEC Staff

As the U.S. money market fund industry was confronted by a growing lack of liquidity in the market for commercial paper and short-term corporate notes, as well as substantial net redemptions, many fund groups turned to transactions with affiliates to obtain the necessary liquidity to meet redemptions and to support their funds' maintenance of a $1 share price. While SEC rules permit an affiliate to purchase defaulted or downgraded securities from a money market fund, fund groups found themselves faced with a liquidity crunch in securities that were still Eligible Securities under Rule 2a-7 and thus ineligible for affiliated purchase under SEC rules. A number of fund groups turned to the SEC Staff for no-action relief to permit affiliate purchases of Eligible Securities from their funds. Other complexes, faced with holdings of paper whose market value had dropped due to market illiquidity, credit concerns, or both, requested and received no-action relief from the SEC Staff allowing them to support their funds' ability to maintain a dollar share price through Capital Support Agreements tied to specific fund assets. Recognizing the urgency of these requests, the SEC Staff frequently has provided relief on an expedited, often same day, basis.

Our Financial Services Group will keep you informed of future developments as they occur, and our regular OnPoints and Client Alerts on these and related topics are available at www.dechert.com/practiceareas/practiceareas.jsp?pg=legal_update&pa_id=19.

SEC and FSA Take Series of Actions to Clamp Down on Short Sales

by **Jennifer O. Epstein**, **Elliott R. Curzon** and **Richard Heffner**

Securities regulators from a number of countries recently have taken actions designed to curtail short selling in an effort to stabilize the financial markets. This article highlights recent regulatory activities by the U.S. Securities and Exchange Commission ("SEC") designed to limit abusive short sales and increase market transparency and liquidity and the UK Financial Services Authority ("FSA") designed to prohibit the active creation or increase of net short positions in publicly quoted financial companies.

United States

Short Selling Emergency Order

On September 17, 2008, the SEC issued an emergency order adopting a new temporary rule imposing restrictions designed to curb naked short selling and the resulting delivery failures and a new anti-fraud rule applicable to short sellers who fail to deliver securities by the delivery date (the "Short Selling Emergency Order"). The Short Selling Emergency Order, which applies to all transactions in equity securities effected, cleared, or settled by or through U.S. broker-dealers or clearing agencies, took effect at 12:01 AM EDT on September 18, 2008. At the same time, SEC Chairman Christopher Cox and Director of the Division of Enforcement Linda Thomsen announced expanded efforts to investigate and prosecute market manipulation effected through abusive short-selling. On September 18, New York Attorney General Andrew Cuomo announced "a wide-ranging investigation" into short selling in the stock of financial services firms.

The SEC addressed three particular aspects of short selling in the Short Selling Emergency Order. The first of the new temporary regulations will require sellers and their broker-dealers to deliver the securities for settlement of any long or short sale in any equity security to the

buyers by the regular settlement day (T+3). The SEC's new regulations also will eliminate the options market maker exception to Rule 203(b)(3) of Regulation SHO, thereby requiring options market makers to abide by the same close-out requirement as all other short sellers. Further, the Short Selling Emergency Order addresses fraudulent short-selling transactions by providing that lying about one's intention or ability to deliver securities within three days after a short sale constitutes a violation of the law when the seller fails to deliver.

Chairman Cox and Director Thomsen emphasized that the SEC will back these new rules, as well as existing anti-fraud and anti-manipulation rules, through expanded enforcement efforts.

On September 18, 2008, the SEC released three further emergency orders to increase market transparency and liquidity. According to the SEC press release, the SEC, "acting in concert with" the FSA, took these temporary actions to prohibit short selling in financial companies "to protect the integrity and quality of the securities market and strengthen investor confidence." On September 21, 2008, the SEC released technical amendments to two of those orders.

Chairman Cox and Director Thomsen emphasized that the SEC will back these new rules, as well as existing anti-fraud and anti-manipulation rules, through expanded enforcement efforts.

Ban on Short Selling "Covered Securities"

The first of the three emergency orders imposes a ban on short selling in the securities of financial institutions (the "Financial Firms Order"). This action follows an SEC emergency order issued in July limiting short sales in Fannie Mae, Freddie Mac and 17 other financial firms. The SEC amended the original Financial Firms Order on September 21, 2008.

To prevent substantial disruption in the securities markets, the Financial Firms Order (as amended) temporarily prohibits any person (with five limited exceptions) from effecting a short sale in the publicly traded common equity securities of any issuer identified by any U.S. national securities exchange listing such securities as being a financial institution (each a "Covered Security").

Each national securities exchange has published a list on its website of the individual listed companies with common equity that will be covered by the Financial Firms Order (as amended), and these lists are expected to include banks, savings associations, broker-dealers, investment advisers, and insurance companies, whether domestic or foreign, and the owners of any of those entities. The national securities exchanges are authorized to exclude any issuers that do not want to be treated as a Covered Security under the Financial Firms Order (as amended).

The Financial Firms Order became effective immediately upon its release on September 18, 2008.

Disclosure of New Short Positions

This emergency order requires certain institutional investment managers to report information concerning daily short sales of securities (the "Disclosure Order"). Like the Financial Firms Order, the Disclosure Order was amended on September 21, 2008. The Disclosure Order applies to all institutional investment managers that exercise investment discretion with respect to accounts holding section 13(f) securities having an aggregate fair market value on the last day of trading of any month of any calendar year of at least US$100,000,000, and that were required to file a Form 13F for the calendar quarter ended June 30, 2008. Form SH, which is to be filed electronically on the SEC's EDGAR system, requires disclosure, for each calendar day of the prior week, of designated information in regards to each section 13(f) security.

Form SH only requires disclosure for short sales effected after the Disclosure Order became effective at 12:01 AM EDT on September 22, 2008, with the first Form SH disclosure to be filed on September 29, 2008.

Relaxation of Limitations on Issuers Repurchasing Their Own Securities

The third emergency order was designed to provide flexibility to issuers conducting repurchases of their own securities pursuant to the safe harbor under Rule 10b-18 of the Securities Exchange Act of 1934, as amended ("Repurchase Order"). The Repurchase Order alters the timing and volume conditions in Rule 10b-18 by suspending the timing provisions in paragraphs b(2)(i), (b)(2)(ii) and (b)(2)(iii) under the Rule and providing that the volume of purchases may not exceed 100% of the ADTV for the security. The Repurchase Order became effective at 12:01 AM EDT on September 19, 2008.

SEC Announces Extension of Short Selling Orders

On October 1, 2008, the SEC released a statement concerning short selling in which it announced that it was extending the effectiveness of the four short selling orders in order to "provide clarity about the future expiration of these actions . . . [and] to allow time for the completion of work on the anticipated passage of legislation." In the same statement, the SEC also announced that it intends to release interim final rules to continue some of the requirements without interruption following the expiration of the relevant orders.

United Kingdom

With effect from 12:01 AM on September 19, 2008, the FSA implemented new requirements prohibiting new or increased short positions in any publicly-traded UK bank, UK insurer or any other UK-incorporated company that heads a financial services group with a UK bank or insurer as a member. The new requirements also compel disclosure of any pre-existing short position in such companies which represents a net economic interest of 0.25% or more of the company's issued capital. They were approved by the FSA board on September 18 using emergency powers, and their text was published only a few hours before coming into effect.

These measures follow similarly structured requirements imposed in June 2008—also using emergency powers—to require disclosure of short positions of 0.25% or more in UK listed companies involved in a rights issue. As with the June short selling measures, the requirements form part of the FSA's Code of Market Conduct and represent the FSA's opinion that such short positions constitute market abuse.

Prohibitions of Short Positions

The requirements prohibit the establishment (or the increase) of any net short positions in relevant UK financial sector companies.

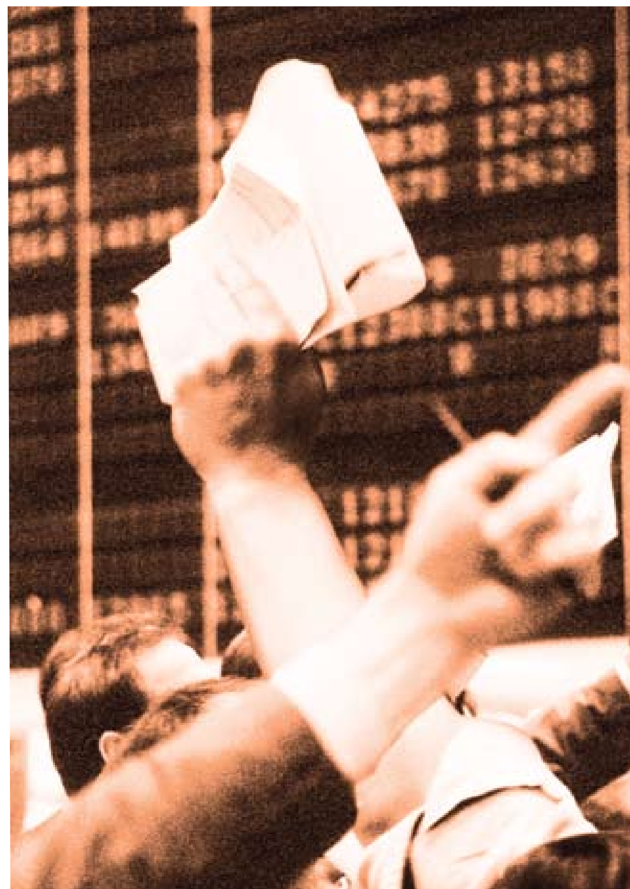
The new short selling requirements' definition of "UK financial sector company" limits its application to UK incorporated banks, general insurers with their head office in the UK and other UK incorporated companies with such a UK bank or insurer as a subsidiary where the main business of the group is financial services. The FSA has issued a list, compiled on a "best efforts" basis, of companies it believes are currently covered by the new requirements.

The new prohibitions exclude any transactions entered into and orders placed before September 19. They also exempt short positions by market makers.

Disclosure of Short Positions

The disclosure obligations fall on a holder of a "disclosable short position", meaning any "net short position" that represents an economic interest of 0.25% or more of the issued capital of a relevant UK financial sector company.

Where an investment manager or authorised fund manager manages discretionary client portfolios containing relevant short positions, the disclosure obligation applies at the level of both the entity to which the prohibition applies and at the level of the investment manager or authorised fund manager. However, the discretionary fund manager may make a net short position disclosure on behalf of its client. In respect of itself, the investment manager or authorised fund manager is required to disclose its aggregate net short position across all of the funds it manages on a discretionary basis. Where a disclosure by an investment manager or authorised fund manager is the same as that being made for its client/fund/sub-fund, it is permitted to make a single disclosure provided that the disclosure makes it clear that it applies to both parties.



In the case of non-discretionary or advisory clients, the disclosure obligation will fall on the individual client. The investment manager may make a net short position disclosure on behalf of its client, but this disclosure must clearly identify that it is the client who holds the disclosable position.

Where the disclosure obligation applies, the holder is required to make "adequate ongoing disclosure", which means an announcement on the Regulatory Information Service ("RIS") no later than 3:30 PM on the business day following each day on which the disclosable short position (0.25%) is held. Once a holder's relevant net short position falls below 0.25%, a final disclosure of that fact is also required.

The new requirements will expire on January 16, 2009.

Further Information

For a more detailed discussion of the SEC and FSA regulatory actions, please refer to "SEC and FSA Take Action to Limit Abusive Short Sales," *DechertOnPoint*, Issue 23 (September 2008), available at www.dechert.com/library/FS-09-18-08.pdf, "SEC and FSA Clamp Down on Short Selling of Financial Firms," *DechertOnPoint*, Issue 24 (September 2008), available at www.dechert.com/library/FS_24_9-08_SEC_FSA_Clamp_Down_Supp.pdf, and "SEC Announces Extension of Short Selling Orders," *DechertOnPoint*, Issue 29 (October 2008), available at www.dechert.com/library/FS_29_09-08_SEC_Announces_Extension_of_Short_Selling_Orders.pdf. For a list of questions and answers pertaining to the SEC's orders relating to short sales, please refer to *DechertOnPoint*, Issue 26 (September 2008), available at www.dechert.com/library/FS_26_09-08_Frequently_Asked_Questions_About_Recent_SEC_Orders.pdf.

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U.S. Treasury Department Releases Plan for Takeover of Fannie Mae and Freddie Mac

by **Brendan C. Fox** and **Stephen H. Bier**

On September 7, 2008, Secretary Paulson of the U.S. Department of the Treasury (the "Treasury") announced a comprehensive plan to take over the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and to provide them with needed capital and liquidity. The plan is designed to provide stability to the financial markets, and support the continued availability of mortgage financing for the housing market, but accomplish these goals while minimizing risk to U.S. taxpayers. The Treasury's plan involves four key components: (1) placing Fannie Mae and Freddie Mac under the authority of a conservator (the Federal Housing Finance Agency ("FHFA"); (2) establishing a preferred stock purchase plan by the Treasury to capitalize Fannie Mae and Freddie Mac; (3) allowing the Treasury to purchase mortgage-backed securities ("MBS") issued by Fannie Mae and Freddie Mac; and (4) establishing a secured credit facility where Treasury will make loans available to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Background

Fannie Mae and Freddie Mac are government-sponsored corporations owned by private stockholders. They were created by Congress for the purpose of increasing the availability of mortgage credit for residential housing. Fannie Mae and Freddie Mac purchase residential mortgages from mortgage originators such as mortgage bankers, commercial banks, savings and loan associations, and credit unions, and in turn issue MBS certificates, the interest and principal on which they guarantee, but which are not backed by the full faith and credit of the U.S. government. Notwithstanding the lack of an explicit U.S. government guarantee, the companies' unique and somewhat ambiguous status as government sponsored enterprises ("GSEs"), coupled with the huge role they play in the nation's mortgage market, has caused the financial markets to treat their mortgage-backed securities as subject to an implicit government

guarantee, and to assume that the U.S. government would step in to prevent Fannie Mae and Freddie Mac from failing.

Because of the recent difficulties faced by the U.S. housing and mortgage markets and the related concerns regarding Fannie Mae's and Freddie Mac's capital levels, on July 30, 2008, Congress passed the Housing and Economic Recovery Act of 2008. That legislation approved the Treasury's plan to authorize the government to buy stock of Fannie Mae and Freddie Mac, and to increase temporarily their credit lines from the Treasury to meet short-term capital needs. In addition, the Federal Reserve voted to allow the Federal Reserve Bank of New York to lend emergency capital to Fannie Mae and Freddie Mac, if needed. On September 7, 2008, the Treasury, the Federal Reserve, and the FHFA announced that they are taking a number of steps under this legislation to protect the stability and liquidity of Fannie Mae and Freddie Mac.

The Treasury's proposal is intended to ameliorate the current disruptions in the housing and financial markets at minimal taxpayer expense, and involves the following:

Conservatorship

As a condition to contributing taxpayer money to support Fannie Mae and Freddie Mac, the Director of the FHFA placed both companies under the conservatorship of the FHFA. Pursuant to the conservatorship plan, the FHFA will assume control and direct the operations of both Fannie Mae and Freddie Mac and exercise all powers collectively held by the shareholders, directors, or officers of the two companies. Under the conservatorship plan, current stock in Fannie Mae and Freddie Mac may continue to trade, although voting rights and dividend payments to shareholders will be suspended during the term of the conservatorship.

Preferred Stock Purchase

As a means of providing liquidity and acknowledging the U.S. government's guarantee of issued MBS offerings, the Treasury has agreed to enter into Senior Preferred Stock Purchase Agreements (the "Purchase Agreements") with both Fannie Mae and Freddie Mac. Under the Purchase Agreements, the Treasury will receive a newly issued class of senior preferred equity shares in exchange for certain cash investments up to $100 billion per agreement. These new preferred equity shares will have the effect of both diluting and subordinating the interests and rights of existing common and preferred shareholders. Pursuant to the specific terms of the Purchase Agreements, existing common and preferred shareholders will bear losses ahead of the newly issued senior preferred shares. In light of the expected dilution in value of existing common and preferred shares, the Treasury has encouraged any depository institutions that have significant holdings in these shares to contact federal regulators if they believe their losses on such holdings will adversely affect their capitalization requirements.

Treasury Purchase of New MBS Offerings

Part three of the Treasury's plan is to create a temporary program to purchase new issue MBS certificates offered by Fannie Mae and Freddie Mac. This program is intended to ensure additional capital and a viable market for new MBS issuance. Moreover, because the Treasury can hold such certificates to maturity, the government does not expect to incur losses from them. The Treasury expects that this purchase program will begin by the end of September.

Available Credit Facility

As a "liquidity backstop," the Treasury will also establish a secured credit facility that will make loans available to Fannie Mae, Freddie Mac, and Federal Home Loan Banks.

For a more detailed discussion of the takeover plan, please refer to "Treasury Department Releases Plan for Takeover of Fannie Mae and Freddie Mac," *DechertOnPoint*, Special Alert (September 2008), available at www.dechert.com/library/FS_FRE-09-08-08.pdf.

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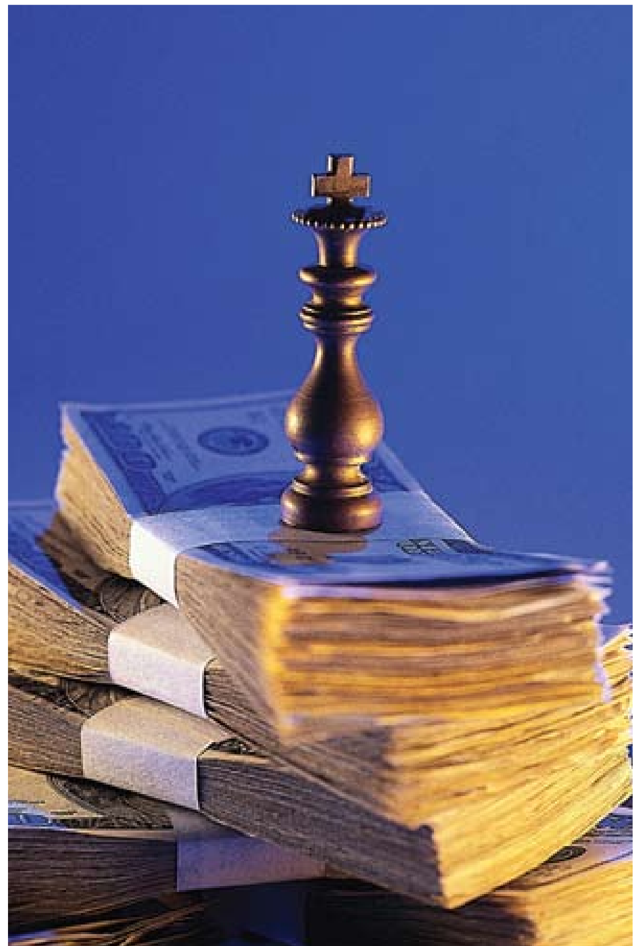
Sovereign Wealth Funds: a Cash Source for the United States*



by **Joseph R. Fleming**, **Christopher D. Christian** and **Maureen Magner**

U.S. and global financial institutions have reported upwards of $200 billion in write-downs from investments in credit-linked instruments, especially those tied directly or indirectly to the U.S. mortgage market. This figure may have grown significantly, due to recent market events. As losses mount and Wall Street firms collapse, entities teetering on the brink of extinction search for a lifeline or cash infusion from any and all sources. One such source has been sovereign wealth funds, which are essentially government-owned investment vehicles. Indeed, huge investments in western companies by Asian and Middle Eastern sovereign wealth funds, including from the Abu Dhabi Investment Authority and the Government of Singapore, had come to the aid of some investment firms hit by the "credit crunch." More recently, sovereign wealth funds have shown a reluctance to invest in struggling Wall Street firms due to poor performance results of prior investments in U.S. entities and the current volatility of U.S. financial markets. Nonetheless, sovereign wealth funds will continue to provide a ready source of funding for western companies should the right opportunity present itself.

Assets under management for sovereign wealth funds are estimated to be between $1.9 and $3.5 trillion. In the fourth quarter of 2007, sovereign wealth funds invested approximately $44.5 billion in Western financial institutions alone. As sovereign wealth funds continue to grow and diversify their underlying investments, concerns have mounted over the lack of transparency regarding their investment objectives and strategies as well as possible non-economic or political influence on U.S. institutions. Congress, the U.S. Department of the Treasury, and international organizations, including the International Monetary Fund ("IMF") and the Organisation for Economic Co-Operation and Development ("OECD"), are assessing the benefits and risks of sovereign wealth funds and their impact on world financial markets. This article seeks to: (i) provide an overview of sovereign wealth funds; (ii) outline the concerns related to their investment in U.S. institutions; and (iii) discuss potential U.S. policy and regulatory responses to these concerns. In addition, this article will highlight several legal issues to consider when marketing to, or managing money for, sovereign wealth funds.

Overview

There is no single agreed upon definition of a sovereign wealth fund. Generally, it is a separate pool of assets owned by a government and managed separately from official reserves to achieve economic and/or financial objectives (e.g., fiscal revenue stabilization, asset diversification, or performance returns). The first sovereign wealth fund was established by the Pacific island nation of Kiribati in 1956 to manage phosphate deposit revenues. By the year 2005, there were approximately 40 sovereign wealth funds in existence representing various countries, including China, Japan, Singapore, United Arab Emirates, and Russia. The largest sovereign wealth funds (in terms of both assets under management and number) are sponsored in the Middle East and Asia, respectively.

Many sovereign wealth funds derive their funding from natural resources (e.g., oil) and are known as commodity sovereign wealth funds. Others consist of revenues from privatization and foreign exchange reserves and are commonly known as non-commodity sovereign wealth funds. Regardless of their origins, sovereign wealth funds continue to grow at an extraordinary pace as the world undergoes a massive redistribution of wealth. By 2015, sovereign wealth fund assets are forecast to reach approximately $10 to $15 trillion. What these figures suggest is that sovereign wealth funds will have an impact on the world economy. The question is—how? Little is known about their activities, including their investment objectives.

What these figures suggest is that sovereign wealth funds will have an impact on the world economy. The question is—how?

Structure, Management, and Investment Policy

There is very little transparency with respect to the activities or organizational structure of sovereign wealth funds. Public information on the structure utilized by various sovereign wealth funds for investment purposes is scarce. Some sovereign wealth funds have operated in the form of a separate account, while others have been established as trusts.

Management responsibility for a sovereign wealth fund varies from finance ministries, central banks, and executive boards to external money managers. Unlike mutual funds and pension funds, sovereign wealth funds typically do not have external investors who may withdraw capital on short notice. Accordingly, sovereign wealth funds have the ability to take higher levels of risk than many traditional investors.

Sovereign wealth funds invest in an array of assets, including equity, fixed income, real estate, bank deposits, and alternative investments. They may invest in foreign and, sometimes, domestic assets. Investment may be long-term and passive in nature. Some sovereign wealth funds, however, operate akin to private equity vehicles and purchase varying investment interests directly and, arguably, for control purposes. Sovereign wealth funds also have invested directly in U.S. financial institutions (e.g., Merrill Lynch and Citigroup). These direct investments as well as the influence sovereign wealth funds may have on the U.S. economy have piqued the attention of the U.S. government.

Political, Economic, and National Security Concerns

Investment in the U.S. economy by sovereign wealth funds provides a necessary influx of capital in certain scenarios. However, there is a concern that a sovereign wealth fund and its government sponsor could control the U.S. company in which the fund has invested for political or other non-economic purposes. To address concerns regarding foreign direct investment, Congress enacted the Foreign Investment and National Security Act of 2007 ("FINSA"). FINSA provides for the Committee on Foreign Investment in the United States ("CFIUS") to review certain foreign direct investments that may result in a non-U.S. entity exercising control over a U.S. entity. An extended CFIUS review may occur for transactions where a foreign entity exercising control over a U.S. company could affect U.S. national security. While FINSA was a first step in addressing some of the concerns regarding foreign direct investment, direct investment in U.S. companies by sovereign wealth funds located in Russia, China, and other foreign countries raises additional concerns regardless of whether the sovereign wealth fund is controlling the U.S. company for definitional purposes.

Accordingly, policy makers and others are apprehensive about foreign ownership of strategic U.S. businesses. Congress has held hearings in 2007 and 2008 to explore the growth of sovereign wealth funds, the attendant unease with such vehicles, and resulting foreign policy implications. Those speaking at the hearings noted several benefits of sovereign wealth fund investment in the United States (e.g., capital infusion, corporate bailouts, and job creation). They also outlined a number of issues surrounding their investment in the United States, including the following:

- ***Foreign Economic Control for Political or Other Motives*** – foreign governments using their economic control over a U.S. entity through a sovereign wealth fund for foreign political interests rather than profit maximization;
- ***Investment Protectionism*** – potential host countries of sovereign wealth fund investments adopting a protectionist stance and rejecting legitimate investments, which could damage the free flow of capital and global investment;
- ***Financial Instability*** – a foreign government mismanaging its international investments with negative consequences for the global economic and financial system;

- ***Market Disruption from Rapid Withdrawal of Foreign Cash*** – a foreign government swiftly withdrawing its investment from the United States; and
- ***Home Country Discontent*** – a rise of local discontent concerning the flow of assets from the home jurisdiction to the United States, when the home jurisdiction may be physically and economically deteriorating.

Those testifying before the various committees urged Congress to reject a protectionist stance against sovereign wealth funds and consider, instead, supporting a framework that would provide greater transparency aimed at alleviating some of the above concerns. There was a consensus that Congress should not act unilaterally and prohibit sovereign wealth fund investment in the United States. Instead, Congress should continue to support and monitor non-governmental efforts by the IMF and OECD to increase transparency of sovereign wealth fund investment objectives and governing structure. To that end, the IMF's Working Group of Sovereign Wealth Funds is expected to release its generally accepted principles and practices in fall 2008 in an effort to promote governance and transparency.

Like the United States, other jurisdictions are also reviewing and enacting policies to regulate foreign investment to protect national security interests.

Like the United States, other jurisdictions are also reviewing and enacting policies to regulate foreign investment to protect national security interests. Countries take differing approaches, from requiring a formal review process for transactions related to investments in entities that are vital to national security (e.g., defense industrial base, energy sector), to mandatory review of an investment that reaches a certain dollar threshold or seeks to control the investee company. Other countries do not have a formal review process but do require some level of reporting.

The Views of the Securities and Exchange Commission

The Securities and Exchange Commission ("SEC") staff also is monitoring the rise of sovereign wealth fund investment in the United States, and has identified additional attendant areas of concern from a securities regulation perspective. For example, the staff has noted that sovereign wealth funds could operate with non-public information, and confidence in the U.S. market could collapse if investors believe that they are at an information disadvantage with respect to a foreign-controlled sovereign wealth fund. Additionally, a foreign government controlling a company under SEC investigation could end its cooperative relationship with the SEC and stymie the SEC's ability to enforce U.S. federal securities laws against the company and/or the foreign government. To address these and other concerns, the SEC staff in public statements has supported open markets and rejected a protectionist position toward sovereign wealth fund investment in the United States. The SEC staff recommends further consideration of the matter and increased transparency of sovereign wealth fund operations and investments.

Transparency and Exchange Act Reporting

There are a number of provisions under the Securities Exchange Act of 1934 (the "Exchange Act") and other federal securities laws that require reporting and that may apply to the investment of sovereign wealth funds in U.S. companies. These include:

Section 16(a) and Form 3. Form 3 under Section 16(a) of the Exchange Act requires a "reporting person," which includes any beneficial owner holding greater than 10% of an issuer's equity securities, to disclose such holder's ownership interest.

Section 13(d) and Schedule 13D. Beneficial owners of more than 5% of an issuer's equity securities are required to file Schedule 13D under Section 13(d) of the Exchange Act. Schedule 13D requires the beneficial owner of the securities to disclose the source and amount of funds being used to purchase the shares, and announce whether the purpose of the purchase is to acquire control as well as any plans or proposals with regard to future actions by the purchaser.

Section 13(f) and Form 13F. Institutional investment managers who exercise investment discretion over $100 million or more of U.S. exchange-traded equity securities are required to file a Form 13F. The form requires a manager to disclose the name of each reportable issuer in the manager's portfolio as of the end of each calendar quarter, as well as the number of shares and market value.

Although the above provisions of the Exchange Act provide some means of obtaining transparency, they may not provide the level of transparency needed with respect to foreign-controlled sovereign wealth funds. These

reporting obligations may fail to provide the SEC staff with the ability to aggregate and compare related data to ascertain the full scope of sovereign wealth fund investment in the United States. This is particularly so when a sovereign wealth fund may be investing indirectly through a collective investment scheme and/or directly through multiple U.S. investment managers that may be tasked with managing assets for the sovereign wealth fund on a separately managed account basis.

Local Jurisdiction Matters

Some form of government and/or self-regulation regarding sovereign wealth fund investment in the United States will inevitably be adopted. Until any such regulation is adopted, U.S. investment advisers should at the very least consider the legal issues below when marketing to, receiving an investment from, or managing money for sovereign wealth funds.

Regulatory Requirements

Sufficient due diligence as to the fund's home regulatory requirements regarding marketing to, accepting an investment from, or managing money for a sovereign wealth fund must be undertaken. In conducting such due diligence, a U.S. money manager should review, among other things: (i) applicable local licensing and/or registration requirements, including any pre-filing or pre-approval requirements; (ii) whether marketing to collective investment schemes or solicitation of advisory services is prohibited by local regulations; (iii) any additional local anti-money laundering requirements; and (iv) whether there are any local restrictions on portfolio management.

When conducting business abroad, managers also must be cognizant of the Foreign Corrupt Practices Act ("FCPA"), particularly if contemplating making a gift or payment to a non-U.S. person. The FCPA prohibits a U.S. manager or its agent from issuing any type of monetary payment, offer, promise, or authorization of payment with the intention of influencing or inducing a foreign official to engage in foreign trade practices. There are exceptions to this prohibition; however, a manager should consult with legal counsel to ensure, among other things, applicability of such exceptions.

Contractual Matters

If sovereign wealth fund assets are managed on a separate account basis by a U.S. money manager, the manager should review the terms of any investment management agreement carefully, including any provisions relating to, among others: (i) governing law and enforceability; (ii) notice of home law jurisdiction regulatory requirements; (iii) discretionary authority; (iv) proxy voting; (v) delegation authority (e.g., clarify whether the U.S. manager may delegate a sleeve of assets to an affiliated or unaffiliated sub-adviser without prior approval from the sovereign wealth fund); (vi) frequency of providing information with respect to portfolio holdings; and (vii) indemnification.

Frequency, Form, and Content of Reporting Obligations

U.S. managers and foreign investors should obtain advice as to the frequency, form, and content of any applicable reporting obligations under both U.S. federal and state law. Attention should also be paid to whether additional foreign reporting obligations are triggered outside of the United States as a result of investors' status as a sovereign wealth fund.

Conclusion

The growth of assets of sovereign wealth funds will certainly have an impact on the world economy. What remains unclear is how the U.S. government will oversee the investment of such funds in U.S. businesses and whether it will heed advice to avoid depriving the U.S. marketplace of a needed source of cash.

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Hong Kong and Greater China Developments

by **Keith T. Robinson**, **Henry Wang** and **Derek B. Newman**

New Opportunities on the Horizon for Foreign Fund Managers to Operate under China's Qualified Foreign Institutional Investor Regime

China's Qualified Foreign Institutional Investor ("QFII") regime was introduced in 2002 and for the first time opened China's A share market to investments by foreign institutional investors, such as investment banks, securities companies, fund managers and insurance companies, that apply for and receive approval from the China Securities Regulatory Commission (the "CSRC"). Although the initial QFII rules, along with significant structural and operational issues, have to date discouraged fund managers operating investment funds from fully utilizing the QFII regime, recent developments and anticipated liberalization of the QFII regime may offer expanded opportunities for non-Chinese investors to access the A share market.

In the fall of 2006, the CSRC, the People's Bank of China and the State Administration of Foreign Exchange ("SAFE") jointly issued new regulations (the "2006 Rules") that provided significant relief for fund management companies and investment funds. In addition to easing certain of the qualification requirements for fund management companies, the 2006 Rules also addressed some of the operational challenges associated with the original rules. For example, the 2006 Rules now permit a foreign fund manager to open multiple securities accounts in the Peoples' Republic of China ("PRC"), thus making it possible to open separate securities accounts in its own name and for each investment fund client (the assets in the latter account expressly belonging to the relevant fund under the 2006 Rules). Under the former QFII rules, fund managers could not comply with domestic regulatory requirements mandating the separation of proprietary assets from customer assets. In addition, fund managers may now appoint multiple brokers so as to seek best execution of securities transactions. Under the former QFII rules, fund managers could only appoint one broker per stock exchange.

Despite these welcome changes, some significant operational hurdles may remain, especially for open-end mutual funds. The original QFII rules imposed strict lock-up periods (one year lock-up for open-end funds and longer periods for other funds) and repatriation limits on QFII

investments that made such investments *de facto* illiquid investments. As a result, it was very difficult for open-end funds to comply with domestic restrictions on ownership of illiquid investments and the need to timely meet redemption requests. The 2006 Rules do not contain specific provisions with respect to lock-up periods and repatriation limits, but instead provide that such issues are to be determined by SAFE in light of foreign exchange and other market factors. To date, SAFE has not issued new rules, with the result that considerable uncertainty exists with respect to a QFII's ability to promptly repatriate assets. However, a senior SAFE official recently announced that new rules with respect to lock-up periods, repatriation limits and other foreign currency controls will soon be issued. These new rules are expected to reduce the lock-up period for open-end funds to three months, which will begin to run once a minimum amount of the QFII's investment quota has been remitted (instead of the full approved quota amount). Furthermore, once the lock-up period ends, it is expected that open-end funds will be permitted to freely effect remittance into and repatriation out of China on a monthly basis so as to accommodate their net subscriptions and redemptions.

In advance of the formal implementation of new rules, regulators within the PRC and local PRC QFII service providers have informally confirmed that SAFE currently may grant open-end funds reduced lock-up periods and greater repatriation flexibility on a case-by-case basis. These changes, coupled with the operational improvements provided by the 2006 Rules, should make the QFII regime a significantly more attractive option for fund managers and their fund clients.

Hong Kong Announces Plans to Develop Islamic Finance Platform

Martin Wheatley, Chief Executive Officer of the Hong Kong Securities and Futures Commission, on August 12, 2008, announced a major governmental and SFC initiative to develop Hong Kong into an Islamic finance center. Building on Hong Kong's current financial infrastructure, ease of access to Mainland Chinese markets, and transparent regulatory regime, the Hong Kong government has identified Islamic finance as a potential growth sector and has authorized the SFC to facilitate development of Islamic finance in Hong Kong. In this regard, Mr. Wheatley noted the following steps that have been taken in furtherance of the development of Hong Kong's Islamic finance platform:

- Completion of an analysis confirming that no fundamental obstacles exist with respect to the issuance and trading of *sukuks* (an asset-backed bond structured in accordance with Shari'ah law that represents a proportionate beneficial ownership in the underlying assets), and that only technical modifications are required to ensure tax neutrality between conventional and Islamic finance transactions.
- The SFC's November 2007 authorization of the Hang Seng Islamic China Index Fund, the first retail Islamic fund for sale in Hong Kong.
- The March 2008 issuance of US$550 million of *sukuks* on the Hong Kong Stock Exchange by Khazanah Nasional Berhad.
- The SFC's April 2008 entrance into a memorandum of understanding with the Dubai Financial Services Authority for the establishment of a framework for the mutual recognition of their regulatory regimes on Islamic funds to facilitate cross-border marketing and distribution of such funds.

The Hong Kong government has identified Islamic finance as a potential growth sector and has authorized the SFC to facilitate development of Islamic finance in Hong Kong.

In addition to the SFC's efforts and in furtherance of the development of Hong Kong as an Islamic finance center, the Hong Kong government and public authorities currently are considering the issuance of *sukuks* in connection with public finance projects in Hong Kong.

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Structuring Shari'ah-Compliant Private Equity Funds*

by **Thomas Gierath**

Shari'ah-compliant private equity funds represent a challenge for both fund managers and their advisors, as certain Islamic investors increasingly insist on compliance with the tenets of Islamic law. This affects both the fund structure and the management of the funds' assets, and requires new professional skills from all involved.

Flourishing Market

The private equity industry has developed vigorously in the Middle East over the last few years and international and regional private equity funds have raised considerable funds in this region. According to the annual report of the Gulf Venture Capital Association for 2006, funds managed by regional private equity firms in 2006 equalled approximately $18 billion (of which almost three quarters were raised in 2006). And the Ernst & Young Islamic Funds & Investments Report 2008 indicates that, at the end of the first quarter of 2008, there were more than 500 Shari'ah-compliant funds in the world, of which 153 were established in 2007 alone. Bearing in mind that Gulf country investors are estimated to be able to tap free liquidity of approximately $2.3 trillion available for reinvestment in the coming years, most private equity fund sponsors have probably considered raising funds in this region.

The Islamic finance industry has been growing annually by 15–20% since its inception, and more and more Middle Eastern investors are requiring Shari'ah compliance in addition to profitable investments.

One might be surprised to learn that of the amount raised, only $1.1 billion has been raised by Islamic funds. This is because Islamic finance (finance in accordance with the principles of Shari'ah law) has only been in existence since the 1970s and not all regional investors adhere to Shari'ah principles when making investment decisions. But the Islamic finance industry has been growing annually by 15–20% since its inception, and more and more Middle Eastern investors are requiring Shari'ah compliance in addition to profitable investments.

An Attractive Asset Class—but with Strings Attached

At first glance, private equity seems an asset class tailor-made to suit the needs of Islamic investors as this asset class should, in principle, be compliant with the principles of Shari'ah. According to such principles, returns must be earned through active participation in the risks of the relevant business. Thus, equity financing is well known to Islamic investors who routinely use similar legal structures, e.g., the *musharakah*-structure (an Islamic kind of joint venture).

However, main characteristics of this asset class are in conflict with Shari'ah law. First, leveraging investments,

used by buy-out funds, and the receipt or payment of interest (*ribâ*) is incompatible with the principles of Islamic law and one of the key reasons why many Western private equity sponsors have so far been cautious in extending their marketing activities to the Middle East. Furthermore, Islamic money must be invested in businesses that offer ethically acceptable products or services. Thus, the fund may not invest into certain *haram* (improper) industry sectors (e.g., the production or distribution of alcohol and pork-related products, or arms, hotels, casinos, or conventional banks), which limits the investment opportunities for private equity funds. The existence of a remarkable number of Shari'ah-compliant private equity funds shows, however, that the above obstacles can be circumvented for both investors and fund sponsors.

Structuring Issues

When setting up a private equity fund for Islamic investors, the fund sponsor should consider the following requirements that impact on the structure, financing, and investments made by the fund:

Legal structure and domicile of the fund

Islamic investors have become increasingly familiar with the conventional GP/LP structure of western private equity funds as this reflects the classic Islamic *mudarabah* investment structure (a Shari'ah-compliant finance structure bundling investor and managing partner together). Fund domiciliation in Gulf countries, such as Bahrain and the United Arab Emirates, has become more popular due to the possibility of Western-owned management companies and the provision of international accounting standards, as well as favourable tax regimes for fund managers. With attractive tax regimes offered to foreign investors, on- and off-shore funds domiciled in, for example, the Cayman Islands, the Channel Islands or Luxembourg, also have proved attractive to Middle Eastern investors.

Investment constraints and observance by Shari'ah board

Increasingly, to ensure that investments of the fund are not made in *haram* industries, Islamic investors require their general partners to provide Shari'ah-compliant investment guidelines to be incorporated in the fund's documentation (i.e., the Limited Partnership Agreement and the Private Placement Memorandum). The extent of such guidelines will depend on the strictness of the Shari'ah scholars advising the investors of the fund. Such guidelines limit the discretionary management of a fund, thus limiting what has traditionally been one of the key advantages of the private equity asset class. However, technology-focused funds, which usually invest in *halal* (permitted) businesses, tend not to be limited by such guidelines.

Further, to be Shari'ah-compliant, a fund has to establish a Shari'ah board with advisory and oversight responsibilities. Usually, such a board will consist of three recognised Shari'ah scholars appointed by the fund's investors. The board generally advises the general partner with regard to Shari'ah law principles affecting the business of the fund and seeks to ensure that the fund's investment activities are in accordance with the investment guidelines of the fund. By issuing legal opinions (*fatwa*) regarding the Shari'ah-compliance of the fund and of its investments, the board continuously oversees the fund managers. Furthermore, proposed investments usually require the prior approval of the Shari'ah board. In the event that investments already made by the fund cease to be Shari'ah-compliant, the board may want to instruct the general partner to divest. These constraints certainly conflict with the discretionary management of private equity funds in the West. Nevertheless, provided that the general partner and the Shari'ah board can cooperate efficiently, such a board can actually be a marketing benefit for the fund, boosting investor confidence by providing a degree of oversight that helps ensure proper management of the fund.

Financing of the fund

Typically, private equity funds are financed by equity contributions provided by the investors. But Western-based funds also provide for leveraging possibilities at the fund level, in particular in cases of bridge financings when draw downs cannot be served within a given period of time, or at the beginning of an investment period due to an initial lack of investors' funds. Such interim debt financing might conflict with Shari'ah law and the general partner should consult with the Shari'ah board regarding the level of strictness the board intends to apply. For example, more liberal Shari'ah boards might allow a fund a leverage of up to 33% of the fund's assets within a given period of time.

Furthermore, the payment and receipt of interest is forbidden under Shari'ah law. This affects not only any leveraging possibilities but also penalties for investors who may be in default with respect to capital draw downs. Finally, it can also impact the fund's free liquidity management. Shari'ah-compliant funds in general should refrain from interest payments, and income that contains unlawful interest should be "purified", i.e., donated to

charities. However, the general partner should always seek the input of the Shari'ah board regarding the type and amount of income to be purified.

Asset Management

Shari'ah-compliant status for a fund requires adherence to the principles of Shari'ah law not only at the fund level but also with regard to the management of its assets. This has an impact not only on the selection of permitted target companies but also on acquisition and financing structures, and requires the general partner to possess expert knowledge of both Shari'ah-compliant and profitable financing instruments.

As mentioned above, leverage of investments is by its very nature in conflict with Shari'ah investment principles. However, some Shari'ah boards accept leverage to a degree, limited either by amount or repayment period. To avoid such limitations, or where a Shari'ah board is not

We are likely to see an increasing number of both regional and Western funds dedicated to this type of investor. The challenge will be to further develop structures that are open and attractive to both Islamic and non-Islamic investors.

as permissive about conventional leverage, debt may be structured in a manner compliant with Shari'ah law by using sophisticated financing structures tailor-made for Islamic investors. Such structures include classic Islamic financing structures such as the *muharabah* (sale structure with deferred payments), *musharakah* (Islamic joint venture), and *Ijara* (structure with leasing components). Also, Western banks now offer Islamic debt instruments and the prices for such instruments are lower than was previously the case. However, the complexity of such instruments on the legal and tax side requires the involvement of Islamic finance experts and may lead to slightly more detailed investment procedures.

When intending to make an investment, the general partner should consult the Shari'ah board as early as possible with regard to the Shari'ah-compliance of the proposed investment. In cases where the Shari'ah board does not consent to an investment due to its incompatibility with Shari'ah law, but the general partner wishes to make the investment, the fund documentation may provide special opt-out provisions for investors. According to these procedures, such investors can be excused from committing to that particular *haram* investment made by the fund. While such provisions help ensure management's discretion, they must be drafted precisely so as not to offer an excuse for investors regarding investments they don't favour for other reasons. The same principles should be followed in case a fund's investment becomes incompatible with Shari'ah law at a later stage.

Parallel Fund Structures

The above constraints show that funds dedicated to Islamic investors require a different fund structure than conventional private equity funds. In addition, non-Islamic investors may not want to be bound by limitations not required for their investment in the fund. Thus, in case the private equity sponsor intends to raise money from both Islamic and non-Islamic investors, it may be advisable to set up two vehicles in parallel. To provide confidence that the general partner also will take care with the sourcing and executing of Shari'ah-compliant investments, a co-investment agreement, usually a three-party agreement between the two funds and the general partner, can be entered into governing the terms and conditions of the joint investments of both funds.

Conclusion

Private equity is an interesting asset class for Islamic investors. Due to its natural fit with the Shari'ah law principle of risk sharing, as well as attractive return rates and the immense free liquidity available in Middle Eastern markets, we are likely to see an increasing number of both regional and Western funds dedicated to this type of investor. The challenge will be to further develop structures that are open and attractive to both Islamic and non-Islamic investors. This will expand the universe of investment opportunities available to Shari'ah-compliant fund-of-funds, potentially opening up private equity investment opportunities to a broader range of Islamic investors.

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UK Tax Developments

by **Mark Stapleton** and **David Gubbay**

Government Releases Proposals to Increase Tax Efficiency of Onshore Funds Regime

The UK government has published three consultation papers aimed at reforming the tax frameworks for a number of UK fund structures in an attempt to make them more competitive with similar non-UK products.

The first set of proposals applies to Authorised Investment Funds ("AIFs"), which include authorised unit trusts, UCITS, Non-UCITS Retail Schemes and Qualified Investor Schemes. Under current rules the AIF is itself subject to 20% corporation tax on certain types of income. However, it is proposed that AIFs be allowed to make an election so that the investors will face broadly the same tax treatment as if they owned the underlying assets directly.

The government intends to achieve this by offering AIFs the opportunity to become Tax Elected Funds ("TEFs"). Different streams of income earned by the TEF would need to remain identifiable as they passed through the fund and certain streams, such as interest, UK dividend income and foreign investment income, would not be taxed at the level of the fund. The TEF would not be permitted to invest in property, as the new Property AIF is considered the more appropriate vehicle for this.

As yet, the government has not produced proposals as to how to treat gains made from the TEF investing in non-UK funds (offshore income gains) but invites comments as to how this should be achieved. The current new tax regime for Funds of Alternative Investment Funds ("FAIFs") deals with this by exempting such gains but treating the investor's gains on redemption of its interest in the fund as income. This is unattractive due to the big tax rate differential between income (40%) and gains (18%) and so, as with FAIFs, another solution needs to be found.

In order to qualify as a TEF, an AIF will need to meet a further genuine diversity of ownership condition (similar to that mentioned below).

The government is seeking to achieve something similar in relation to investment trust companies ("ITCs"), which are not currently subject to tax on capital gains. The government is now proposing to allow ITCs to deduct the cost of any interest earned provided that it is distributed to shareholders, effectively moving the point of taxation of that interest from the ITC to the investor.

The final set of proposals relates to qualified investor schemes ("QIS"), a type of AIF introduced in 2004. Currently, QISs are subject to a substantial holding rule so that any investor that holds more than a 10% holding in a QIS will be subject to a tax charge.

The government has released draft regulations that would replace the 10% holding rule with a new requirement that the QIS should instead have "genuine diversity of ownership".

This differs from the current approach in that the new requirement is more focused on the marketing and documentation of the fund than with its actual ownership. The QIS prospectus must make clear both who its eligible investors are and that the shares are open to all such investors. The manager must continue to market the fund to its eligible investors in order to meet the requirement.

Important VAT Change for Investment Managers

Currently, supplies of investment management services to UK authorised unit trusts, open-ended investment companies and trust-based schemes are exempt from VAT. This restricts the ability of managers of these types of funds to recover the VAT on their own related expenses. Following a recent decision in the European Court of Justice, new legislation extends this exemption to investment management of a wider range of funds, including certain non-UK funds, and may result in substantial loss of VAT recovery on associated expenses for certain investment managers.

Broadly, the UK entities covered by the new VAT exemption are closed-ended funds that are traded on a regulated market and that fulfill certain criteria relating to investment type and object (and that will include investment trust companies, venture capital trusts and similar offshore funds available for investment in the UK under the same conditions).

The exemption also will apply to funds established outside the UK which are recognised overseas schemes under the Financial Services and Markets Act 2000, provided that funds are able to be marketed to UK investors. Recognised non-UK funds fall into three basic categories:

(i) funds that are established in an European Economic Area state that has authorised them as UCITS-compliant and that have given notification to the FSA of the intention to market the units to UK investors. This category includes funds established in Gibraltar;

(ii) funds established in Guernsey, Jersey, the Isle of Man and Bermuda that have similar regulation to the UK and have been recognised by the FSA so that investments can be marketed to UK investors; and

(iii) funds established elsewhere that have similar regulation to the UK and have been given individual recognition awards by the FSA to enable them to market units to UK investors.

The practical effect of this change will be to apply the VAT exemption to supplies of investment management services to all sufficiently regulated collective investment schemes made available to the UK general public.

It is intended that this legislation will have effect for supplies of management services made on or after 1 October 2008.

Investment managers should consider the potential impact of the proposed changes and consider what steps should be taken to minimise potential loss of VAT recovery on associated expenses.

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Proposed Europe-Wide Regime for Open-Ended Real Estate Funds

by **Ruth Abernethy**

Earlier this year, the Expert Group appointed to advise the Internal Market directorate of the European Commission ("Commission") on issues concerning open-ended real estate funds ("OEREF") published its report, which recommended a pan-European OEREF regime constructed broadly along UCITS lines.

Primarily designed for retail investors, OEREFs allow investors to gain a broader exposure to real estate assets than would likely be possible by direct investment. By combining exposure to real estate assets with the possibility to redeem at regular intervals, OEREFs allow short- and medium-term investments to be made indirectly in an asset class that is traditionally viewed as a long-term investment. This is a formula so successful that at the time the Expert Group published its report, over 110 billion euro of assets was managed in this way.

Despite the popularity of OEREFs within domestic markets (12 Member States of the EU already have national retail OEREF regimes), cross-border promotion of OEREFs to investors is extremely difficult due to the absence of formally recognized retail distribution

channels and the differences between national regimes, each of which evolved in some degree of isolation. To address the barriers to the cross-border marketing of OEREFs and to ensure sufficient investor protection, the Expert Group made five recommendations, which are summarised below:

Recommendation One – EU policy makers should create a new Europe-wide regime for the offering of OEREFs to retail consumers, as it is only through the creation of an EU passport for OEREFs that a single market can be created.

Recommendation Two – To ease negotiations and to speed up the process, the new EU OEREF regime should be based on existing tried and tested national regimes.

Recommendations Three and Four – To allow consumers and asset managers in all EU Member States to access and benefit from the investment and business opportunities presented by cross-border OEREFs, legislation at the Europe-wide level is required. Only through clear, binding rules can the legal certainty needed for distributing OEREFs to foreign markets be achieved. The Expert Group concluded that a Europe-wide regime may be best achieved through a modification to the current UCITS Directive as this would allow distribution of OEREFs through existing distribution channels. If a modification to the UCITS Directive cannot be achieved, the Expert Group recommended a stand-alone OEREF directive as a second best plan.

Recommendation Five (Tax Recommendation) – As the situation stands, national governments often tax foreign OEREFs in a discriminatory way compared to domestic OEREFs as, usually, domestic OEREFs are tax exempt at the fund level whereas foreign OEREFs are not. Further, the national tax law of some Member States discriminates against individuals investing in foreign OEREFs rather than domestic OEREFs. In its report, the Expert Group reminded the Commission that the free movement of capital is a treaty freedom and, as such, discrimination against foreign OEREFs is prohibited, and asked the Commission to remind Member States of, and if necessary enforce, this freedom.

The Expert Group proposed the following key attributes to be built into a pan-European OEREF regime:

1. OEREFs should be able to make full use of property Special Purpose Vehicles (SPVs).
2. OEREFs should be allowed to borrow up to 60% of their real estate assets, including real estate SPV assets.
3. OEREFs should redeem units at an investor's request, at least quarterly.
4. OEREFs should maintain a minimum liquidity of 10% of their assets and install a sophisticated liquidity management system appropriate to their subscription/redemption policy.
5. The properties comprising an OEREF's portfolio should be independently valued at least once per year using internationally recognised valuation principles.
6. OEREFs should disclose their pricing policies and explain to investors the long-term investment focus of OEREFs and that the redemption of shares may be suspended in exceptional circumstances.

The EU Commission is currently considering the report. There is no set timetable for it to respond, although we understand that a Commission Communication expected this autumn is due to cover the topic.

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Identity Theft Red Flag Rule Goes into Effect in November 2008 – a U.S. Regulation that has Practical Application

by **Roderick J. Cruz**

Identity theft is a borderless crime conducted by criminals who may be located a continent away from the victims. This global threat has caused U.S. regulators to require businesses to adopt measures to guard against and to respond to identity theft.

This fall, certain financial institutions and creditors that hold any consumer account, credit and debit card issuers, and users of consumer credit card reports will be required to implement policies and procedures to detect possible identity theft, and maintain a written program addressing how to prevent and mitigate such theft. The new regulations (the "Final Rules")[1] implement particular sections of the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act").

A financial institution or creditor is not necessarily required to comply with all of the provisions set forth in the Final Rules. The services a firm conducts and its business relations with third parties determine which provisions of the Final Rules apply to a firm. However, one particular provision that will likely apply to a wide spectrum of financial institutions and other businesses, and which is the focus of this article, is the requirement to adopt policies and procedures that address identity theft "red flags."[2] Indeed, due to the borderless nature of identity theft, financial institutions that are not specifically subject to the Final Rules might look to these rules for guidance in strengthening their privacy policies and IT security measures.

Who must comply?

The financial institutions that are subject to the Final Rules are U.S. state or national banks, state or federal savings and loan associations, mutual savings banks, state or federal credit unions, and any other person that, directly or indirectly, holds a "transaction account"[3] belonging to a consumer. To the extent investment companies hold transaction accounts, such investment companies appear to be subject to the Final Rules.[4]

Furthermore, businesses not normally considered to be financial institutions, such as automobile dealers, mortgage brokers, utility companies, telecommunication companies, and creditors (persons or entities that regularly extend, renew, or continue credit or regularly arrange for the extension, renewal, or continuation of credit) may also be subject to the Final Rules.

The key factor to determine whether a financial institution or other business must comply with the provisions regarding identity theft red flags is whether such a firm offers and maintains "covered accounts." A "covered account" means an account for personal, family, or household purposes designed to permit multiple payments or transactions, and any other account for which there is a foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft.

What must be implemented?

The Final Rules require the following:

- Financial institutions and creditors must develop and implement, and obtain Board[5] approval of, a written Identity Theft Prevention Program (the "Program") to detect, prevent, and mitigate identity theft in connection with certain "covered accounts."
- Credit and debit card issuers must implement policies and procedures to assess the validity of notifications of changes of address in conjunction with a request for a new card.
- Users of consumer credit reports must implement reasonable policies and procedures to apply when a consumer reporting agency sends a notice of address discrepancy.

Do I really need to implement an Identity Theft Prevention Program if my financial institution is not subject to the Final Rules?

The threat of identity theft is real. Recent news articles include a data breach of a Virginia investment firm that exposed the names, dates of birth, and social security numbers of the firm's clients, including those of Supreme Court Justice Stephen G. Breyer. No financial institution wants that type of headline. Any financial institution, whether located in the United States or outside the United States, that stores personal data in an electronic database and maintains online accounts is a potential target. In particular, financial firms that cater to high net worth clients such as hedge funds and private wealth institutions may be primary targets of identity thieves and should undertake measures to safeguard their investors' personal information. As such, to minimize operational risk and reputational risk, financial institutions not subject to the Final Rules should strongly consider adopting certain measures of the Final Rules to enhance their own privacy policies.[6]

Outlined below are the key components of the Program that financial institutions must adopt or should consider integrating into pre-existing privacy policies and procedures.

The Identity Theft Prevention Program and Other Obligations

Section 114 of the FACT Act requires financial institutions to develop, implement, and maintain a Program for combating identity theft in connection with new and existing accounts. There are four elements that the Program must address. The Program must include reasonable policies and procedures for detecting, preventing, and mitigating identity theft and enable a financial institution or creditor to:

1. *Identify* activities signaling possible identity theft ("red flags") for covered accounts and incorporate those red flags into the Program;
2. *Detect* red flags that have been incorporated into the Program;
3. *Respond* to red flags that are detected to prevent and mitigate identify theft; and
4. *Update* the Program periodically to reflect new risks from identity theft and new methods to perpetrate identity theft and to reflect changes in a firm's business.

The Final Rules also require that the Board (or senior management) approve the Program, the Board (or senior management) receive annual reports assessing the effectiveness of the Program, and relevant staff receive training to effectively implement the Program.

Furthermore, if a financial institution outsources the servicing of covered accounts to third-party service providers, the financial institution has an obligation to ensure that its service providers comply with the Final Rules.

Managing the Process/Designing the Program

Implementing the Program may require the involvement of several groups within a firm—IT, legal and compliance, the business team, and senior management. Logistically, it is important to create a team to develop, implement, and administer the Program. When establishing the Program, each financial institution should assess the following:

- Which accounts are "covered accounts?" This assessment includes reviewing the following factors: the type of accounts subject to risk of identity theft; the level of identity theft risk associated with such accounts; the methods used to open client accounts; and the methods provided to access such accounts.
- What is the firm's previous experience with identity theft?
- Which red flags are relevant to each type of covered account? Red flags to consider include:[7]
  - alerts, notifications, or other warnings received from consumer reporting agencies;
  - presentation of suspicious documents;
  - presentation of suspicious personal identifying information;
  - unusual use of, or other suspicious activity related to, a covered account; and
  - notice from customers, victims, or law enforcement authorities about identity theft.

Firms also should consult the Guidelines in the Final Rules, which are included to assist financial institutions and creditors in the formulation and maintenance of the Program. While a firm is not required to adopt all of the Guidelines, the firm should have written justification as to why a specific provision was not adopted in the event examiners question why certain measures were not adopted.

What should a financial institution do to deal with identity theft?

- Review current IT and privacy policies and procedures.
- Determine areas of vulnerability.
- Adopt safeguards to shield against online intrusions.
- Have a pre-determined action plan to respond to online intrusions and data breaches both at the IT level and at the customer level.
- Update electronic safeguards periodically in response to the latest methods of attack by hackers and identity thieves.

After identifying which red flags to include in the Program, the next step is to put in place reasonable polices and procedures to detect red flags. When designing the Program, it must be appropriate to the size and complexity of the firm and the nature and scope of its activities. Ultimately, a firm's Program should provide for the following:

- identifying practices or activities that indicate possible existence of identity theft;
- obtaining and verifying identifying information of a person opening a covered account, and authenticating customers;
- monitoring transactions;
- verifying the validity of any change of address requests for existing covered accounts; and
- responding to Red Flags. This may entail:
  - monitoring a covered account for evidence of identity theft;
  - contacting the customer;
  - changing passwords or security codes that permit access to a covered account;
  - reopening a covered account with a new account number;
  - closing an existing covered account that has been compromised; and
  - notifying law enforcement.

Furthermore, to the extent third parties service covered accounts, agreements should be reviewed and possibly amended to ensure that such service providers are in compliance with the Final Rules.

What are my liabilities for violations and non-compliance?

The Final Rules do not provide private rights of action to anyone harmed by a financial institution's failure to comply with the Final Rules. However, failure to comply with the Final Rules could result in civil penalties under the Fair Credit Reporting Act, imposed by the Federal Trade Commission or by the other federal regulators.

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1 Identity Theft Red Flags and Address Discrepancies under the Fair and Accurate Credit Transactions Act of 2003, 72 Fed. Reg. 63,718 (Nov. 9, 2007).

2 "Red flag" means a "pattern, practice or specific activity that indicates the possible existence of identity theft." "Identity theft" is defined to mean "a fraud committed or attempted using the identifying information of another person without authority." "Identifying information" includes: name; date of birth; identifying numbers (e.g., SSN, EIN, TIN, official state or government issued driver's license number, passport number); biometric data; unique electronic identification number; and address.

3 A "transaction account" is an account " . . . on which the . . . accountholder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone transfers, or similar items for the purpose of making payments or transfers to third persons or others."

4 *See* "Certain Funds Must Implement Identity Theft Prevention Program by November 1, 2008," *DechertOnPoint*, Issue 20 (August 2008) available at http://www.dechert.com/library/FSG_08-19-08.pdf.

5 In instances when a firm does not have a Board, the Final Rules permit firms to rely upon a designated employee of senior management in situations that require Board involvement.

6 A point to remember is that all U.S. financial institutions (including investment companies) are required to safeguard the nonpublic personal information of their natural person clients under Title V of the Gramm-Leach-Bliley Act of 1999. Section 501(b) of that Act specifically requires financial institutions to adopt policies and procedures that address administrative, technical and physical safeguards to ensure the security of customer records and information, to protect against anticipated threats or hazards to the integrity of such records and to protect against unauthorized access to such records.

7 The Final Rules include a suggested list of 26 red flags to identify.

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