DechertOnPoint

First Quarter 2008 – Inaugural Issue

Financial Services Quarterly Report

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Welcome

By **Peter D. Astleford** and **Joseph R. Fleming**

"The continued integration of the world's capital markets . . . is bringing the world's nations together like no other development in history. . . . Ultimately, our capacity to live peaceably with each other depends upon our ability to communicate intelligibly and reason coherently. In every case, to succeed, we need to first construct a language of mutual understanding. Throughout the world, there is no better opportunity to do this than through commerce."
– Christopher Cox, Chairman, U.S. SEC[1]

The great challenge for business leaders, their advisers, and their regulators, is to stay ahead of the curve, rather than to merely react to events. In a recent speech, Walt Lukken, the Acting Chairman of the U.S. CFTC, quoted hockey great Wayne Gretzky's famous statement that "A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be." Lukken continued, "Like hockey players, what differentiates average regulators from exceptional regulators is the ability to anticipate and adapt to change—to play where the markets are going, not where the markets have been. You cannot talk about the direction of our markets without addressing the most significant driver of change—globalization. . . . Nowhere are the "flattening" forces of globalization more evident than in the financial services sector."[2]

The globalization trend can be observed in every quarter of our industry. On January 17 of this year, NYSE Euronext, the first transatlantic equities market, announced it had agreed to acquire the American Stock Exchange. Just the previous month, the SEC had approved rule changes clearing the way for Eurex and the International Securities Exchange

to merge. And last September, Borse Dubai and NASDAQ announced a series of transactions, including a combination with OMX, that would create a global financial marketplace spanning the United States, Europe, the Middle East and strategic emerging markets.

Spurred on by technological advances, economic liberalization and investor desire for diversification, national borders are becoming increasingly open to capital flows. Consider also the following:

- In Europe, net assets in "true" cross-border funds increased by approximately 80 percent during the two-year period of 2005 and 2006, and net sales of "true" cross-border funds represented 53 percent of the total net sales of funds in Europe in 2006, up from 22 percent in 2003.[3]
- U.S. private holdings of non-U.S. securities increased by approximately 25 percent to $5.43 trillion during 2006. Non-U.S. private holdings of U.S. securities other than U.S. Treasury securities increased by approximately 20 percent to $5.23 trillion during 2006.[4]
- Non-U.S. companies listed on the NYSE represent approximately 42 percent of the total global market value of all NYSE-listed companies and $11.4 trillion in total global market value.[5]

We counsel asset managers throughout the world on their endeavors, not only to tap new sources of capital in the United States, Europe, Asia, the Middle East and elsewhere, but in search of differentiating investment products. With constant developments in regulation, market practice, infrastructure and investor demands, structuring optimal investment products and the business entities to support them demands both local and international expertise.

As our clients expand their businesses and products to take advantage of global opportunities, regulators are increasingly motivated to focus outside national boundaries and develop ambitious but much needed strategies for mutual recognition and cooperation. Regulators have signed an ever-expanding number of cooperation and supervisory arrangements. One recent example is the China Banking Regulatory Commission's announcement that it has signed memoranda of understanding with the UK Financial Services Authority and the Monetary Authority of Singapore, opening the door to increased overseas investment by Chinese investors (similar arrangements with the United States, Germany and Japan are in the pipeline).

Charlie McCreevy, the European Commissioner for Internal Market and Services, remarked that "[t]he debate, launched in the G7, is now about a transatlantic free trade securities area based on mutual recognition. I welcome this. I have always been in favour of open borders, of giving business the opportunity to decide how to best organise itself. But I also realize it will be a difficult and complex process. There needs to be strong political will and vision to achieve it. We need strong and competitive capital markets on both sides of the Atlantic—and beyond."[6]

Building on this, Commissioner McCreevy and Chairman Cox met in early February of this year to discuss topics of shared interest, including mutual recognition of securities regulation. Following this meeting, the European Commission and the U.S. Securities and Exchange Commission announced that Commissioner McCreevy and Chairman Cox had "jointly mandated their respective staffs to intensify work on a possible framework for EU-US mutual recognition for securities in 2008" with the goals of increasing "transatlantic market efficiency and liquidity while enhancing investor protection."[7] We welcome these developments—although the process may take some time. While Europe continues to make steady progress in its quest for a true single market in financial services, implementation can be patchy and its scope is not all-encompassing. We are still a long way, for example, from a unified European private placement regime, but arguments in favor are compelling.

With constant developments in regulation, market practice, infrastructure and investor demands, structuring optimal investment products and the business entities to support them demands both local and international expertise.

Industry bodies continue to act as forces of change. January 2008 saw the publication of the European-focused Hedge Fund Working Group's best practice standards for hedge funds, the most recent self-regulation initiative by the industry in Europe. Also, the Investment Company Institute, the national association of U.S. investment companies, has recommended that a new form of U.S.-registered investment company be developed as a competitive, attractive investment option for both U.S. and non-U.S. investors.

In our Financial Services Group, we are proud to have built up a fully integrated practice group of some 150 lawyers, spanning the United States, the United Kingdom, continental Europe and Asia. We are committed to having world-class sector expertise in the locations in which we operate. From this platform, we relish the challenges that financial services globalization brings and look forward to continuing to work with clients in taking advantage of new opportunities that result.

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In 2006, China's companies raised US$56.6 billion, leading the world in amount of capital raised in initial public offerings,[8] and we are particularly excited by the opportunities presented by the opening of our office in Hong Kong. Keith Robinson, a Dechert partner formerly resident in the Washington, D.C. office, has been admitted as a registered foreign lawyer in Hong Kong and joins Basil Hwang, a Dechert partner admitted in Hong Kong, England and Singapore, in providing advice to Dechert's financial services clients out of our newest office.

We are pleased to introduce the first issue of Dechert's *Financial Services Quarterly Report*, a review of developments in the international financial services industry. We hope you enjoy it, and welcome your feedback.

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1 Christopher Cox, Chairman, SEC, "International Business—An SEC Perspective" (Jan. 10, 2008), *available at* http://www.sec.gov/news/speech/2008/spch011008cc.htm.

2 Walt Lukken, Acting Chairman, CFTC, "The Keys to Smart Regulation" (Nov. 27, 2007), *available at* http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-30.pdf.

3 *See* European Fund and Asset Management Association, EFAMA Fact Book 2007, Trends in European Investment Funds, at 45. "True" cross-border funds are categorized by excluding round-trip funds from the funds domiciled in Luxembourg and Ireland, i.e., as "funds sold by fund promoters outside their home market, either elsewhere in Europe or in other parts of the world." *Id.* at 44.

4 *See* Bureau of Economic Analysis, U.S. Department of Commerce, News Release: U.S. International Investment Position, 2006, *available at* http://www.bea.gov/newsreleases/international/intinv/2007/intinv06.htm.

5 *See* http://www.nyse.com/about/listed/listed.html (as of December 31, 2007).

6 Charlie McCreevy, European Commissioner for Internal Market and Services, "Security Markets Consolidation and its Implications" (Nov. 30, 2007), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/07/776&format=HTML&aged=0&language=EN&guiLanguage=en.

7 Press Release, SEC, Statement of the European Commission and the U.S. Securities and Exchange Commission on Mutual Recognition in Securities Markets (Feb. 1, 2008), *available at* http://www.sec.gov/news/press/2008/2008-9.htm.

8 Ernst & Young, Globalization: Global IPO Trends Report 2007, at 26, *available at* http://www2.eycom.ch/publications/items/2007_global_ipo_trends_report/ey_2007_global_ipo_trends_report.pdf.

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Hong Kong and Greater China Developments

By **Keith T. Robinson**, **Basil H. Hwang**, and **James Stonehill**

Opening the Door to Chinese Foreign Investment

The China Banking Regulatory Commission ("CBRC") is expected to soon enter into a memorandum of understanding with the U.S. Securities and Exchange Commission ("SEC") that will allow Chinese commercial banks that offer wealth management services to invest in equity securities, including investment funds, in the United States under the Qualified Domestic Institutional Investor ("QDII") program. If finalized, the move would further expand the CBRC's recent liberalization of the QDII program through entry into comparable memoranda of understanding with the UK's Financial Services Authority in December 2007 and the Monetary Authority of Singapore in January 2008. The United Kingdom and Singapore are only the second and third markets, respectively, to sign a memorandum of understanding with the CBRC. Prior to December 2007, Hong Kong was the sole market which was covered by the QDII program. The CBRC also has announced that it intends to enter into memoranda of understanding with Germany and Japan to widen the QDII program further.

The QDII program was formally launched by China in 2006 as a means of easing upward pressure on asset prices and giving Chinese investors and intermediaries greater experience with, and access to, overseas investment. When first authorized, the QDII program only allowed QDIIs to invest overseas in fixed income products, including bonds and notes. The initial reception was tepid, as Chinese investors preferred to keep their money at home in China with its then-booming stock market and the steady appreciation of the yuan against the U.S. dollar. Accordingly, in May 2007, the CBRC issued a notice that significantly expanded the permitted scope of investment under the QDII program to allow Chinese commercial banks to invest in equities and public funds authorized by a supervisory authority with whom the CBRC has a memorandum of understanding. It is worthy of note that the May 2007 notice and the anticipated memorandum of understanding between the CBRC and the SEC will only apply with respect to QDIIs that are Chinese commercial banks, and not to other types of QDIIs. As of a recent date, 21 commercial banks had been authorized to invest approximately US$15.1 billion under the QDII program.

Despite the recent liberalization of the QDII program, there has not been any sudden rush by the Chinese to invest overseas, particularly as major stock markets around the world have experienced increased volatility. As the *Wall Street Journal Asia* commented on January 30, 2008, "quite simply, investors in China don't think the rest of the world looks very attractive right now." Moreover, it is unclear what effect, in the short term at least, the U.S. subprime crisis will have on Chinese investment in the United States when the QDII program finally opens to the U.S. markets. However, it is widely believed that the expansion of the QDII program will have a significant long-term impact on China, as well as on the approved foreign markets.

Expansion of the markets in which QDII assets may be invested will give Chinese investors increased access to a more diversified array of investments and investment advisers, and likely will encourage further liberalization of China's foreign exchange controls and restrictions on foreign investment. This, in turn, may help relieve inflationary pressures and the potential for asset or stock market "bubbles" in China. In addition, expansion of the QDII program should help non-Chinese asset managers, including fund managers, gain greater access to Chinese investors and the estimated US$2.4 trillion of savings in China.

Hedge Fund Manager Licensing Eased in Hong Kong

Hong Kong's Securities and Futures Commission ("SFC") recently has taken steps to ease the path for foreign hedge fund managers to obtain licenses in Hong Kong. The application process for managers to be licensed had become very time-consuming and somewhat uncertain. Moreover, individuals nominated to be responsible officers of licensed managers had to take exams to qualify for a license, yet the exams only had a pass rate of approximately 15 percent. The SFC was compelled to take action to address the growing problem of foreign fund managers

setting up operations in jurisdictions other than Hong Kong, and particularly in Singapore, due to the restrictions and delays which had been experienced by managers when applying for Hong Kong licenses.

In response, the SFC issued a circular in June 2007 making clear that firms already licensed or registered in the United States or the United Kingdom as investment managers or advisers can expect to benefit from a streamlined licensing process if

Expansion of the QDII program should help non-Chinese asset managers, including fund managers, gain greater access to Chinese investors and the estimated US$2.4 trillion of savings in China.

they have good compliance records and serve only professional investors, as defined under applicable Hong Kong statutes and regulations. Firms that are not so licensed or registered also may be able to benefit from the same streamlined process if they have proven track records, to the satisfaction of the SFC. In addition, the SFC expanded the types of professional experience that can satisfy the required "relevant industry experience" for responsible officers, and proposed responsible officers of hedge fund managers who fulfill certain criteria may be exempted from having to take the regulatory exams.

The streamlined licensing process appears to be having an effect. During the first three quarters of 2007, 37 hedge fund manager licenses were approved by the SFC, compared with 29 licenses approved during the entirety of 2006. Moreover, processing times have been significantly improved. Martin Wheatley, the CEO of the SFC, recently stated that "our experience has been that reputable and experienced US and UK hedge fund managers receive our approval in three to four weeks after submitting their application to us."

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How the World of Mutual Fund Directors has Changed[*]

By **Robert W. Helm**[**]

Governance issues have been a central focus of mutual fund directors in recent years and have led to changes in board practices throughout the industry. Changes in fund governance practices can be viewed from two perspectives: first, those changes that have been made in response to regulatory initiatives; and, second, those changes that have arisen more organically in evolving board best practices.

Since at least the late 1990s, the role of mutual fund directors has been much discussed. In February 1999, then-Securities and Exchange Commission Chairman Arthur Levitt hosted a roundtable for high-level SEC officials and industry leaders to explore the role played by fund independent directors.[1] Various panels discussed issues facing funds at the time, including the distribution of fund shares, the valuation of portfolio securities, and the negotiation of advisory fees, and the role that independent directors play in each of those areas. During the roundtable and in subsequent speeches, Chairman Levitt stated his intention to make fund governance a top SEC priority.[2]

Best Practices

Meanwhile, the Investment Company Institute convened its own "blue ribbon" panel to consider best practices for fund directors. The ICI committee's report was released in June 1999.[3] The report recommended 15 best practices, including that (i) at least two-thirds of a fund's directors be independent directors;[4] (ii) independent directors meet separately from management and management directors as necessary, especially during deliberations regarding advisory contract approvals or renewals; (iii) legal counsel to the independent directors be sufficiently independent from the adviser and other fund service providers; and (iv) incumbent independent directors should select and nominate independent directors. With a few exceptions, the ICI panel's recommendations reflected the practices in effect at many of the largest mutual fund complexes at the time.

In late 1999, the SEC proposed fund governance standards that incorporated several of the ICI panel's best practices while at the same time noting that many of the ICI's best practices, however laudable, may be impracticable or unnecessary for all funds to adopt.[5] The SEC proposed to implement these governance standards by amending several exemptive rules (e.g., Rule 12b-1, Rule 17a-7, Rule 17e-1, and Rule 18f-3) to require funds that elected to rely on the rules to satisfy the following standards: (i) the fund's board would be composed of at least a majority of independent directors; (ii) the incumbent independent directors would have responsibility for selecting and nominating additional independent directors; and (iii) any designated legal counsel for the independent directors would be sufficiently independent of fund management. In proposing the governance standards, the SEC stated that it chose to amend the exemptive rules because they required "the independent judgment and scrutiny of independent directors in overseeing the activities that are beneficial to funds and investors, but involve inherent conflicts of interest between the funds and their managers." These governance standards were adopted in January 2001.[6]

New Regulations

In recent years, regulatory proposals developed in the wake of the mutual fund market timing/late trading scandal and revenue sharing inquiries have focused on

"enhancing oversight" by directors. At the same time, the SEC proposed additional governance standards designed to further refine the standards it had originally adopted in 2001.[7] Several of the standards (requiring an annual board self-evaluation, separate meetings for independent trustees, and authority for independent directors to hire staff) were adopted without controversy. The standards requiring funds to have an independent board chairman and a board composed of 75 percent independent directors have been challenged in court[8] and are still not effective.

Meanwhile, corporate scandals such as Enron and WorldCom led Congress to pass the Sarbanes-Oxley Act of 2002. SOX mandated significant changes in the financial control systems of public companies, and resulted in parallel governance changes for funds—mainly to audit committee oversight and responsibilities. Audit committees, which are typically comprised solely of independent directors, have gained substantial responsibility for overseeing the relationship between funds and their auditors, including review and approval of certain non-audit services performed for the funds and their affiliates.

As noted above, many of the recent regulatory developments affecting mutual fund governance have been externally driven. Many of these developments have assumed that something is "wrong" with mutual fund governance. As one recent research paper has argued, it is not clear that proposed remedies to enhance board oversight will produce the desired regulatory result. Indeed, there is evidence to the contrary. A review of economic literature produced by the SEC's Office of Economic Analysis in connection with its work on the independent chair rule concluded that "[b]road cross-sectional analysis [of research data] reveals little consistent evidence that board composition is related to lower fees and higher returns for fund shareholders."[9] This study, as well as subsequent commentary in response to it, has also noted that optimal governance structures are likely to vary from fund to fund. This highlights the point that the external imposition of a particular governance model may not be in the best interests of all boards or funds. In some cases, a change in structure may even weaken existing governance.[10]

Meanwhile, the role of fund directors has evolved for other reasons. Undeniably, increased media and political attention, along with developments related to private litigation and regulatory enforcement actions, have focused some directors' attention more sharply on issues that fund boards and fund managers once considered well-settled but now appear to be open for reconsideration. Such issues include board discussions surrounding "soft dollars," the financing of distribution through use of plans subject to Rule 12b-1, and the practice of reallowing or "sharing" revenues among service providers to support distribution activities.

In many or all of these cases, directors are requesting that fund management revisit underlying rationales for these practices and provide additional information about them, to confirm that the practices continue to benefit funds and their shareholders. Directors are also focusing additional attention on fund advisory fees and fund performance, often with the same objective—to ensure that fund and shareholder interests are best being served in accordance with the standards imposed on directors by law.

Changes in the Boardroom

One recent regulatory development that has had a significant impact in the fund boardroom is the SEC's adoption of the rule requiring funds to appoint a chief compliance officer. The rule requires that the CCO report directly to the board and that the board appoint the CCO and determine the CCO's compensation. Further, the rule also requires that the CCO and the board's independent directors meet in executive session at least annually. While perhaps not an intended consequence, the CCO rule has altered the balance of power between fund boards and management in a way that most industry participants would cite as a healthy change in practice. The rule further supports the view of fund managers that a rigorous compliance system is not a luxury—it is a critical component of a successful business, serving to protect the enterprise from the unintended consequence of harms that may or may not yet have been detected. In

The rule further supports the view of fund managers that a rigorous compliance system is not a luxury—it is a critical component of a successful business, serving to protect the enterprise from the unintended consequence of harms that may or may not yet have been detected. In short, there is considerable agreement in the boardroom that a robust compliance program protects fund managers as much as it protects fund shareholders.

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What has changed in the boardroom of the typical mutual fund? Among the best boards, not as much as one might think. Discussion of many topics may be more extensive than in prior environments, and there may be more willingness on the part of directors to challenge "received wisdom" and past practices. A common concern voiced by fund directors is that they be free to focus their time and energy on the issues that matter most to their funds and their shareholders. Directors have reacted favorably to recent statements by Andrew "Buddy" Donohue, director of the SEC's Division of Investment Management, that indicate his Division is undertaking a review of current regulations to determine which rules might be revised to make better use of director time. To the extent such

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review resulted in limitations on the directors' role in reviewing certain routine items, directors would be able to devote greater time and intellectual resources to matters they view as being of greater importance.

Finally, there remains fairly widespread sentiment that the best boards are those that succeed in bringing together management company and independent directors to thoughtfully consider the issues and options before them and make decisions in the best interest of their funds and shareholders. Most industry participants would agree that the fund board process operates as an effective control mechanism, ensuring that the management company does not "overreach," and that transactions in which the management company has an interest opposed to the interests of the fund are fully vetted. Indeed, that is the principal rationale for requiring that mutual funds be separately incorporated vehicles, apart from the management company, and that certain of their directors be independent. That simple structure has served shareholders very well since the Investment Company Act of 1940 was enacted. It deserves continued respect.

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[*] Reprinted with permission of *Fund Directions* (July 2007).

[**] Mr. Helm would like to thank Megan Johnson for her assistance in drafting the article.

[1] Transcripts from the Roundtable on the Role of Independent Investment Company Directors, Feb. 23-24, 1999, *available at* http://www.sec.gov/divisions/investment/roundtable/iicdtoc.shtml.

[2] "Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds," Remarks of Chairman Arthur Levitt at the Mutual Funds and Investment Management Conference, Palm Springs, Calif., March 22, 1999.

[3] *Report of the Advisory Group on Best Practices for Fund Directors—Enhancing a Culture of Independence and Effectiveness,* June 24, 1999.

[4] Section 10(a) of the Investment Company Act of 1940 requires that at least 40% of a fund's directors be independent of fund management, while Section 10(b)(2) requires that any fund with an affiliated principal underwriter have a majority of its directors be independent of fund management.

[5] *Role of Independent Directors of Investment Companies*, Release No. IC-24082 (Oct. 14, 1999).

[6] *Role of Independent Directors of Investment Companies*, Release No. IC-24816 (Jan. 2, 2001).

[7] *Investment Company Governance*, Release No. IC-26323 (Jan. 16, 2004).

[8] *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006) (finding that the SEC had not corrected violations of the Administrative Procedures Act, which required the Court to vacate the rules). Note that the Court delayed issuing a mandate to vacate the rules to give the SEC an opportunity to seek public comment on certain extra-record materials relied on in its decision making. The SEC reopened the comment period in June 2006. *See Investment Company Governance,* Release No. IC-27395 (June 13, 2006). Recently, the SEC again reopened the comment period to seek comments regarding recently published studies by its Office of Economic Analysis, which comment period closed on March 2, 2007. *See Investment Company Governance,* Release No. IC-27600 (Dec. 15, 2006).

[9] Office of Economic Analysis Memorandum, Chester S. Spatt, Chief Economist, *Literature Review on Independent Mutual Fund Chairs and Directors*, Investment Company File No. S7-03-04 (Dec. 29, 2006).

[10] *See, e.g.*, Letter from Vern O. Curtis to Nancy M. Morris, Securities and Exchange Commission, Investment Company File No. S7-03-04 (Feb. 28, 2007).

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Upcoming and Recent Events

MARCH 18, 2008
7:00 AM – 8:00 AM

Financial Services Breakfast Briefing at 2008 ICI Mutual Funds and Investment Management Conference

Presented by Dechert LLP

JW Marriott Desert Ridge Resort and Spa
Phoenix, AZ

This program will examine side-by-side management issues, China's qualified domestic institutional investor (QDII) program and qualified investor standards, and valuation matters, including lessons from recent enforcement actions, potential issues involving sub-prime securities, and preventive measures.

For more information, contact Natasha Hill at +1 202 261 7731 or via e-mail natasha.hill@dechert.com.

MARCH 13, 2008
4:00 PM – 6:00 PM

Tackling the Hedge Fund Working Group Final Report – Implications and Compliance

Presented by Dechert LLP

Dechert LLP
London

In January 2008, the Hedge Fund Working Group (HFWG) released its Final Report, which establishes best practice standards that hedge fund managers are invited to sign up for on a "comply or explain" basis. This seminar aims to provide hedge fund managers with an overview of the Final Report, including discussion of best practice standards, the requirements and process for compliance, and the wider implications for the industry. The seminar will include a panel discussion on industry reactions to the Final Report. Panelists will include members of the HFWG and investment managers.

For more information, visit www.dechert.com/seminars.

MARCH 12, 2008
5:00 PM – 6:00 PM

Distribution of Foreign UCITS to Germany and Changes to the German Investment Act

Presented by Dechert LLP

Dechert LLP
London

This workshop will focus on the distribution of foreign UCITS to Germany and the practical impact of The Amended German Investment Act, including a discussion of guidelines released by the German financial regulator, BaFin. Topics will include offerings of sub-funds of umbrella UCITS, certifications, disclosure requirements for simplified prospectus, delivering notifications to shareholders, de-registrations of foreign UCITS, and reduced waiting period for foreign UCITS distributions.

For more information, visit www.dechert.com/seminars.

FEBRUARY 19, 2008

Islamic Investment Funds

Presented by Dechert LLP and The Islamic Conferences Group (ICG)

London

This full-day conference provided insight into the Islamic finance industry and focused on topical issues, identified current opportunities, and highlighted future trends.

JANUARY 17, 2008

Understanding the Proposed Short-Form Prospectus for Mutual Funds

Presented by Dechert LLP

Webinar

The SEC recently approved a long-awaited proposal for the short-form or summary prospectus. This online program discussed the how and why of the proposed short-form prospectus, and was designed to help participants understand what is being proposed, the liability issues relating to the use of the summary prospectus, and practical issues raised by the proposal.

Should you wish to receive materials from this seminar, please contact Natasha Hill at +1 202 261 7731 or via e-mail natasha.hill@dechert.com.

OCTOBER 16, 17, 23 and 24, 2007

Deal Activity in the Asset Management Industry

Presented by Dechert LLP and Grail Partners LLC

Sales of asset management firms worldwide reached record-setting levels by mid-2007, but will this trend continue? This four-city seminar series examined the future of asset management M&A, what drives a deal, critical elements of a transaction, the changing role of fund boards, and the development and retention of people.

Should you wish to receive materials from this seminar, please contact Natasha Hill at +1 202 261 7731 or via e-mail natasha.hill@dechert.com.

Dechert LLP

Providing Cross-Border Investment Advice into Germany

By **Angelo Lercara**

With more than €1.4 trillion in assets under management, German investment funds and institutional investors are attractive clients for U.S. investment advisers. However, provision of portfolio management services in Germany generally requires a license from the German financial regulator, BaFin, and such licenses are only available to entities established in Germany. While European managers can provide such services in Germany through the "European Passport" under the Markets in Financial Instruments Directive of the European Union ("MiFID"), a U.S. adviser generally would need to establish a German subsidiary and obtain a regular banking license pursuant to section 32 of the German Banking Act.

As most U.S. investment advisers would be likely to want to test the German market and marketing opportunities prior to incurring the costs of establishing a German subsidiary, many will look to provide such services on a cross-border basis.

The availability of the exemption does not appear to be widely known. In fact, Dechert advised in relation to the first exemption granted to a U.S. investment adviser.

Prior to 2003, no license was required for an entity domiciled outside Germany that provided financial services to customers in Germany. A circular issued in September 2003 and updated in April 2005 changed that. The requirement to be licensed by BaFin is triggered if the service provider has its place of business abroad but "solicits" clients in Germany. In mid-2007, BaFin's interpretation on the license requirement was confirmed by two court decisions in Germany.

According to BaFin, a service provider is deemed to be soliciting clients in Germany if it offers banking or financial services repeatedly and on a commercial basis to persons resident in Germany.

Thus, if a U.S. investment adviser acquires German clients through targeted visits to those clients, a license is required. Similarly, if a U.S. investment adviser acquires new clients in Germany by establishing and using a distribution network or organization provided by independent sales agents based in Germany, the investment adviser also must be licensed, even if the brokers or sales agents in Germany are themselves licensed.

Targeting the German market is assumed to occur where the contractual relationship or the form of the business relationship between the foreign institution and the German institution (e.g., credit institutions, financial portfolio manager, or investment/contract brokers) suggests that the foreign institution uses the German institution as a distribution network. This is particularly so where a commission is paid for the brokerage of clients or where the banking and/or financial services of the foreign institution are advertised to the customers.

However, the April 2005 circular distinguishes between offering services in a "directed" or "target-oriented way", which requires a license, and providing services passively in response to the request of a German resident, which does not require a license. Services provided by a non-German portfolio manager, for example, in response to an approach made on the initiative of a customer do not require a license under the German Banking Act.

In practice, "foreign" service providers typically will not have sufficient contacts and business relationships to trigger significant unsolicited requests from potential clients. The reality is that in most cases a license, or an exemption from the license requirements, will be required.

Exemptions from the License Requirements

According to the April 2005 circular, foreign entities may be eligible for an exemption from the license requirement pursuant to paragraph 2(4) of the German Banking Act. Exemptions may be granted by BaFin on a case-by-case basis, but only for limited business activity and only where BaFin is satisfied that there is no need for supervision in addition to that of the entity's home-country regulator.

Foreign investment advisers also may be exempt in respect of transactions involving institutional investors,

such as the German Federal government; German States; local authorities; credit and financial services institutions, including investment companies, mutual funds, and insurance companies; and certain major corporations.

An exemption only will be granted if the investment adviser is effectively supervised in its home country in accordance with international standards, and the competent authority of the home country cooperates with BaFin. The SEC is considered a competent and cooperating authority.

The following documents are required for the application for exemption from BaFin:

- a certified copy of the articles of association of the adviser;
- a certificate of incorporation and good standing;
- a copy of the latest available annual report and annexes thereto (if any);
- a declaration of good standing by each of the directors of the investment adviser;
- a copy of the contractual documentation that the investment adviser intends to use for its business relationship with the German clients; and
- a brief description of the activities that the investment adviser intends to provide on a cross-border basis in Germany as well as a description of the potential clients and the intended distribution and marketing methods in Germany.

Specific Regulatory Issues for U.S. Entities

A U.S. investment adviser must also submit a certificate from the SEC which confirms that:

- the adviser holds a license for the financial services that it intends to provide on a cross-border basis in Germany;
- the commencement of the intended cross-border services in Germany raises no supervisory concerns; and
- if such concerns should arise, these will be immediately reported to BaFin by the SEC.

The foreign institution must also nominate an authorised agent for service of process in Germany.

The declaration the SEC is prepared to give in these certificates does not always contain everything requested by BaFin. SEC letters typically confirm that the investment adviser has been registered with the SEC; the investment

adviser is regulated by the SEC pursuant to the provisions of the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”), and the rules thereunder; and the fact that an entity is registered with the SEC does not represent a determination by the SEC as to the entity’s professional integrity or its standards of compliance with the U.S. federal securities laws. This is because the Advisers Act does not authorise the SEC to make registration determinations based on those factors. Rather, the Advisers Act requires investment advisers that seek to become registered to make certain public disclosures regarding, among other things, their experience and operations under the U.S. federal securities laws.

In the application to BaFin for exemption it is therefore necessary for U.S. investment advisers to describe in detail the registration and supervisory environment and in particular the “depth” of the SEC examinations and the areas covered by such examinations under the Advisers Act and the relevant rules.

The availability of the exemption does not appear to be widely known. In fact, Dechert advised in relation to the first exemption granted to a U.S. investment adviser. While it is uncertain how long an application for exemption might take to be approved, provided the investment adviser is registered and supervised in the United States and the application is well prepared, there would be no reason for BaFin to refuse to grant an exemption in appropriate cases.

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Unregistered Securities Trading: Could It Offer the Type of Relief Investors Have Been Seeking?

By **Thomas J. Friedmann** and **D. Chad Larson**

The past few months have seen the creation of U.S. markets for unregistered securities with a limited number of participating traders, due in part to the recent financial strength of private capital in comparison to public capital. There are questions about the long-term viability of these securities markets, but one potential impact is regulatory reform aimed at restoring the appeal of public markets to investors.

In May, Goldman Sachs launched its Tradable Unregistered Equity market ("GS TrUE"), which allows large financial institutions worth at least $100 million to participate in trading of securities not registered with the U.S. Securities and Exchange Commission (the "SEC"). The market permits trading of unregistered securities in accordance with the exemption from SEC registration allowed by Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"). GS TrUE limits the holders of each "listed" company's offered unregistered stock to 499, because once an unregistered company has 500 investors, it must register its equity securities with the SEC, thereby becoming a U.S. public company. The first offering on the market by Oaktree Capital Management LLC on May 21 was a success, with the share price rising on the first day and the stock selling at only a slight discount to what it would have received from a public offering.[1] The second offering on August 3, conducted by Apollo Management L.P., proved a bit of a failure: the securities traded at $24 per share instead of the expected $27 to $30 per share.[2]

Other markets seek to offer and trade securities pursuant to the exemption from SEC registration allowed by Rule 144A. On August 14, Citibank, Lehman Brothers, Merrill Lynch, Morgan Stanley, and The Bank of New York Mellon announced the establishment of the Open Platform for Unregistered Securities market ("OPUS-5"), which allows securities trading in accordance with Rule 144A. In September, Bank of America, Credit Suisse, and UBS AG decided that they would participate in the market. FBR Capital Markets, Bear Stearns, and JPMorgan Chase each operate their own markets for unregistered securities. The NASDAQ Stock Market has also revamped its Private Offerings and Reciprocal Trading through Automated Linkages market ("PORTAL") for the trading of unregistered securities of smaller companies. Goldman Sachs recently called for the consolidation of the markets to create an industry-wide private placement market. This appears to be occurring, as evidenced by the November 12 announcement of the planned establishment of the PORTAL Alliance, a private placement market with the founding members consisting of Bank of America, Bear Stearns, Citibank, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, NASDAQ, UBS AG, and Wachovia Securities.

The development of these markets stems from three dynamics:

- regulatory permissibility;
- the burdensome and increasing economic, informational, and liability costs of being a registered public company in the United States; and
- the recent financial strength of private capital in comparison to public capital.

The U.S. securities laws clearly permit these markets. Generally, a holder of an unregistered security cannot sell the security except pursuant to an exemption from the securities laws. Rule 144A under the Securities Act allows the selling of unregistered securities to qualified institutional buyers ("QIBs"), which generally are large financial institutions. The federal government considers such investors to possess enough sophistication to not need protection. As long as these markets consist only of security holders who are QIBs selling unregistered securities to each other, the markets will not come under the purview of the securities laws, barring regulatory action by the SEC. These nascent markets also dramatically increase the potential liquidity of the unregistered securities by giving holders of such securities easy access to multiple potential buyers.

The new markets allow companies to raise capital without incurring the financial and disclosure burdens of selling capital in a public market. Companies bear huge costs in conducting an initial public offering and in complying with the SEC's reporting requirements. According to a survey of approximately 80 companies that conducted initial public offerings in the United States in the first eight-and-a-half months of 2005, the average price of an initial public offering was almost $2.7 million.[3] As an example of the expense of continued compliance with the SEC's regulations, a poll of 200 companies with average revenues of $6.8 billion found that the companies spent on average $2.9 million in 2006 to adhere to the accounting oversight procedures demanded by Section 404 of the Sarbanes-Oxley Act of 2002, as amended.[4]

The disclosure requirements of the securities laws can further injure companies by forcing them to divulge information. Periodic reporting allows the management of public companies to come under constant scrutiny and can cause public companies to disclose data or strategies that they would prefer not to share with their competitors. Finally, public companies face huge potential liability from shareholder derivative suits.

Although public companies incur large economic, informational, and potential liability costs, they do gain access to vast amounts of public capital. The new private placement markets could only come into existence to compete with the public markets due to the recent expansion of private capital. Jay Ritter, a finance professor at the University of Florida, noted that these markets for unregistered securities are "a manifestation of the growth of private equity in comparison to public equity," and cited as proof the recent and unprecedented number of private equity buyouts of public companies.[5] Companies can now raise a comparable amount of capital by turning to large private investors rather than needing to raise funds from the general public. In 2006, corporate entities raised $162 billion in Rule 144A private placements, versus $154 billion in initial and secondary public offerings on the New York Stock Exchange, the NASDAQ Stock Market, and the American Stock Exchange.[6] The vast sums of investment capital in the hands of private companies and individuals make these markets viable.

Significant questions surround the future of these markets because they are so new. First, it is not clear whether, and to what extent, corporate entities will rely on them for raising capital. The first two offerings on GS TrUE had mixed results. The recent turmoil regarding the lending markets might affect private capital's strength in comparison to public capital, and the limit of 500 shareholders may deter companies from listing on the private placement markets.

Second, if these markets become major vehicles for raising capital, the SEC will likely try to implement some regulatory authority over them, but it remains unclear just how much, and on what basis, the SEC could exert such authority. Alternatively, the SEC may seek to make public markets relatively more attractive by reforming public listing and trading regulations to make them less onerous. Henry Paulson, the Secretary of the Treasury and a former chief executive officer of Goldman Sachs, has called for streamlining and easing the reporting requirements of public companies.[7]

A new type of financial market has come into existence, and it remains to be seen whether it will usher in a new age of securities trading. Even if it does not, it could spur the type of regulatory reform that some investors and public companies have sought, potentially increasing investors' options.

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1 Randall Smith, "Goldman Takes 'Private' To a New Level: Firm's Trading System Lets Unregistered Stock Reach Exclusive Market," *Wall Street Journal*, May 24, 2007, at C1; Henry Sender, "Live at Apollo Management: Plan to Cash In, Limit Scrutiny," *Wall Street Journal*, July 17, 2007, at C1.

2 "Apollo Raises $828 Million," *Wall Street Journal*, August 7, 2007, at C6.

3 Carl W. Schneider, Joseph M. Manko and Robert S. Kant, Going Public, Venture Capital and Small Business Financing, ed. Robert J. Haft, *available on Westlaw at* SECVENTURE s 12:22 (citing CCH IPO Week in Review, Vol. III, Issue 39 (September 2005)).

4 "Five Years Under the Thumb," *Economist*, July 28, 2007, *available at* http://www.economist.com/displaystory.cfm?story_id=9545905.

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Closing a Loophole? Making Sense of the SEC's New Anti-Fraud Rule–Rule 206(4)-8*

By **Joseph R. Fleming** and **Christopher D. Christian**

In recent years, the hedge fund industry has seen remarkable growth in terms of the number of funds, the size of assets under management, and the number of participating investors. This tremendous growth has not gone unnoticed by the Securities and Exchange Commission ("SEC"), which attempted to bring hedge funds and their advisers under stricter SEC regulation by adopting Rule 203(b)(3)-2 under the Investment Advisers Act of 1940, as amended (the "Advisers Act") in December 2004 (the "Hedge Fund Registration Rule"). The Hedge Fund Registration Rule was, however, short-lived, and in its wake, Rule 206(4)-8 under the Advisers Act was born.

In 2006, the United States Court of Appeals for the D.C. Circuit vacated the SEC's controversial Hedge Fund Registration Rule in *Goldstein v. SEC*, and in the SEC's view, created ambiguity regarding the application of Sections 206(1) and 206(2) of the Advisers Act in cases where investors in a pooled investment vehicle are defrauded by an investment adviser. In addressing the scope of the exemption from registration as an investment adviser under the Advisers Act in Section 203(b)(3) and the meaning of "client" as used in that section, the D.C. Circuit expressed the view that, for purposes of Sections 206(1) and 206(2) of the Advisers Act, the "client" of an investment adviser managing a pool is the pool itself, and not an investor in the pool.

The SEC intentionally avoided delineating in Rule 206(4)-8 a standard for what would constitute per se fraud, in order to avoid providing a "roadmap" for potential wrongdoers to escape punishment.

To close the loop and eliminate any perceived gap or uncertainty regarding the ability of the SEC to bring enforcement actions against hedge fund advisers under Section 206 of the Advisers Act in their dealings with investors or potential investors in pooled investment vehicles, the SEC unanimously adopted Rule 206(4)-8.

The Rule, which became effective on September 10, 2007, prohibits investment advisers to "pooled investment vehicles," whether or not the adviser is registered with the SEC, from:

- making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in pooled investment vehicles; or
- otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or potential investor in pooled investment vehicles.

Rule 206(4)-8 is broad in scope, and its interpretation by the SEC contains some noteworthy wrinkles.

This article examines Rule 206(4)-8 and highlights its potential consequences for fund advisers and managers.

Scope of the Rule

Rule 206(4)-8 is broad in its reach, covering any investment adviser, whether registered or unregistered, and without regard to investment strategy or the type of pooled investment vehicle managed. The Rule defines a "pooled investment vehicle" as "any investment company as defined in §3(a) of the Investment Company Act . . . or any company that would be an investment company under §3(a) . . . but for the exclusion provided from that definition by either §3(c)(1) or §3(c)(7)." Through this definition, the SEC has cast a wide net on the number and type of investment funds impacted by the Rule, including not only hedge funds but also mutual funds, private equity funds and venture capital funds.

Moreover, unlike many of the SEC's other anti-fraud provisions, Rule 206(4)-8 is not limited to fraud committed in connection with the purchase or sale of a security. Rule 206(4)-8 prohibits advisers to pooled investment vehicles from making false or misleading statements to investors or *prospective* investors in a pool, regardless of whether the pool is offering, selling, or redeeming securities. The Rule differs from Rule 10b-5 under the Securities Exchange Act of 1934 in this respect. Thus, the scope of the Rule extends equally to solicitations, offering circulars, private placement memoranda, responses to "requests for

proposals" and statements made in face-to-face meetings with existing and potential investors.

Application of the Rule

The application of Rule 206(4)-8 arguably does not require investment advisers to take any additional steps to comply with the Rule. However, investment advisers should be aware of the following significant points outlined below in determining the application of the Rule to their individual facts and circumstances:

No Definition of Fraud Provided

The SEC intentionally avoided delineating in Rule 206(4)-8 a standard for what would constitute *per se* fraud, in order to avoid providing a "roadmap" for potential wrongdoers to escape punishment. The SEC did, however, provide some examples of acts considered fraudulent under the Rule. For example, defrauding investors in distributions of shareholder reports or by manipulating or misrepresenting the value of the fund is prohibited. Moreover, collecting fees for which an adviser is not entitled and absconding with investor money without investing the funds are also fraudulent acts. While these instances are relatively clear-cut, less obvious cases will turn on their particular facts and circumstances.

No Scienter Required

Rule 206(4)-8 does not require the SEC to prove scienter in establishing liability under the Rule. In other words, the SEC need not show that the investment adviser acted with the intent to defraud. As such, mere negligence is sufficient to establish liability under the Rule. This is somewhat extraordinary among anti-fraud rules, which generally require some showing of scienter. This particular point was a source of controversy within the SEC. While some Commissioners raised questions about the appropriateness of excluding a scienter requirement, SEC staff members and the Rule's adopting release cited *SEC v. Steadman* as authority for its position that scienter is not required to violate Section 206(4) and maintained that not requiring scienter made the Rule a more powerful tool in preventing fraud.

The net effect of this interpretation is to impose a standard of negligence with respect to the accuracy of all potentially false or misleading communications (or omissions) to investors and prospective investors. As such, the Rule would prohibit, for example, false or misleading statements equally to both current and prospective clients regarding investment strategies a pooled investment vehicle will pursue, the experience and credentials of the investment adviser (or its associated persons), the performance of the pool or other pools managed by the adviser, the valuation of the pool, risks associated with the pool, and performance of the pool, among others.

No Fiduciary Duty Created

Rule 206(4)-8 does not create a fiduciary duty to investors or prospective investors in the pooled investment vehicle not otherwise imposed by law. The Rule would also not alter any existing duty or obligation an investment adviser has under the Advisers Act or state law to investors in pooled investment vehicles. As such, the SEC could, for example, bring an action under the Rule if the investment adviser negligently or deliberately failed to make disclosure required under state law.

No Private Right of Action Created

The SEC acknowledged that Rule 206(4)-8 does not create a private right of action for investors to sue managers or advisers for money damages. The Rule may only be enforced by the SEC through civil and administrative enforcement actions against advisers.

Conclusion

The SEC apparently intends to use Rule 206(4)-8 to combat what it views as the looming presence of potential fraud in the comparatively unregulated hedge fund industry. The lack of a scienter requirement in the Rule is somewhat alarming. While it is arguable that the Rule adds very little to the compliance burden of fund managers and advisers, it is advisable for fund managers to review their compliance policies and procedures to ensure that Rule 206(4)-8 and its negligence standard are adequately addressed. Given the SEC's determination to bring hedge funds into its regulatory sphere, Rule 206(4)-8 should, at the very least, serve as a reminder to advisers and managers to act with due care in connection with the marketing and sale of hedge funds.

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Governing Law and Jurisdiction – Who Cares?

By **Duncan Black**

Most legal contracts contain standard "boiler plate" clauses buried at the end, one of which says something about choice of law and jurisdiction. Few clients attach much importance to it. The reason for this may be because contracting parties, on the threshold of a new life together, do not want to spoil the wedding day by squabbling over the terms of a pre-nup. The problem is, however, that the consequences of the wrong choice, or no choice, can be quite severe.

Governing Law

Governing law clauses establish which country's rules of interpretation and legal remedies apply. The governing law clause will be relevant in determining issues such as the validity of the original agreement and any amendments, the interpretation of clauses if there is uncertainty, whether there has been a material breach and the calculation of any damages.

Where the nationalities of the contracting parties differ or where there is some other connection with another jurisdiction, there is usually a choice to be made. Often the choice of the dominant party prevails, even when the rationale for his or her selection seems hazy. Sometimes the choice is made by the lawyers with most influence over the drafting of the agreement. There is normally great latitude in choosing the governing law, although the legislation or regulations of one country may still apply irrespective of the choice of governing law (for example financial services regulations to which a party may be subject in the conduct of its obligations under the agreement).

In English language contracts between parties of different nationalities, the choice is usually between U.S. law, or more precisely the law of a particular U.S. state, and English law. The decision will often rest on factors such as where the contract will be performed and where the assets are located.

Jurisdiction

Jurisdiction clauses determine the place where a dispute will be heard and how it will be dealt with. Nearly always, the place of jurisdiction will be the same as the place of the choice of law.

There may be strong reasons for one party to want to avoid a particular jurisdiction, and conversely reasons why the other party may welcome that jurisdiction. Some organisations will want to insulate themselves as far as possible from the jurisdiction of particular countries. Choice of jurisdiction provisions can help reduce, if not eliminate, the possibility of being successfully sued in any particular jurisdiction.

The consequences of the wrong choice, or no choice, can be quite severe.

Litigation or Arbitration?

Once governing law and jurisdiction have been determined, there is another choice to be made: litigation or arbitration. Arbitration has been gaining in popularity for the last few years. Compared to litigation it is sometimes perceived as more flexible, quicker and confidential. It is not necessarily cheaper than litigation; the parties will have to pay the fees of the arbitral panel (one, three or even five experienced arbitrators) as well as the secretariat fees of the organisation; whereas for litigation, in most countries, judge time and courtroom use remain free of

charge or available at nominal expense. The fees of the parties' advocates and legal advisers in an arbitration will be little different from those in court proceedings.

Because the process of arbitration depends upon a degree of mutual cooperation between the parties, there is the possibility of a reluctant disputant dragging things out. Even with cooperative parties it can take a surprisingly long time to agree upon and appoint an arbitral panel. To some extent one is at the mercy of the speed with which the secretariat of the selected arbitration organisation works, and in this, and other, respects the choice of arbitration organisation can be an important factor.

The quality of the decision and the procedure depends on the quality of the arbitrator. They are not uniformly good. Similarly, the litigation courts of some jurisdictions have better reputations for speed and quality than others, but experiences can vary widely within jurisdictions depending on the case, the parties and the judge.

The main benefit claimed for arbitration is that it is confidential, whereas, by and large, court proceedings are public. If there is sensitivity about business information being publicly available, or concerns about witnesses being cross-examined in the glare of the press,[1] then arbitration has an advantage. In practice, in the UK, only a small proportion of disputes make it to full trial. Most cases settle on agreed terms long before then. It follows that the risk of adverse publicity may sometimes be overstated.

In some commercial arrangements, when things go wrong, quick remedial action is needed. For example assets may need to be frozen or documents seized. There is no time for agreement and selection of an arbitration panel. Where this is a possibility, it is best to select a dispute resolution clause which allows one or both parties, depending on the circumstances and bargaining power, to apply for immediate injunction relief from the courts of the selected country. After that, the parties can revert to arbitration if necessary.

Key Points

- Don't just leave it to your lawyers to select choice of law—ask them to explain their choice and what factors, especially business considerations, they have taken into account.
- Consider how you would want any dispute arising from your contract to be handled. Do you have a 'house' view about dispute handling generally?
- How important is confidentiality compared to other factors, for example, speed of decision-making?
- What are you doing to insulate yourself from the risk of being sued in a jurisdiction that is geographically inconvenient or whose laws may tend to favour the position of the other party?

If litigation is selected, there is a trap for the unwary when both parties are domiciled in EU Member States. Even if the exclusive jurisdiction of country 'A' is selected, it is possible for one of the parties to commence proceedings in country 'B'. The time taken for country 'B' to decide whether it can continue to hear the case can be used as a delaying tactic. For example a reluctant debtor may find it convenient and cost-effective to preempt and frustrate efforts by a creditor to collect money by deploying this procedural ruse.[2] It cannot be done where the parties have agreed to arbitrate, however. Nor does it apply to courts outside the EU. In the case of agreements where the principal obligation is to repay money, careful thought needs to be given to this risk.

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1 As famously happened in the *Unilever v. Mercury Asset Management* case in 2001.

2 *See JP Morgan Europe Ltd v. Primacom AG and others* [2005] EWHC 508.

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Hedge Fund Working Group Issues its Final Report on Hedge Fund Standards

By **Philip Orange**

The Hedge Fund Working Group ("HFWG"), which was set up in July 2007 and whose 14 members include some of Europe's largest hedge fund managers and one of the largest U.S. hedge fund managers, issued its Hedge Fund Standards Final Report on 22 January 2008.

The Final Report sets out best practice standards (the "Standards") that all hedge fund managers will be invited to adopt. The Standards relate closely to the regulatory regime in the UK; indeed they derive to a greater or lesser extent from the FSA's Principles for Businesses. However, the Report takes the view that, from the perspective of investors or lenders, compliance with the Standards ought to be of comfort wherever the hedge fund manager is situated. The Report recognises that U.S. managers based in the United States are engaged in a parallel process, under the auspices of the President's Working Group, in developing best practice standards, and the HFWG hopes that this may lead to the gradual development of standards for the global hedge fund industry which will command respect generally and apply to managers in all major jurisdictions.

The Standards broadly reflect those proposed in the Consultation Paper published in October 2007, but with some significant amendments to address our and others' concerns about the need to recognise the reality and structure of the existing hedge fund regime. One particular concern is the fact that hedge fund managers may not be in a position to ensure that certain actions occur, when ultimate responsibility for those actions rests with the fund's governing body. Accordingly, many of the Standards in the Final Report are expressed in terms that the hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to take any required action, rather than ensure that such action occurs.

The Standards address five areas of concern identified by the HFWG: disclosure to investors and counterparties, valuation, risk management, fund governance and shareholder conduct, including activism. The HFWG's best practice standards for each of these areas include, *inter alia*, the following:

- **Disclosure**—There should be transparency about fees payable by a fund and appropriate disclosure to investors of a fund's investment policy, associated risks and commercial terms (including "material" side letter terms), as well as appropriate disclosure of information to a fund's counterparties. In addition, references to a fund's performance should contain appropriate disclosure of any factors which may be material to the robustness of the performance calculation in situations where, in the view of the manager, a fund had material exposure to hard-to-value assets.
- **Valuation**—Valuation arrangements should address and mitigate conflicts of interest in relation to asset valuation. The HFWG believes that the most effective way to achieve this is for the fund governing body to appoint an independent and competent third party valuation service provider. However, the Final Report acknowledges that this will not always be possible and, in these circumstances, the manager should operate an in-house valuation function which is segregated from the portfolio management function. If smaller or start-up managers consider it impractical to operate a segregated valuation function they should disclose this in their marketing documents and encourage the fund governing body to disclose it in the fund's offering documents. The Report also includes some relatively prescriptive requirements in connection with the use of side pockets for hard-to-value assets.
- **Risk management**—Managers should put in place a risk framework which sets out the governance structure for its risk management activities and specifies the respective reporting lines, responsibilities and control mechanisms intended to ensure that risks remain

within the manager's risk tolerance (or risk appetite), as conveyed to and discussed with the fund governing body. The risk framework should cover all relevant categories of risk (including portfolio, operational and outsourcing risks). Managers should explain their risk framework to the fund governing body, and encourage the fund governing body to explain the risk framework in the fund's offering documents, which should also disclose all relevant risks.

- **Governance**—Suitable and robust governance arrangements that are capable of dealing with potential conflicts between managers and investors should be put in place when a fund is established. Prior to the establishment of a fund, managers should seek to encourage and assist the fund governing body to identify and recruit members of the fund governing body with suitable experience and integrity to enable the fund governing body to be able to discharge effectively its role with the appropriate degree of independence. Throughout the life of the fund, managers should be cognisant of the need for the fund governing body and governance processes to be effective and appropriate. In addition, managers should carefully consider the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance or other director guidance is appropriate and do what it reasonably can to encourage and assist the fund governing body to act accordingly.
- **Shareholder conduct, including activism**—In relation to the conduct of a fund as an investor, managers should ensure that they have internal compliance arrangements designed to identify, detect and prevent breaches of market abuse laws and regulations. Managers should have a proxy voting policy which allows investors to evaluate their approach. Managers should not generally borrow stock in order to vote.

By signing up, managers will be expected to adopt the Standards on a "comply or explain" basis. Managers that sign up will have until 31 December 2008 to adopt the "comply or explain" regime, and signatories will be required to make available to investors and prospective investors in the funds they manage a statement in relation to those Standards, if any, with which they do not comply.

The HFWG will give way to a permanent Hedge Fund Standards Board (HFSB) that will own and maintain the Standards and keep them up-to-date. It is envisaged that the Alternative Investment Management Association (AIMA) will play a key role in providing a secretariat for the HFSB and developing guidance in relation to the Standards and in working towards the convergence of global hedge fund standards.

A key to the success of the Standards will be whether larger investors, such as funds of hedge funds and major institutional investors, strongly encourage or even require compliance by managers of hedge funds in which they invest.

Widespread adoption of the Standards is likely to have a positive impact on the level of professionalism displayed by managers and may well lead to greater investment by traditional wholesale investors. In addition, it may be successful in warding off new mandatory regulation.

Managers will need to decide whether to sign up to the Standards. While U.S. managers will be looking to the outcome of the President's Working Group, for European and particularly UK-based managers, this question is one that cannot be ignored. Adherence to the Standards is likely to be a positive selling point for signatories and good for investors. At the same time, signing up will increase the regulatory and compliance burden and standards by which signatories are judged, and by which they may be sued.

Declining to sign up will avoid a degree of increased compliance burden but may carry negative inferences, particularly in the eyes of investors who place importance on, or may even require, compliance with the Standards. In addition, while the standards by which signatories are judged are certain to rise, declining to sign up will not necessarily mean a preservation of the status quo: the mere existence of the Standards may act as a raising of the bar, both in terms of the claims of plaintiffs in civil litigation and the standards expected by the regulators.

A key to the success of the Standards will be whether larger investors, such as funds of hedge funds and major institutional investors, strongly encourage or even require compliance by managers of hedge funds in which they invest.

The Standards themselves can be viewed on www.hfsb.org.

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Mutual Recognition and Accounting Standards Convergence

By **Wendy Robbins Fox***

The U.S. Securities and Exchange Commission ("SEC") has undertaken a number of initiatives during the past year that share a common purpose—the facilitation of cross-border transactions. The SEC held a roundtable discussion on "selective mutual recognition," a proposed international framework whereby non-U.S. stock exchanges, operating through trading screens physically located in the United States, and non-U.S. broker-dealers generally would be allowed to provide services directly to U.S. investors under an abbreviated registration system. It also adopted a rule (the "Final Rule") to accept in filings from non-U.S. private issuers[1] financial statements prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") without reconciliation to generally accepted accounting principles as used in the United States ("U.S. GAAP"). The SEC also recently held two roundtable discussions on whether to allow U.S. issuers, including investment companies subject to the Investment Company Act of 1940, as amended (the "Investment Company Act"), to prepare financial statements in accordance with IFRS rather than U.S. GAAP.

In a recent speech, SEC Chairman Christopher Cox said, "[I]f you practice and work in the international arena . . . this is what you need to know from the SEC's standpoint: IFRS is coming. XBRL is coming.[2] And mutual recognition is coming." According to Chairman Cox, "Each of these three initiatives represents an important step toward addressing the rapid convergence of trading and investment in the world's capital markets. Together, they offer the prospect of the development of a truly global approach to the many financial and regulatory challenges we face."[3]

Selective Mutual Recognition of Regulatory Regimes with Respect to Stock Exchanges and Broker-Dealers

Selective mutual recognition would generally require non-U.S. stock exchanges and non-U.S. broker-dealers to register with the SEC under an abbreviated system, provided that such entities are subject to regulatory oversight in their primary jurisdictions under regimes that the SEC recognizes as "substantially comparable" to that in the United States. Under the proposed concept, if a jurisdiction satisfies the SEC's criteria, the SEC would negotiate a memorandum of understanding ("MOU") with that jurisdiction's securities regulator. Among other things, the MOUs would likely provide for the logistics of enforcement information-sharing and regulatory cooperation between the SEC and that jurisdiction's securities regulator and require reciprocal treatment for U.S. stock exchanges and U.S. broker-dealers to conduct business in that jurisdiction. The mechanics of mutual recognition could be structured so that the SEC would retain responsibility for investigating and prosecuting violations of the anti-fraud provisions of the U.S. federal securities laws, including Rule 10b-5 of the Securities Exchange Act of 1934, as amended ("Exchange Act").

Currently, U.S. federal securities laws generally require non-U.S. stock exchanges conducting business in the United States, and non-U.S. broker-dealers that induce or attempt to induce securities transactions by investors in the United States, to register under the Exchange Act or operate pursuant to an exemption from registration thereunder.

During the SEC-hosted roundtable discussion, the panelists focused on three issues:

(i) increased access by non-U.S. stock exchanges through trading screens physically located in the United States;

(ii) increased access by non-U.S. broker-dealers to investors in the United States; and

(iii) whether and to what extent a non-U.S. securities regulatory regime could be deemed substantially comparable to that in the United States.

The roundtable was moderated by senior SEC staff, and panelists included representatives from stock exchanges and broker-dealers, former SEC Chairmen David Ruder and Harvey Pitt, and other industry experts. Current and former SEC commissioners also participated in the discussion.

The panelists generally supported allowing non-U.S. stock exchanges to operate trading screens in the United States accessible to U.S. broker-dealers subject to the Exchange Act. There was a concern, however, that U.S. stock exchanges might be at a competitive disadvantage given the SEC's more stringent regulatory regime.

The panelists distinguished between retail and institutional investors, in considering the impact of mutual recognition. They noted that retail investors may lack the sophistication to understand differences in market structure and regulation, and to evaluate the risks of invest-

ing in non-U.S. markets. The panelists emphasized the importance of investor protection, and expressed concern regarding possible consequences to retail investors if non-U.S. broker-dealers could directly access investors in the United States without registering with the SEC.

In assessing the comparability of non-U.S. securities regulatory regimes to that in the United States, the panelists generally supported a principles-based approach and not a cumbersome rule-by-rule comparison. According to Chairman Cox, this would include, at a minimum, "a comprehensive review of the jurisdiction's commitment to investor protection" and the regulatory mandate of that jurisdiction. Additionally, the SEC would review how that jurisdiction "addresses such things as fair markets, fraud manipulation and insider trading and . . . such issues as registration qualifications, trading surveillance, sales practice standards, financial responsibility standards and dispute resolution."[4]

In early February of this year, Chairman Cox met with Charlie McCreevy, the European Commissioner for Internal Market and Services, to discuss topics of shared interest, including mutual recognition of securities regulation. Following the meeting, the European Commission and the SEC announced that Chairman Cox and Commissioner McCreevy had directed their staffs to collaborate on a possible framework for EU-U.S. mutual recognition in 2008, and encouraged input from market participants. In addition, the SEC and European Commission officials, together with staff of the Committee of European Securities Regulators, plan to hold regular technical meetings to develop this framework.

Authorization for Non-U.S. Private Issuers to File Financial Statements Prepared in Accordance with IFRS without Reconciliation to U.S. GAAP

The SEC's adoption of the Final Rule in November 2007 was a part of its "efforts to foster a single set of globally accepted accounting standards," which would facilitate U.S. investors' understanding of non-U.S. investment opportunities "more clearly and with greater comparability than if those issuers disclosed their financial results under a multiplicity of national accounting standards, and . . . will enable issuers to access capital markets worldwide at a lower cost."[5]

Based in London, the IASB is an independent, privately-funded accounting standard-setter "committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements." Such accounting standards are known as IFRS. Currently, approximately 100 countries throughout the world allow or mandate the use of IFRS, including Member States of the European Union, where the use of IFRS has generally been mandated since 2005 for companies incorporated in a Member State and whose securities are listed on an EU-regulated market. The U.S. Financial Accounting Standards Board ("FASB") is an independent, private-sector organization whose mission "is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." Subject to SEC oversight, FASB develops U.S. GAAP.

In 2002, the FASB and the IASB issued a memorandum of understanding, called the Norwalk Agreement, where the organizations "pledged to use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained." In a February 2006 memorandum of understanding, the FASB and the IASB reaffirmed their commitment to the convergence of IFRS and U.S. GAAP.

The Final Rule permits non-U.S. issuers to file with the SEC, without providing a reconciliation to U.S. GAAP, financial statements prepared in accordance with the English language version of IFRS. An issuer choosing to do so must state in a note to its financial statements, "explicitly and unreservedly," that its financial statements are in compliance with IFRS as issued by IASB. The independent auditor of such issuer must provide an unqualified report opining on that compliance. The Final Rule, however, generally does not extend to financial statements prepared in accordance with any other set of accounting standards, including a jurisdictional variation of IFRS.

Concept Release and Roundtable Discussions Regarding Whether to Allow U.S. Issuers to File Financial Statements Prepared in accordance with IFRS

In August 2007, the SEC published a concept release seeking public comment on whether to allow U.S. issuers, including investment companies subject to the Investment Company Act, to file financial statements prepared in accordance with IFRS as issued by IASB rather than U.S. GAAP (the "Concept Release").[6] Then, in December, the SEC hosted two roundtable discussions regarding the Concept Release. The first roundtable focused on "big picture" issues from the perspective of U.S. investors, issuers and markets, as well as the global market. The second roundtable discussed practical issues involved with the potential use of IFRS by U.S. issuers. The roundtables were moderated by senior SEC staff and the panels included auditors, academics, executives of multinational corporations, credit rating agencies and an investment company, and other market participants, including Robert Herz, Chairman of FASB, and Richard Thorpe, Head of Accounting and Auditing Policy at the UK FSA. The SEC commissioners also participated in the discussions.

The panelists generally agreed that allowing U.S. issuers to prepare financial statements in accordance with IFRS would increase global capital formation and the competitiveness of U.S. issuers, by decreasing regulatory burdens and costs to certain issuers. Further, according to some panelists, both U.S. and non-U.S. investors would benefit because they would be able to more adequately and accurately compare investment opportunities provided by U.S. and non-U.S. issuers. This could be of particular importance in those industries in which companies generally prepare financial statements in accordance with IFRS.

Panelists in the first roundtable expressed strong support for the application of a single set of high quality globally accepted accounting standards, and a recognition that the end point would be IFRS rather than U.S. GAAP. The second roundtable discussed the mechanics involved in the transition process. The panelists discussed whether compliance should be optional at first, with a time frame for subsequent mandatory compliance. They also considered the costs involved in the transition process, and the impact upon small issuers. Overall, there was a general consensus supporting an eventual requirement for U.S. public companies to file financial statements prepared in accordance with IFRS, with issues of timing and incremental phase-in to be determined.

Conclusion

Mutual recognition of securities regulation is a concept that is supported on both sides of the Atlantic, in light of potential benefits including increased transatlantic market efficiency and liquidity, and oversight coordination among regulators. The staffs of the SEC and the European Commission have been directed to collaborate on a possible framework for EU-U.S. mutual recognition in 2008.

The Final Rule and Concept Release are also significant in that they illustrate the SEC's continued commitment to the convergence of IFRS and U.S. GAAP, and demonstrate the SEC's potential willingness to adopt a single set of high quality globally accepted accounting standards for all issuers.

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1 The release describes such entities as "foreign private issuers," as defined in Rule 3b-4(c) of the Securities Exchange Act of 1934.

2 XBRL stands for "eXtensible Business Reporting Language," and provides computer-readable identifying tags for individual items of financial data. These tags enable computers to process the underlying information automatically, thereby allowing companies to streamline their processes for compiling information more effectively and consumers of financial data to compare and analyze such data more efficiently. The SEC is conducting an analysis of a pilot program of companies using XBRL, the results of which should be compiled in early 2008. This article will focus on selective mutual recognition and IFRS, and not on XBRL.

3 Christopher Cox, Chairman, SEC, "International Business—An SEC Perspective" (Jan. 10, 2008), *available at* http://www.sec.gov/news/speech/2008/spch011008cc.htm.

4 Christopher Cox, Chairman, SEC, Remarks at the SEC Roundtable on Selective Mutual Recognition (June 12, 2007), at 130-31, *available at* http://www.sec.gov/news/openmeetings/2007/openmtg_trans061207.pdf.

5 Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP (Dec. 21, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8879.pdf.

6 The Concept Release is available at http://www.sec.gov/rules/concept/2007/33-8831.pdf, and comments to the Concept Release are available at http://www.sec.gov/comments/s7-20-07/s72007.shtml.

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