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Second Quarter 2008

Financial Services Quarterly Report

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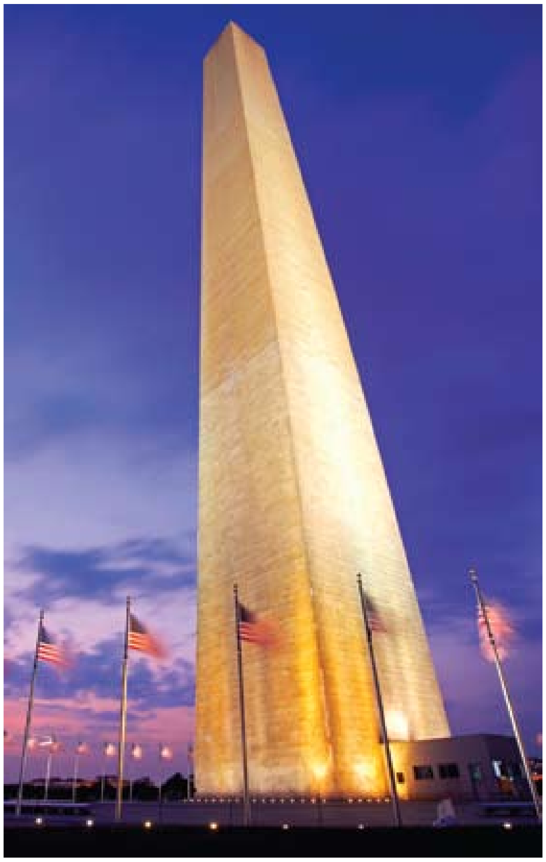
Proposals to Create an Alternative Investment Company Structure in the United States


by **Robert W. Helm** and **Christopher D. Christian**

Over the last ten years, the global mutual fund industry has experienced unprecedented growth. Between the beginning of 1998 and the end of the third quarter of 2007, worldwide mutual fund assets grew from $9.3 trillion to a record $25.82 trillion. This rapid growth has accelerated over the past three years with the global mutual fund industry adding nearly $10 trillion since the end of the fourth quarter of 2004. While U.S. mutual funds continue to lead global assets under management at 47.5% as of the end of the third quarter of 2007, European domiciled funds are slowly gaining ground on U.S. mutual funds with 34.2% of the total. U.S. mutual funds, moreover, are not seen as a "competitive product for export to fast-growing foreign markets."[1] Instead, European "UCITS" are rapidly gaining footing at an incredible pace, particularly in Asia and Latin America.

In light of this growing trend and the increased competition to the U.S. mutual fund industry, there is a growing "national conversation" among government officials and industry participants aimed at addressing the challenges for U.S. investment advisers and promoters attempting to compete in today's global market. This conversation has recently sparked a proposal from the Investment Company Institute ("ICI"), among others, to create an alternative form of U.S. registered investment company for the global funds marketplace. This proposal has been widely debated, including recently at the opening panel of the 2008 ICI Mutual Funds and Investment Management Conference ("2008 ICI Conference"), and has prompted calls from the U.S. Department of the Treasury ("Treasury") for the Securities and Exchange Commission ("SEC") to address the topic.



ICI Proposal

The ICI recently recommended to the Treasury legislation to permit an alternative form of investment company, which would be registered under the Investment Company Act of 1940 ("Investment Company Act"). The ICI recently made a similar recommendation to the Senate Republican Capital Markets Task Force, in connection with the Task Force's examination of the competitiveness of the U.S. financial markets. The impetus for the recommendation was the globalization of the mutual fund industry and the decrease in global market share among U.S. mutual funds, and the desire to propose a framework more suitable for competition in the global market for both U.S. and non-U.S. investors. The ICI noted that proposals to create an alternative investment company structure in the United States have previously been recommended by, among others, the SEC.

According to the ICI, the most significant disadvantage to U.S. registered investment companies vis-à-vis their non-U.S. counterparts (e.g., UCITS) is the tax treatment to non-U.S. investors. Under U.S. tax law, U.S. registered investment companies must normally distribute all of their net income and net gains to avoid taxation of such income and gains at the fund level. Subject to certain exceptions, such distributions are generally treated as dividends to fund shareholders. Distributions to shareholders who are non-U.S. persons are generally subject to U.S. federal withholding tax at the rate of 30% on distributions of net investment income and net short-term capital gains, unless the tax is reduced pursuant to a tax treaty.

On the other hand, in many European countries, a fund is permitted to retain its income and gains without imposing current tax liability for the fund or its shareholders. Instead, such retained income and gains generally will be taxed only upon redemption of fund shares, a structure that the ICI suggests will facilitate investment growth and long-term savings.

The ICI also noted the lack of flexibility with respect to a U.S. fund's organizational structure, including the requirement that a registered investment company be organized as a corporate entity separate and apart from its sponsor. Conversely, a UCITS may take the form of an unincorporated fund with a management company, a trust, or an investment company per se. Which form a particular fund takes will depend on the legal structures available in the country in which it is situated (e.g., Luxembourg or Ireland). The UCITS Directive covers both unincorporated and incorporated types of funds without indicating a preference for either.

The ICI suggested features it believed should be considered in any proposed model, including:

- a straightforward fee structure, such as a single, or unitary, fee from which the investment company sponsor would pay virtually all fund expenses and earn a profit;
- a tax "roll-up" of the investment company's income and gains;
- a more streamlined, market-based structure; and
- many of the same core protections of the Investment Company Act that characterize the other forms of U.S. registered investment companies.

While the ICI has not endorsed a specific model, it believes that independent review, a necessary element to investor protection, may be obtained through mechanisms other than independent directors, including through depositories or trustees. Other jurisdictions employ similar safeguards.

The Mutual Fund Directors Forum ("MFDF"), an independent, nonprofit membership organization for investment company directors, also has recommended modifications to the current regulatory structure of U.S. mutual funds. However, the MFDF takes issue with the ICI's views regarding the structure for an alternative model of U.S. registered investment company. Although expressing its agreement with the ICI "that there are ways to increase the benefits of mutual funds for investors," including alternative fee structures, and improved tax treatment of fund investments, the MFDF believes that "independent directors are central to the success of the United States fund industry."

Whether a new global fund model should be created in the United States was a subject of debate at the recent 2008 ICI Conference.

Convergence and Divergence of Fund Regulation Around the Globe: Panel Discussion at the 2008 ICI Conference

At the 2008 ICI Conference, the opening panel discussed whether the need for a new type of U.S. mutual fund exists, the advantages and disadvantages of the current mutual fund structure compared to that of a UCITS, and the features of a U.S. mutual fund that would be included in any new U.S. global fund proposal. Panelists included: Andrew "Buddy" Donohue, current Director of the SEC's Division of Investment Management; Paul F. Roye, Senior Vice President, Fund Business Management Group, Capital Research & Management Company and former Director of the SEC's Division of Investment Management; Craig S. Tyle, Executive Vice President and General Counsel, Franklin Templeton Investments; and Robert W. Helm, a partner at Dechert LLP.

The panel addressed the differences between the U.S. and European regulatory regimes and the competitive implications for U.S. registered funds in the global marketplace. Much of the debate focused, however, on what role, if any, independent directors should play in any new form of U.S. mutual fund, with industry panelists endorsing the role played by independent directors in overseeing potential conflicts of interest between a fund and its adviser. The debate sparked a lively discussion and mirrored much of what is being said in the industry and in government on the topic.

Treasury Recommendation of Global Fund Product

On March 31, 2008, the U.S. Department of the Treasury released its Blueprint for a Modernized Financial Regulatory Structure. In the Blueprint, among other recommendations, Treasury cited tax disadvantages of offering U.S. mutual funds globally and recommended that the SEC, in consultation with others, propose legislation to expand the Investment Company Act to permit registration of a new "global" investment company. The goal of the proposal would be to allow for the registration of investment companies that can be marketed more competitively to overseas investors. The new global investment company would be required to maintain certain protections of the U.S. regulatory framework, including a robust governance system, fee disclosures, and other disclosures. A global fund would allow U.S. investment advisers to compete with non-U.S. investment advisers in the global funds marketplace without having to clone their U.S. mutual fund or otherwise organize an investment fund outside of the United States as a UCITS. No timeline was given by Treasury to the SEC with respect to this proposal, and it remains to be seen whether, and how, the SEC will act on Treasury's recommendation.

Section 7(d) of the Investment Company Act

A recurring topic in the global debate over fund regulation is the concept of "mutual recognition." In the United States, Section 7(d) of the Investment Company Act provides that only funds organized under the laws of the United States, or any state, are permitted to offer shares in the United States. As such, UCITS are not permitted to register with the SEC the offer and sale of shares directly to the public in the United States. Similarly, the UCITS regime requires that a UCITS eligible fund be organized under the laws of an EU Member State, with no mechanism for recognizing funds domiciled in other jurisdictions.

Section 7(d) authorizes the SEC to issue orders permitting foreign-organized funds to offer shares in the United States if the SEC finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of the Investment Company Act against the foreign fund, and that permitting the foreign fund to offer shares in the United States is consistent with the public interest and the protection of investors. However, the SEC has not issued any order exempting a foreign fund from the provisions of Section 7(d) since 1973. The standard under Section 7(d) for an exemptive order has proved to be extremely difficult to meet, primarily because foreign funds are unwilling to submit to the imposition of all provisions of the Investment Company Act, especially when the provisions of the Investment Company Act may conflict with—or at least be perceived as being more stringent than—the regulations of their home jurisdiction. It remains to be seen whether the SEC will revisit its approach to Section 7(d) in light of calls globally for mutual recognition. At the 2008 ICI Conference, industry panelists expressed the view that in today's global market, a more liberal approach to fund regulation was warranted on both sides of the Atlantic.

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1 Letter from the Investment Company Institute to the U.S. Chamber of Commerce (pub. avail. Jan. 26, 2007).

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UK Developments


Funds of Alternative Investment Funds

by **Mark Stapleton** and **Jim Baird**

In the current economic market, making an allocation to a fund of alternative investment funds product may not be the top priority for the typical UK retail investor. However, with the Financial Services Authority (FSA) now considering responses to the most recent Consultation Paper requesting comments on the rules for retail-oriented funds of alternative investment funds (FAIFs), the question once again comes into focus.

A FAIF regime in the UK would not be the first time regulated fund of alternative investment funds products have been launched in Europe. However, the proposed FAIF regime would provide greater genuine access to retail investors compared to equivalent regulated products in France, Spain and Italy, which, by requiring minimum investments of €500,000, €50,000 and €10,000, respectively, are beyond the reach of many retail investors. The UK proposal (which would expand the UK's non-UCITS retail scheme regime (NURS) to incorporate FAIFs) does not require a minimum investment threshold.

Dan Waters, FSA Director of Retail Policy and Themes, remarked on the release of the Consultation Paper:

> *"Permitting consumers access to a wider range of innovative investment strategies through authorised onshore vehicles will allow more choice and a better opportunity for risk diversification, while maintaining consumer protection through our proportionate rules on the operation of the product. We aim to make the final adjustments to the new regime before the end of the year, including the additional areas on which we are consulting today."* [1]

Mr Waters' statement correctly identifies the main issue: the imperative of maintaining consumer protection, on the one hand, and the need for "proportionate rules", on the other. With consumer products, there can be no dispute as to the need for proper investor protection. The difficult part is achieving proportionality in a way that preserves investor protection without creating rules that are too cumbersome or costly to be viable (and therefore gain acceptance in the industry).

While the Italian "speculativi" funds have achieved some following with around €30 billion under management, this is largely confined to very wealthy investors. The German version of regulated funds of alternative investment funds has not enjoyed widespread adoption, in part due to a shortage of suitable target funds willing to provide the necessary tax reporting required to realise the benefits of the tax structure. It is hard to argue that any of the European retail funds of alternative investment funds products have yet enjoyed truly broad-based acceptance in the retail market.

If the UK regime is to achieve the stated aim of "permitting consumers access to a wider range of innovative investment strategies. . ." it has to be accessible to the public, it has to be operable on a commercially viable basis and it has to have attractive tax treatment (or at least a tax treatment that does not put it at a competitive disadvantage). As proposed, the FAIF regime would be accessible to retail investors as part of the NURS regime but would stand a limited chance of success unless it was also commercially viable and tax efficient.

On the viability issue, while progress has been made in the consultation process to date, there are still concerns in the industry over whether the proposed rules would be workable in practice. One key point is the rules for settlement of redemption payments. NURS funds are subject to a T+4 settlement requirement for payment of redemption proceeds and this is proposed to remain unchanged for FAIFs. However, alternative funds (which would form a significant proportion, if not the majority, of the underlying assets held by many FAIFs) often require two or three weeks from the valuation date to produce valuations following which there will also be a relatively long payment settlement period. The result would be that FAIFs would be required to pay redemption proceeds long before they had a reliable basis for calculating the redemption price for the redeemed FAIF units. FAIFs would also need to manage redemption of underlying fund interests with a view to receiving the cash proceeds shortly in advance of their own redemption settlement date.

FAIFs might, with some difficulty, be able to juggle redemptions of their underlying investments, borrowing (although this is restricted) and other means of raising cash in order to meet the redemption requests. However, it might be argued that it would be more efficient for

The difficult part is achieving proportionality in a way that preserves investor protection without creating rules that are too cumbersome or costly to be viable.

funds, and therefore result in better returns for investors, if the FAIF settlement provisions matched those of the underlying investments.

More problematic, however, are the potential concentrative or dilutive effects on investors of payment of redemption proceeds on the basis of, what would in effect be, estimated valuations. As proposed, the redemption payments would need to be made weeks before an accurate valuation was available for the underlying assets. Any difference between the paid price and the actual valuation would give rise to concentration and dilution, affecting both redeeming and continuing investors. While many net asset valuations of open-ended fund products involve a degree of estimation, this is normally confined to a small proportion of the portfolio and the past valuations (on which estimates are normally based) are seldom more than a few days old. For FAIFs investing largely in hedge funds, the effect would be exaggerated as a large proportion (if not the majority) of the portfolio would be valued on the basis of estimates most of which would be a month, and possibly more, out of date.

This is a case where imposing the standard normally applied to retail products may actually offer less protection for investors than adapting that standard to the new set of circumstances. Settlement terms for alternative funds have, in the main, evolved as they have to ensure equitable treatment of investors by avoiding payment on the basis of estimates. There is good reason to consider applying an equivalent, matching, standard to a retail regime operating in the same market.

The other key requirement for a successful FAIFs regime will be modifying the tax rules generally applicable to authorised investment funds to accommodate their particular requirements. Ideally, FAIFs should enjoy a tax regime that is as efficient for a UK and non-UK investor as the equivalent UK tax regime for non-UK funds of funds. Further, investing in a hedge fund through a FAIF should, ideally, be as tax efficient as investing in the underlying fund directly.

UK authorised investment funds have a tax exemption for capital gains but are subject to tax on most forms of income receipts. In particular, a gain realised by a FAIF on redemption of an interest in a hedge fund that does not have distributing status (see below) is taxable as income as an "offshore income gain". Accordingly, it was imperative that such offshore income gains could be exempt from UK tax in the same way as other capital gains to ensure that FAIFs could achieve tax equivalence with non-UK funds of funds. In light of this, the Government Budget in March 2008 contained an announcement providing an ability for such funds to elect to become taxed as a "Tax FAIF". A Tax FAIF will be exempt from tax on an offshore income gain but, to preserve equivalence with the tax position of a non-UK fund and that of a direct investor

Ideally, FAIFs should enjoy a tax regime that is as efficient for a UK and non-UK investor as the equivalent UK tax regime for non-UK funds of funds.

in the underlying hedge fund, a UK investor in a Tax FAIF will become liable to income tax on any gain made on realisation of its investment in the Tax FAIF.

In recommending this change to the tax rules, the FSA's tax working group understood that it was merely a step in the right direction rather than being a complete tax solution for FAIFs. Investors in Tax FAIFs may rightly complain that they will incur far more tax than an investor in a traditional UK authorised investment fund. Investors in traditional funds will obtain capital gains tax treatment on redemption of their interest at 18% and this therefore represents a significant advantage as compared to investors in a Tax FAIF who would be taxed at their marginal income tax rate. Furthermore, it means that it will make little sense for funds of funds seeking to invest in both traditional and alternative funds to seek such Tax FAIF status as it would result in taxation as income.

Further developments in the tax position of FAIFs will be linked with the outcome of the current consultation process in respect of the taxation of offshore funds and the proposed new "reporting fund" regime to be introduced in 2009 for offshore funds (see below). Ideally, FAIFs should also have the ability to obtain capital gains treatment for their investors and this could be on the basis of a similar reporting fund concept. However, the real barrier to this outcome is whether it will be possible for hedge funds, and indeed a substantial number of hedge funds, to become reporting funds under the proposed new regime.

Hedge funds have found it difficult to qualify for distributing status under the existing distributing fund regime with only a small number of such funds qualifying for such status. A big concern in this respect has been confusion over whether hedge funds might be deemed to be "trading" and whether as a consequence gains on underlying assets might need to be reported as income. As noted below, the current proposal is that reporting funds will use as the starting point the appropriate accounting measure of income (subject to certain adjustments discussed below). This needs careful consideration by the hedge fund industry to ensure that as many hedge funds as possible can achieve reporting fund status without having to report large amounts of income. Failure to address this issue appropriately will lead to a major disincentive for investors to invest in open-ended funds in the hedge fund sector, and an advantage to equivalent closed-end funds, due to the new 22% differential between income tax and capital gains for investors. If a level playing field is to be achieved for open-ended funds of hedge funds as compared to traditional funds and closed-end funds and for onshore and offshore FAIFs it is our view that it is vital for Her Majesty's Revenue and Customs (HMRC) to introduce an appropriate measure of reportable income.

UK Offshore Funds Tax Regime – Reporting Funds

by **David Gubbay**

On 15 May 2008, HMRC published partial draft regulations amending the UK tax regime for offshore funds. The regulations will replace the current “offshore fund rules” and will create a new division between “reporting” and “non-reporting” funds. The regulations are intended to build on, and give effect to, the approach set out in the “next steps” paper published on 27 March 2008 by HMRC which summarised the responses to the original 2007 consultation paper on the proposed new regime.

Comments are sought on the regulations by 11 July 2008. HMRC is planning to publish a full set of draft regulations following the current consultation in the autumn; the regulations are expected to be made at the end of 2008 and take effect from some time in 2009.

The current rules seek to tax certain gains of investors in offshore funds as income as opposed to capital. However, under the rules, provided the offshore fund qualifies as a “distributing fund” during the period of ownership, the gains of UK investors remain subject to tax as capital gains. The attainment of capital gains tax treatment for investors is generally preferable and is particularly relevant now that the capital gains tax rate for individuals has dropped to 18% from 6 April 2008 (compared to the higher rate income tax at 40%).

Some of the key aspects of the proposed new regime are as follows:

- Distributing fund status will be replaced by “reporting fund” status. The provision’s requirement to distribute 85% of income will be replaced with a requirement to report up to 100% of a fund’s income—there will be a 10% margin for error allowed. This means there will no longer be a need to physically distribute income but rather there may be deemed distributions or a combination of physical and deemed distributions. Deemed distributions should assist those funds which seek to accumulate income. A UK investor in a reporting fund will be taxable on its share of reported income in the fund on a current basis whether or not it is actually distributed.
- The rule that a distributing fund may not invest more than 5% of its assets in other offshore funds will be abolished for reporting funds.
- The starting point in the calculation of reportable income will be total recognised income and expenses for the period for a fund using International Accounting Standards (IAS) or an “equivalent amount”, with adjustments then made for certain capital items and expenses. In particular, adjustments will be required for capital gains and losses on investments as identified in accordance with the Investment Management Association’s Statement of Recognised Practice (IMA SORP). This will be introduced as an alternative to the existing requirement for distributing funds to make the income calculation on a UK equivalent profits basis. This should ease the administrative burden of the existing system and may also enable more hedge funds to qualify as reporting funds.
- Minor failures to keep to the conditions will not result, as at present, in a fund being removed retrospectively from the reporting fund regime (with the loss of capital treatment that would result).

The original discussion paper also proposed the introduction of a new definition of “offshore fund”. The Budget stated that no such change will occur in 2008 as the Government will continue to discuss the point with industry with a view to legislating for a revised definition in 2009.

The final version of the draft regulations should include transitional arrangements for funds that currently have distributing status under the existing offshore funds regime.

Although the draft regulations are not complete, they provide a welcome opportunity to comment on the current thinking behind the new rules and indicate an encouraging movement towards a less onerous regime for offshore funds and their investors.

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1 FSA, “Further Progress on Access for Retail Customers to Alternative Investments”, news release, 22 February 2008.

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Hong Kong and Greater China Developments


by **Keith T. Robinson** and **Basil H. Hwang**

Hong Kong to Review and Update its Fund Regulatory Code

The Hong Kong Securities & Futures Commission (SFC), the primary regulator of the fund industry in Hong Kong, has announced a comprehensive review of its Code on Unit Trusts and Mutual Funds (Code). The Code is the main source of regulatory guidance governing the authorization of mutual funds for public sale in Hong Kong. The SFC has indicated that it anticipates completion of a thorough update of the Code sometime in 2009, with an opportunity for industry and public comment during the process. The SFC's proposal is the first significant proposed update to the Code since 1997, and represents the SFC's efforts to keep pace with changes in the marketplace, to implement regulatory best practices as they emerge, and to continue to make Hong Kong an attractive environment in which to do business and invest.

The draft revised Code has not yet been circulated for public review and comment. However, the SFC has indicated that the new Code will be drafted with the following principles in mind:

- The Code will be principles-based in order to provide regulatory flexibility and scalability to accommodate growth, and prescriptive measures generally will be avoided.
- Funds will not be restricted to rigid asset classes or investment structures.
- Guiding investment principles will be available which are to be in line with international standards and emerging best practices.
- Fundamental investor protection tenets will remain, such as the requirement for segregation of custody from management.

As part of this process, the SFC also anticipates revisiting its "recognized jurisdiction scheme" and "acceptable inspection regime" classifications, which are two means by which funds and managers organized in selected jurisdictions outside of Hong Kong may be authorized to offer funds in Hong Kong on an expedited basis. The SFC's goal

The SFC is undertaking this modernization of the Code at a time when Hong Kong has been increasingly successful in attracting funds and fund managers.

is to broaden these classifications and expand the list of jurisdictions and regulatory authorities that are considered to offer regulatory oversight that is comparable to the SFC's oversight, and consistent with protection of investors and Hong Kong's markets. This process will include consultation with overseas regulators.

Several working groups are expected to be set up in the near future, and the SFC hopes that the discussion process with regional fund managers can be concluded by the third quarter of this year. Re-examination of the recognized jurisdiction scheme and acceptable inspection regime classifications and consultations with overseas regulators will take place on a parallel track. The SFC then intends to circulate a draft of the revamped Code for informal industry comment during the fourth quarter of 2008, solicit public comment during the first quarter of 2009, and adopt the revised Code at some point later in 2009.

It is worthy of note that the SFC is undertaking this modernization of the Code at a time when Hong Kong has been increasingly successful in attracting funds and fund managers. Net sales of funds in Hong Kong hit a record in 2007, increasing by over 80% compared to 2006. As of a recent date, over 2,000 SFC-authorized funds are available for investment in Hong Kong, and these funds have aggregate net assets in excess of US$1 trillion. In the last two years alone, the SFC has granted 130 new fund manager licenses and authorized 480 new fund products for sale.

Renminbi (RMB) Denominated Funds on the Upswing

Fueled by an appreciating local currency, increased access to PRC domestic investors, and a booming domestic IPO market, renminbi (RMB) denominated funds enjoyed a record year in 2007. RMB funds are private investment funds that are organized under Chinese law, denominated in RMB, and focused on investments in the PRC. There are two types of RMB funds: (1) domestic RMB funds that are organized under domestic PRC laws and invest assets raised from domestic PRC investors; and (2) foreign-invested RMB funds, which are funds with full or partial non-Chinese ownership that are organized under PRC laws and regulations governing foreign investments into China. Significant regulatory distinctions exist with respect to the approval and operation of these two types of RMB funds, although this summary focuses primarily on the latter type of fund.

Foreign managers typically form foreign-invested RMB funds as joint ventures or wholly foreign-owned enterprises (commonly referred to as “WFOEs”) under PRC regulations authorizing foreign investors to engage in venture capital investments in the PRC. Traditionally, foreign-invested RMB funds have been restricted to investing only in unlisted high tech companies, although recently regulatory changes appear to broaden the permitted scope of investments for such RMB funds.

Currently, foreign-invested RMB funds may be structured as either a limited liability company, or as an entity that is not considered to be a “legal person” and which is roughly equivalent to a limited partnership. The PRC currently is considering adoption of regulations permitting investment limited partnerships. Foreign-invested RMB funds structured as limited liability companies offer the advantage of limitation of investor liability to the amount invested, but are subject to the PRC’s enterprise income tax. Foreign-invested RMB funds that are not considered to be “legal persons” subject their “indispensable investors” (roughly the equivalent of a general partner) to joint and several liability with the fund, but traditionally have been able to be structured to permit pass-through tax treatment pursuant to which neither the fund nor investors are subject to the enterprise income tax, although a withholding tax is imposed on distributions. However, recent legislative and regulatory changes in the PRC ultimately may have the effect of lessening the tax advantage of this latter type of foreign-invested RMB fund.

While recent market volatility may impact manager and investor appetite for RMB funds in the near term, asset managers likely will continue to view RMB funds as an attractive means of accessing the PRC investor market and investing in Chinese growth companies.

Both types of RMB funds have experienced significant growth recently in light of investor interest in Chinese investments denominated in an appreciating currency, as well as a booming IPO market that permitted a relatively straightforward exit strategy for investors in Chinese growth companies. While recent market volatility may impact manager and investor appetite for RMB funds in the near term, asset managers likely will continue to view RMB funds as an attractive means of accessing the PRC investor market and investing in Chinese growth companies, whose prospects generally continue to look promising in light of the PRC’s continued economic growth and the recent adjustments to company valuations occasioned by market fluctuations.

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Regulators Worldwide Play "Catch-Up" on Insider Trading

U.S. authorities, notably the Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ"), have traditionally pursued insider trading more aggressively than regulators in other countries. Although the latter have, from time to time, promised to sharpen their focus on this issue, we have previously questioned whether they truly intended to conduct more vigorous investigations and prosecutions. The recent actions of these authorities have answered that question with a qualified "yes;" although the authorities have been more vigorous, they have yet to match the U.S. approach. At the same time, the SEC and DOJ have continued and expanded their long-standing commitment to pursue insider trading involving U.S. companies, even where the traders are not U.S. citizens and do not have substantial contact with the United States other than through their securities trading.

In this article, we describe recent developments in the United Kingdom, Germany, France and the United States. We also expand on our earlier analysis[1] with a description of developments in Hong Kong.

Although the U.S. authorities remain the bellwether for aggressive enforcement of insider trading laws, other jurisdictions have identified this as an area to which they will apply greater scrutiny.

United Kingdom

by **Duncan Black**

In the last twelve months, the Financial Services Authority ("FSA") has reacted robustly to media comment that it is a soft touch when it comes to insider trading (or "insider dealing" as it is referred to in the UK and certain other jurisdictions). A number of new initiatives have been announced, and the FSA has launched its first criminal prosecution of an insider dealing claim. These changes have been announced in response to the growing perception that the U.S. authorities were not only more vigorous in apprehending and convicting offenders in the United States but were to some extent stepping in to act as the world's policeman in these matters, given that no other foreign regulatory authorities seemed to be doing much about the problem.

First, the UK regulator has announced the hiring of specialist criminal barristers as well as staff from the UK's Serious Fraud Office to add expertise to its ranks and to support its increasing emphasis on criminal (not civil) prosecution powers to apprehend offenders. Second, it is being given the statutory power to grant immunity—plea bargaining—in the hope that this will help build strong cases against the key players. Third, it has started calling traders unannounced to question them regarding suspicious trades. The FSA reads the trader his rights over the telephone, and he then has to answer questions about any unusual looking transactions. Fourth, there will be an increased requirement for firms to record telephone conversations and keep records for six months. Fifth, there will be increased cooperation with foreign law enforcement authorities.

The FSA is keen to establish a successful track record of prosecuting insider dealing so that eventually a deterrent effect will spread. All eyes are now on their first case—the defendants are the former general counsel of a telecom company and his father-in-law, who allegedly bought shares ahead of a takeover announcement. What is notable about this case, however, is that neither defendant was employed in the financial services industry. Commentators will watch with interest to see whether the FSA brings proceedings against better known industry participants in the months to come.

Germany

by **Angelo Lercara**

While the German Federal Financial Supervisory Authority ("BaFin") is very keen to detect and report insider dealing, the efforts of the public prosecutor's office to prosecute cases have been criticised as too slack. BaFin does not have criminal enforcement powers; rather these are left to public prosecutors. Jochen Sanio, President of BaFin, stated in a recent interview that approximately 75% of the cases concerning suspected insider dealing which BaFin refers to the public prosecutor's office are not pursued further. Only 40 out of the 550 reported cases since 2001 have ended with a verdict. BaFin has expressed particular dissatisfaction with the public prosecutor's office in Frankfurt, which has brought charges in only five reported instances over the past five years.

At the September 2007 yearly BaFin workshop "White-Collar-Crime and Capital Markets" in Frankfurt, over 250 representatives from public prosecutors' offices, police authorities, trading monitoring departments from several German stock exchanges, and the German Federal Bank came together to pursue more effective cooperation, in combating insider trading, market manipulation and money laundering. In his address, BaFin President Sanio emphasized the importance of such cooperation, in order to increase the proportion of cases brought that end with a verdict. A senior public prosecutor noted that "continuous and close cooperation" between BaFin and public prosecutors is needed to clarify areas of responsibility, more effectively gather evidence, and otherwise strengthen enforcement efforts.

France

by **Stéphan Alamowitch**

Changes made in recent years to the powers of the French regulatory authority, the *Autorité des Marchés Financiers* ("AMF"), have increased its ability to seek administrative sanctions for violations of the insider trading and other market rules, but the power of criminal prosecution still lies with the public prosecutor's office. This could lead to the overlapping of administrative sanctions and of criminal convictions based on the same facts. This duality has previously been upheld by French courts, but it has been challenged by a report of a panel headed by J-M Coulon and submitted to the French Minister of Justice in March 2008.[2] The Coulon Report, dealing with white collar crime, considers that such dual prosecution is not permitted under the European Convention for the Protection of Human Rights and Fundamental Freedoms, and it suggests a revision of the coordination between the AMF and the public prosecutor's office. Although the grounds for this criticism are questionable in light of the French Republic's signature of Protocol n°7 of the European Convention on Human Rights allowing dual prosecution, the possibility that the French legislature will nevertheless proceed to amend the law cannot be discounted. This new coordination would ultimately give the public prosecutor's office the authority to choose whether criminal or administrative proceedings are appropriate.

Some officials of the AMF have raised concerns about the resulting effectiveness of insider dealing regulation, as criminal law has proved rather ineffective in France. In either case, the manpower available is limited and in the case of the AMF is but a fraction of that available to the FSA or BaFIN, and is not even on the same scale as that of the SEC. In theory, aggrieved parties acting as civil parties could force the public prosecutor to pursue criminal proceedings, although this could be costly and given the evidentiary issues is a rarity in the area. Recent scandals have given rise to a series of high profile investigations and to prosecutions which are currently pending. Changes in French criminal procedure now make it possible to obtain plea bargains as well, but the law is untested and the rules of criminal procedure are such that one wonders whether defendants would not be better off if they took their chances on a full trial. Following the March 2008 Coulon Report, the French legislature could also render access to criminal prosecutions harder for civil parties. As a counterpart it might also give them incentives to act before the AMF (e.g., creation of class action suits with a possibility of having procedural fees refunded) rather than pursuing criminal prosecution.

Hong Kong

by **Basil H. Hwang**

In Hong Kong, the primary source of the law relating to insider dealing is the Securities and Futures Ordinance ("SFO"). Insider trading is considered to take place when a person who has relevant information in relation to a listed company, and who is connected with that listed company, deals or counsels or procures another person to deal in the listed securities (or their derivatives) of that listed company or a related corporation, and who knows or reasonably believes that such person would deal in them. Examples of persons who are connected with a listed company include a director, a shareholder or an employee, or any person who has access, by reason of being connected with another corporation, to information concerning the listed corporation which relates to any transaction involving both of those corporations.

Under the SFO, insider dealing is a category of "market misconduct". The Market Misconduct Tribunal is the tribunal in Hong Kong that has civil jurisdiction over various types of market misconduct, including insider dealing. Defenses or exceptions are available to a person (who has the corresponding burden of proof) who is alleged to have engaged in market misconduct by reason of insider dealing, and if any such defenses or exceptions apply, then no sanctions can be imposed by the Securities and Futures Commission ("SFC") against him even in circumstances where, by definition, his actions would be regarded as insider dealing. Examples of such defenses and exceptions include situations where a corporation can prove that a proper system of "ethical walls" was in place to prevent insider dealing, and when a person can prove that the insider dealing was not intended to secure or increase a profit or to avoid or reduce a loss by the use of relevant information.

The SFO provides civil and criminal penalties for insider dealing. This means that if insider dealing is suspected, a case may either be brought against the alleged inside dealer before the Market Misconduct Tribunal as civil proceedings or in court as criminal proceedings.

Between April 2006 and March 2007, six cases were referred to and concluded by the Insider Dealing Tribunal (the predecessor of the Market Misconduct Tribunal) following the completion of SFC investigations. A total of 17 persons were found by the Insider Dealing Tribunal to be liable for insider dealing in four of these cases, and penalties totaling approximately HK$24.8 million were imposed. As of 30 September 2007, 16% of all the investigations conducted by the SFC involved insider dealing. Insider dealing investigations ranked as the third most common type of investigation by the SFC, behind market manipulation (32%) and intermediary misconduct (25%).

In addition, criminal proceedings were commenced by the SFC earlier this year against five individuals for insider dealing. These represent the first criminal prosecution under the SFO for insider dealing since insider dealing was made a criminal offence in 2003. The charges in these proceedings concerned trading in the shares of a listed company prior to an announcement made to the market about a proposal to privatize the company.

The maximum penalty that can be imposed for insider dealing upon conviction by indictment is 10 years' imprisonment and a fine of HK$10 million.

United States

by **Paul Huey-Burns**

As to the United States, the past year has been characterized by both tough talk and tough action. In a recent speech,[3] the Director of the SEC's Division of Enforcement characterized insider trading as a financial crime with "a unique hold on the American popular imagination" and went on to say that "Whether it's the real Ivan Boesky or the fictional Gordon Gekko, the fall of the mighty has always been one of America's favorite spectator sports."

> *As to the United States, the past year has been characterized by both tough talk and tough action.*

Despite some notable defeats, such as the appellate decision in March 2008 overturning the conviction of the former CEO of Qwest Communications, U.S. authorities have backed up this swagger. This has been particularly noteworthy because the rest of the SEC's enforcement program in the recent past has struggled to find its footing.

The SEC and DOJ have pursued several important actions involving market professionals. They also have pursued cases involving prominent non-U.S. traders and even have pursued creative theories involving traders who have hacked into corporate information technology systems from overseas locations. The SEC sometimes has not been successful in pursuing these theories, but the fact that the authorities are willing to pursue such cutting edge cases is yet another measure of their aggressive approach to this area.

Conclusion

In sum, although the U.S. authorities remain the bellwether for aggressive enforcement of insider trading laws, other jurisdictions have identified this as an area to which they will apply greater scrutiny. We expect this trend to continue, particularly in regard to the multinational information flows among hedge funds and other highly sophisticated institutional investors.

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1 *See, e.g., The FSA Begins to "Think Tough" on Insider Dealing—But will Thoughts Turn to Deeds?*, Dechert On Point (May 2007), available at http://www.dechert.com/library/FSSA05-07.pdf

2 *See "La dépénalisation de la vie des affaires"*, [Depenalization of Business Conduct] report submitted by a commission directed by J-M Coulon issued on February 20, 2008 and submitted to the Minister of Justice in March.

3 Linda Chatman Thomsen, *Remarks Before the Australian Securities and Investments Commission 2008 Summer School: U.S. Experience of Insider Trading Enforcement*, Melbourne, Australia (February 19, 2008).

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U.S. President's Working Group Recommends Best Practices for Hedge Fund Industry

By **Jennifer O. Epstein** and **Markus Sgouridis**

Two private sector committees established by the U.S. President's Working Group on Financial Markets, the Asset Managers' Committee and the Investors' Committee, released separate but complementary reports on April 15, 2008 setting out proposed sets of best practices for hedge fund managers and investors. The committees were tasked to develop best practices for market participants with a view to enhancing investor protection and mitigating systemic risk. Each committee's report acknowledges that both the hedge fund manager and the investor are accountable and must implement appropriate practices to maintain strong controls and infrastructure to support their activities.

The best practice recommendations are not binding and do not have the force of law or regulation. However, as has already proved to be the case in many other instances, best practice recommendations such as these ultimately may serve as the basis for a subsequent legal framework. The Investors' Committee in particular recognizes that there is a substantial and ongoing debate among policymakers as to how to address the challenges of the stress that the financial markets currently face, and that these reports have a role to play in influencing that debate.

Consistent with the goal of the President's Working Group to enhance current investor protection standards, the recommendations exceed existing industry standards. Hedge fund managers and investors will need to carefully assess their specific practices against the practices recommended by the committees in deciding whether they wish to follow the recommendations.

The Best Practices Recommended by the Asset Managers' Committee

The report by the Asset Managers' Committee suggests best practices with respect to five key areas: disclosure; valuation; risk management; trading and business operations; and compliance, conflicts and business practices.

There is a substantial and ongoing debate among policymakers as to how to address the challenges of the stress that the financial markets currently face, and that these reports have a role to play in influencing that debate.

Disclosure – A manager should establish a disclosure framework to provide material information to investors with sufficient frequency and detail to allow investors to make informed investment decisions and monitor the risks associated with their investments. A managers should adapt the core principles of the U.S. public company disclosure regime in developing its disclosure practices. That disclosure regime is designed to provide investors with material information at the time of making their investment and ongoing updates throughout the life of the investment. Most of the information that will be material to investors when making their investment decision will be contained in the fund's private placement memorandum which should be reviewed and updated as appropriate at least annually.

Valuation – A manager should maintain consistent and documented policies as well as appropriate controls for segregation of responsibilities between portfolio managers and those responsible for valuations. A manager should also establish a governance function, such as a valuation committee, with ultimate responsibility for establishing and reviewing compliance with the manager's documented valuation policies. Independent personnel should be responsible for the valuation of the fund's investment positions. Managers should also follow specific guidance with respect to valuing investment positions with no readily ascertainable market value and when using side pockets or other similar arrangements.

Risk Management – A manager should establish a risk management framework suited to the size, portfolio management process and investment strategies of its funds and communicate such framework to investors.

Trading and Business Operations – A manager should develop a framework to manage trading and business operations, taking into account the size and complexity of its activities, the nature of its investments and the requirements of its investment strategies.

Compliance, Conflicts and Business Practices – A manager should develop a framework addressing compliance, conflicts and business practices. It is considered critical to the success of the framework that a strong culture of compliance should exist at the manager. The Asset Managers' Committee expressly recommends that a manager have a chief compliance officer.

The Best Practices Recommended by the Investors' Committee

The Investors' Committee report recommends best practice standards for investors to use when making a decision to invest in a hedge fund and when managing and overseeing their hedge fund investments. The report includes two guides: a *Fiduciary's Guide*, for fiduciaries, and an *Investor's Guide*, which provides recommendations to those charged with executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio. The key recommendations of both guides are highlighted below.

The Fiduciary's Guide

Fiduciaries (i.e., those with portfolio oversight responsibilities, such as plan trustees, banks or consultants) should take appropriate steps to determine whether an allocation of assets to hedge funds contributes to an institution's investment objectives, and whether internal staff or agents of the institution have sufficient resources and expertise to effectively manage the hedge fund component of an investment portfolio.

The Investor's Guide

In recommending best practice for responsible investment in hedge funds, particular focus is placed on due diligence, risk management, legal and regulatory issues, valuation, fees and expenses, reporting and taxation.

Due Diligence – Investors should follow a number of specific recommended best practices and related guidance notes with regard to proper due diligence and monitoring responsibilities in relation to personnel, business management, investment performance track record, style integrity and model use.

Risk Management – Investors should establish their own risk management framework and best practices, with regard to evaluating the risk management framework employed by a hedge fund manager. Investors should also understand the principles of underlying liquidity and leverage in a hedge fund, including the risk posed by the behavior of other investors. Investors need to be comfortable that the manager selects prime brokers with adequate liquidity and that, among other things, counterparty credit risk is managed appropriately.

Legal and Regulatory – Investors should confirm that the hedge funds in which they invest prepare audited financial statements in accordance with acceptable accounting standards, such as U.S. generally accepted accounting principles (U.S. GAAP) or international financial reporting standards (IFRS).

Valuation – Investors should verify that a fund's manager has established a written valuation policy and procedures to assure that the fund's portfolio is consistently valued under U.S. GAAP (or other relevant accounting standards), including those provisions regarding the fair valuation of assets.

Fees and Expenses – Investors should determine the overall percentage of total and excess return they are willing to pay to their respective investment managers. They should seek to actively negotiate fees and performance targets to avoid overpayment for investment management services.

Reporting – Investors should seek sufficient reporting and transparency regarding a fund's performance. In particular, they should periodically seek confirmation from the manager as to the percentage of the hedge fund portfolio that the manager considers "illiquid."

Taxation – In relation to taxation, investors should consult with their tax advisers and carefully review the tax-related disclosures provided by a hedge fund prior to investing.

Global Impact and Application

Although both the Asset Managers' Committee and the Investors' Committee most directly address U.S. market participants, there is no clear geographical limitation as to the application of the best practices they propose. The proposed best practices have the potential (and arguably are intended) to influence the behavior of the global hedge fund industry by influencing investor behavior. In this regard, the proposed best practices appear to favor the framework existing for U.S.-registered investment advisers, and have the potential to effectively impose that regulatory framework on non-U.S. investment advisers and other investment advisers that are not subject to registration in the United States.

Given the global nature of financial markets, the best practices have also been designed to be consistent with the work done in the United Kingdom by the Hedge Fund Working Group to improve hedge fund oversight.

The reports of the Asset Managers' Committee and the Investors' Committee in the United States and the Final Report of the Hedge Fund Working Group in the United Kingdom have identified the same key principles and areas of concern. In this respect both the proposed best practices in the United States and the recommended best practices in the United Kingdom are consistent. In many aspects such as in the areas of risk management and compliance, the Asset Managers' Committee and Investors' Committee have been more prescriptive than the UK's Hedge Fund Working Group standards.

However, the best practices proposed by both the Asset Managers' Committee and the Investors' Committee allow for voluntary conformity in contrast to the standards established by the UK Hedge Fund Working Group, which follow a "comply or explain" approach for managers who become signatories to such standards. The "comply and explain" approach provides an incentive to hedge fund managers to sign up to the standards. The proposed U.S. best practices do not provide for a comparable incentive to follow the best practice recommendations. It remains to be seen which approach will prove to be more successful or more widely adopted, as both sets of best practices are (although not expressly) addressed to hedge fund managers globally.

The proposed best practices have the potential (and arguably are intended) to influence the behavior of the global hedge fund industry by influencing investor behavior.

Consultation Period

The recommendations will be open to public comment until June 13, 2008 with a view to revising them subsequently, if neccessary.

Further Information

For a more detailed discussion of the best practice recommendations, please refer to the Dechert OnPoint dated May 2008 which is available at http://www.dechert.com/library/FS_9_05-08_President's_Working_Group_Recommends_Best_Practices.pdf.

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The Post-MiFID Landscape in Europe

by **Richard Frase**

The Markets in Financial Services Directive (MiFID) finally came into force on 1 November 2007. In the post-MiFID landscape, firms have already dealt with the formal changes required by the rules, new best execution and conflicts policies, and changes to contracts and disclosure requirements. But the industry is still waiting to understand how the regulators will interpret the new rules, and how this might be shaped by industry practice in the months ahead.

Broker-dealers and investment managers around the world have been affected by MiFID in different ways. Of course many firms are based in an European Economic Area (EEA) member state and are directly subject to the new MiFID obligations. But firms outside the EEA can be affected as well. European clients of U.S. brokers have been asking for execution and transaction reporting to MiFID standards. Non-EEA investment managers acting as sub-managers to European firms have found that they are now subject to MiFID outsourcing rules, and are being asked to provide their management services in a MiFID compliant manner. Non-EEA investment managers have also been on the receiving end of a series of MiFID based communications from EEA brokers, and have had to find out what it means to be classified as a professional client or eligible counterparty, and whether having an execution policy statement served on them is a good thing or simply increases their liability.

This article gives an outline of some of the more distinctive topics which emerged during the implementation of MiFID, and which are likely to raise issues in the future – best execution, conflicts and outsourcing.

Best Execution

Although the best execution debate eventually reached an acceptable conclusion, much of the run up to implementation seemed to have been spent trying to redesign the markets to fit the rules rather than the rules to fit the markets. Initially, the concept of the dual capacity broker-dealer was simply ignored. All firms, even those trading for their own account, were required to offer best execution unless they were dealing with clients who were classified as eligible counterparties. Firms such as investment managers who were categorised as eligible counterparties

had no right to best execution, but were still expected to provide best execution for their own clients.

In the end it was agreed that a best execution obligation only arises where the broker is acting "on behalf of" its client, rather than simply dealing "with" it. Whether a firm is dealing "on behalf of" its client is a matter of fact, but this will normally be the case where:

- the broker executes the manager's order by dealing as an agent ("agency execution");
- the broker executes the order by dealing as a riskless principal ("riskless principal execution"); or
- the broker executes the other side of the manager's order from its own book, if this is on the understanding that the firm will execute at the best market price available ("own-account best execution").

By contrast, the firm will not be dealing on behalf of its client where it is simply acting as a proprietary trader, quoting prices at which it is prepared to deal, or responding to a "request for quote", without assuming any responsibility to the client for the quality of the price or the transaction generally ("own-account counterparty execution"). It is thus important for managers and other clients to be clear as to the basis on which their brokers are dealing with them, and use their services accordingly. A manager who wants to rely on its broker to find the best price should not be dealing with a broker who is quoting a two-way spread off its own trading book.

Although the best execution debate eventually reached an acceptable conclusion, much of the run up to implementation seemed to have been spent trying to redesign the markets to fit the rules rather than the rules to fit the markets.

Another developing topic is the disclosure of the firm's best execution policy. The level of formality and sophistication in an execution policy varies dramatically from firm to firm, with small firms in particular often having very informal arrangements. The level of disclosure varies as well. The MiFID rules appear to contemplate quite a detailed disclosure process, but disclosure of this sort also creates potential legal liability for any breach of the policy. Many firms have chosen to take a fairly minimalist approach to disclosure for this reason.

Worth a final comment is the complicated structure of the MiFID best execution process. The original process was designed for executing brokers, and adapted only at second level directive stage for managers. As a result there is one execution regime for the manager who executes a transaction directly with a counterparty, and another for the manager who executes by placing an order with an executing broker. The immediate reaction of many managers was that they only execute through brokers. However, there will often be at least some situations such as bond or derivatives transactions where this is not the case. Most managers are therefore likely to find themselves operating two different execution policies.

Conflicts

The MiFID conflicts rule introduces a formal concept of the duty to avoid, or at any rate minimise, conflicts of interest across the whole of the EEA. This is a particular innovation for civil law jurisdictions where the common law concept is unknown. MiFID does not attempt formally to define what a conflict of interest is; the inference being that this is a concept which can naturally be understood from general principles of proper behaviour – a form of common law without directly relying on case law precedent. In this environment, English and Commonwealth case law on conflicts may have a new role, not as binding authority, but as evidence of reasonable and commonly accepted standards.

In the UK too, however, the effect of the MiFID rule is also potentially significant. Current case law on conflicts is not always consistent, and rarely relates to financial services practice, being mostly concerned with solicitors, directors, etc. It also contains some very rigid principles which are not well suited to 21st century business. In this regard the MiFID conflicts rule helpfully takes a lead by recognising that there needs to be some disadvantage to the client before a conflict becomes a matter for concern (case law suggests that a fiduciary can be liable for a conflict, even where there is no detriment to the client). MiFID also emphasises the importance of managing a conflict by establishing a standard of impartiality, rather than the case law approach which relies heavily on formal disclosure as the only acceptable means of resolving a conflict.

The application of the conflicts policy requires a firm to use all reasonable efforts to identify the conflicts which arise in its business, and identify how they will be resolved. While this is clearly a very useful exercise, for the firm and also for the regulator when it carries out its supervisory visits, it is by no means straightforward. As with execution policies, there is a big variation between firms which write the policy as a serious analytical exercise and others which see it as merely a formal requirement.

Outsourcing

There is still some uncertainty as to exactly when the MiFID outsourcing rules will apply. The rules are triggered where a firm outsources critical or important functions, including its key operational functions, compliance and risk management functions. But what exactly does this mean? A broad interpretation could catch a whole range of routine services, but in the UK at any rate the rule currently seems to be being interpreted fairly narrowly. A rule of thumb is to ask whether the activity concerned forms part of the service which the client was expecting the firm itself to provide. If it is apparent to the client that the firm was never going to carry on the activity itself, but is simply arranging for someone else to do so, this is not outsourcing. A custodian will in the natural course of its business appoint a number of sub-custodians, and a client would normally expect this. Where, however, a custodian outsources the whole of its custody function to a single sub-custodian the situation is rather different, and the outsourcing rules almost certainly apply. The same may be true of portfolio managers and brokers, according to whether they sub-contract the provision of management or execution services to a number of other firms, or to a single service provider. However, some firms are taking a more cautious approach, and there is particular scope for different EEA regulators to take different views in an area of this sort.

MiFID contains some very broad principles and firms will often find themselves acting without clear guidance or precise standards to follow.

The detailed requirements of the rules also raise the issue of how closely the service provider must be monitored, and how closely it must track the regulatory obligations of the outsourcer. This is a particular issue where the service provider is outside the EEA, and therefore not itself subject to the MiFID regulatory requirements. Is such a service provider required nevertheless to follow the exact requirements of MiFID, rule for rule, or is substantive compliance sufficient?

Whatever the answers to these questions, firms have some very specific requirements to meet. For example, a firm must make sure that it:

- establishes performance standards or levels for the service provider and has a sound policy for managing the outsourcing arrangement;
- takes appropriate action if the outsourcing arrangement is not working effectively;
- requires the service provider to cooperate fully with the firm if the outsourcing arrangement is terminated; and
- requires the service provider to develop an exit management strategy in the event the firm wants to transfer services to another service provider, if necessary.

Many firms have incorporated the new MiFID's outsourcing obligations into their current contracts. But outsourcing firms should also maintain procedures to manage these arrangements and make sure that the outsourced services are being carried out appropriately and competently.

One controversial aspect of outsourcing concerned firms which outsourced portfolio management to non-EEA firms. Initially there were indications that this would only be allowed on a very restrictive basis. However, the final result has been relatively low impact. A manager acting for retail clients may outsource to a non-EEA firm, but only if there is a cooperation agreement in place between the UK and the relevant non-EEA national regulator, and the firm itself is prudentially supervised by its home regulator. Where this is not the case, the firm must obtain the approval of its regulator before outsourcing to the non-EEA firm. The most significant impact of this has been in relation to outsourcing to the United States, where managers are regulated but not subject to prudential rules.

Another significant development is that the MiFID personal account dealing rules extend to individuals employed by a service provider to whom a MiFID firm has outsourced services. The firm must ensure that the personal dealing rules (on the face of it, the firm's personal dealing rules rather than the service provider's, but there may be some flexibility here) must be followed by staff at the service provider engaged in providing the outsourcing service.

Conclusion

Although a good deal of guidance has been issued by the Committee of European Securities Regulators and the European Commission, MiFID contains some very broad principles and firms will often find themselves acting without clear guidance or precise standards to follow. The topics discussed above give a flavour of the sorts of issues which arise, but are by no means the only ones for firms to consider. Where a MiFID rule cannot simply be applied verbatim, firms will need to come up with their own "reasonable" interpretation of the rule and be prepared to justify it to their regulator.

The author is indebted to Laurence Bolton for his assistance in preparing this article.

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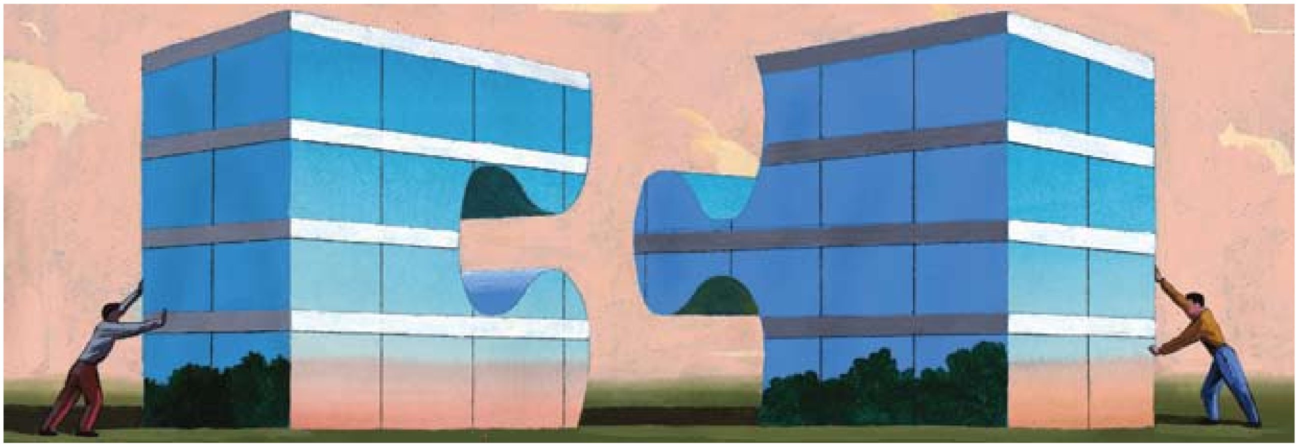

Treasury Blueprint for a Modernized U.S. Financial Regulatory Structure

by **Yogesh K. Rai**

On March 31, 2008, in the midst of the sub-prime crisis and the Bear Stearns rescue, the U.S. Department of the Treasury ("Treasury") issued its Blueprint For a Modernized Financial Regulatory Structure ("Blueprint"). The Blueprint contains proposals for a far-reaching reorganization of the U.S. financial regulatory structure, including the creation of several new federal regulators, the abolition of another, and the merger of the SEC and the CFTC. The Blueprint follows a Treasury-hosted conference in March of 2007 on capital markets competitiveness, with panelists consisting of a renowned group of leaders in U.S. capital markets, and subsequent Treasury review of, and public comment on, the regulatory structure for U.S. financial institutions.

The Blueprint sets out a series of short-term and intermediate-term recommendations. In addition, Treasury presents a conceptual model for a long-term optimal regulatory framework, with a key theme being to improve the competitiveness of U.S. capital markets in the global marketplace.

- In the short term, Treasury would like to see an expanded President's Working Group on Financial Markets, the creation of a federal Mortgage Origination Commission (to regulate mortgage brokers and others involved in mortgage origination) and greater information sharing between the Federal Reserve, the SEC and the CFTC in connection with the opening of the Federal Reserve's discount window to non-depository institutions.
- Treasury's intermediate-term recommendations include the abolition of thrifts (savings and loan associations) and the Office of Thrift Supervision, introduction of a federal charter and related regulatory system for systemically important payment and settlement systems, creation of an optional federal charter for insurance companies, merger of the SEC and CFTC, modernization of the Investment Company Act of 1940 and creation of a new U.S. global investment company which could market its shares on a global basis without the disadvantages currently experienced by U.S. mutual funds, and harmonization of broker-dealer and investment adviser regulation (including the creation of a new SRO (self-regulatory organization) for investment advisers).
- For the long term, Treasury recommends an objectives-based regulatory structure. Specifically, Treasury proposes to create three new regulators, with each having responsibility over one regulatory objective (market stability, prudential regulation and business conduct), and to rationalize the federal chartering of financial institutions by creating three new types of federal financial institution (broadly, depository institutions, insurance companies, and all other types of financial institution). In addition, Treasury envisages a new federal insurance guarantee corporation that would replace the FDIC and a new corporate finance regulator.

For more information on the Treasury proposals, see a forthcoming Dechert OnPoint authored by attorneys in Dechert's Financial Services, Securities Litigation, and Finance and Real Estate Groups.

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ERISA Litigation: The Wave of Revenue Sharing Cases Continues with No End in Sight

by **Alan D. Berkowitz** and **J. Ian Downes**

The Employee Retirement Income Security Act of 1974 (ERISA) governs most benefit plans provided by employers to their employees in the United States, including nearly all retirement benefit plans. The statute does not require employers to provide any particular benefits to their workers, but rather regulates the manner in which the benefits provided are administered and secured. Because ERISA-governed pension plans frequently control millions, if not billions, of dollars of assets, they can be major players in the financial services industry, and major targets for plaintiffs' attorneys.

In recent years, plaintiffs' lawyers have filed dozens of lawsuits against many of the nation's largest employers and plan service providers based on allegedly improper "revenue sharing" and other fee arrangements affecting plan participants. These suits have important ramifications for plan service providers, both by threatening providers with significant potential liability and litigation costs, and by their potential impact on providers' relationships with plan sponsors and fiduciaries.

Although the specific details vary, the claims asserted in these actions generally relate to agreements providing for fee-sharing between plan service providers and the investment managers of the mutual funds and other investment vehicles in which plan participants are invested. The plaintiffs typically claim that these fee-sharing arrangements are not disclosed to plan participants and violate ERISA's fiduciary duty and prohibited transaction provisions.[1]

The responses of the U.S. federal courts to these claims have been far from uniform, creating an uncertain environment for plan service providers, plan sponsors and fiduciaries. In *Hecker v. Deere & Co.*, for instance, the district court dismissed claims against Fidelity Management Trust Company and Fidelity Management Research Company because neither entity—one of which was the plan trustee, the other of which was investment adviser to a number of funds that were investment options under the plan—exercised responsibility for making plan disclosures or selecting plan investments.[2] Generally, a person is a fiduciary of an ERISA plan only if the person exercises discretionary authority or control over the management of the plan or the plan's assets. According to the court in *Hecker*, where the menu of investment options available to plan participants is selected by the plan sponsor, plan service providers should not be deemed to exercise discretionary authority over a plan or its assets within the meaning of ERISA.

The court in *Hecker* also reached the significant conclusion that the "safe harbor" created by ERISA § 404(c)—which provides that "[i]n the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account . . . no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control"—precluded any claims against Fidelity. The court held that "to the extent participants incurred excessive expenses, those losses were the result of participants exercising control over their investments within the meaning of the safe harbor provision."

Because ERISA-governed pension plans frequently control millions, if not billions, of dollars of assets, they can be major players in the financial services industry, and major targets for plaintiffs' attorneys.

Unfortunately, however, courts in many of the cases in which plan service providers are named as defendants have not been as decisive as the *Hecker* court, meaning that providers all too often find themselves dragged through the costly discovery process. These courts reason that, because the determination of fiduciary status under ERISA is a "functional" one that depends upon whether a person "acts like a fiduciary" even if not specifically designated as one, a full factual record must be developed before claims against a service provider can be dismissed due to lack of fiduciary status. Indeed, one court has gone so far as to conclude that a Department of Labor advisory opinion stating that a plan service provider should not be deemed a fiduciary simply because it has the authority to "delete or substitute a fund from a program of investment option and services offered to plans, provided that the appropriate plan fiduciary in fact makes the decision to accept or reject the change," is not appropriately applied to a motion to dismiss a complaint at the outset of a case.[3]

One of the most recent fee-related cases that has been filed is against retail giant Wal-Mart. The case, *Braden v. Wal-Mart Stores, Inc.*,[4] was filed in late March, 2008 and reflects the evolution of revenue-sharing claims over the last several years. The plaintiffs allege that Wal-Mart and numerous individual plan fiduciaries breached their fiduciary duties to plan participants by selecting investment options offered by the plan's platform provider that charged "excessive" fees, "significantly underperformed," and "substantially diminished the retirement savings of Plan participants." Their complaint goes on to allege that "despite clear fiduciary duties to the contrary, Wal-Mart agreed to conceal from its employees and Plan participants the amount of revenue sharing and other kickbacks paid to Merrill Lynch by the mutual fund companies whose funds comprise the Plan Investment Options."

Interestingly, the *Braden* complaint does not name Merrill Lynch, the Wal-Mart plan's platform provider, as a defendant. This is consistent with what may be a recent trend among plaintiffs' attorneys to avoid naming platform providers as defendants in traditional fee-sharing cases. However, in some cases financial services companies have themselves been targets of the plaintiffs' bar. Over the last 18 months, plaintiffs' lawyers have filed a number of suits against such companies relating to the benefit plans offered by those companies to their own employees. These cases typically allege that the companies engaged in prohibited transactions and breached their fiduciary duties by offering their own funds and other investment products as investment alternatives under their plans and by paying excessive fees to affiliated service providers.

In light of the varied judicial rulings with respect to revenue-sharing allegations, significant challenges for plan service providers remain, particularly in terms of their relationships with their plan sponsor clients. Faced with an increased risk of litigation, sponsors are likely to place a potentially undue emphasis on minimizing plan fees. Such pressure from plan sponsors regarding cost issues could potentially compromise the ability of plan service providers to ensure that plan investments are entrusted to the most trustworthy and experienced investment managers.

Sponsors may also demand more extensive disclosures from service providers in response to the threat of revenue-sharing claims, and may soon become legally entitled to them. The U.S. Department of Labor has issued a proposed final regulation that would compel the provision of detailed information to plan sponsors by service providers.[5] This proposed regulation would limit the availability of the prohibited transaction exemption that allows a plan to enter into a "reasonable contract or arrangement" with a party in interest to those circumstances in which there has been a disclosure of any compensation or fees paid to a service provider that has been requested by a plan fiduciary. Additionally, the Department has filed a brief as an amicus curiae[6] in the appeal of the *Hecker* decision in which it urges reversal of the district court's findings in favor of the defendants. According to the Department, "the statutory duties of prudence and loyalty . . . can, in certain circumstances, require fiduciaries to disclose information that participants need to know" beyond the specific disclosures required by ERISA's text. The Department's brief goes on to note that it "is currently drafting a regulation which would mandate specific participant-level disclosures about fees which is based on these broad fiduciary duties." Finally, the U.S. Congress has been considering legislation that would expand the disclosure obligations of plan service providers, and new momentum for passage of such legislation could follow the November 2008 presidential and congressional elections.

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1 ERISA imposes two general duties upon the fiduciaries of covered benefit plans: the duty to act "solely in the interest" of plan participants "for the *exclusive purpose* of providing benefits to participant [and] defraying reasonable expenses of administering the plan" and, the duty to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(A)-(B). ERISA's prohibited transaction provisions preclude certain financial arrangements between a plan and a "party in interest" and forbid self-dealing by plan fiduciaries. 29 U.S.C. § 1106.

2 496 F. Supp. 2d 967 (W.D.Wisc. 2007). This decision has been appealed to the U.S. Court of Appeals for the Seventh Circuit.

3 *Phones Plus, Inc. v. The Hartford Financial Svcs. Group, Inc.*, No. 06-CV-1835, 2007 WL 3124733 (D. Conn. Oct. 23, 2007). The *Phones Plus* case is significant for a number of reasons, including that the plaintiff in the case is the plan sponsor itself, not a plan participant.

4 Civil Action No. 08-03109, United States District Court for the Western District of Missouri, filed March 27, 2008.

5 72 Fed. Reg. 70988 (Employee Benefits Security Administration, Dept. of Labor, December 13, 2007).

6 Literally, "friend of the court." Such briefs are filed by persons or entities who are not formally parties to a case but who have an interest in the outcome and seek to express their views to the court.

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Upcoming and Recent Events

SECOND TUESDAY OF EACH MONTH

U.S. Regulation for UK Legal and Compliance Professionals

London

This ongoing series of lunchtime workshops on U.S. regulatory topics provides an overview of the applicable regulations for SEC-registered and unregistered advisers, practical tips for compliance and an opportunity to ask questions.

Program schedule:

April 8	Compliance Program Updates and Annual Reviews for SEC-Registered Advisers
May 13	Website Disclosure
June 10	Form ADV (Part I)
July 8	Form D Filings
August 12	Late Summer Open Forum: Bring Your Own Questions
September 9	Form ADV (Part II)
October 14	ERISA

JUNE 26, 2008

2008 Hedge Fund Roundtable: HFWG's and PWG's Best Practices/Counterparty Risk Issues

New York

Responding to calls for tighter controls on hedge funds worldwide and for improved transparency in the hedge fund industry, groups in both the UK and the U.S. have produced recommendations for best practices for hedge fund managers. This seminar will compare the best practice recommendations of both groups, and focus on the cross-border evaluation of the legal framework governing the insolvency of broker-dealers and their affiliates.

JUNE 3, 2008

Real Estate Fund Formation II

New York and London

This seminar addressed the issues presented by special opportunity assets, and cutting-edge approaches and structures used to address them. Topics included key considerations in handling special opportunity funds, documenting and negotiating a restructure, finding leverage, and current market examples.

MAY 29 AND 30, 2008

UCITS for U.S. Investment Managers: An Opportunity to Compete in the Global Fund Marketplace

New York and Boston

As Europe's UCITS gain popularity as a global fund vehicle, U.S. investment houses are increasingly looking at creating and marketing UCITS to attract more assets. This seminar focused on practical information for U.S. investment managers looking to structure and market UCITS.

MAY 8, 2008

Hedge Fund Structures for the German Market

London

German hedge fund activity is expected to increase, and many in the industry are looking to structure products to expose German investors to hedge fund strategies. This workshop examined possible hedge fund structures and how off-shore funds can achieve tax transparency in a cost-effective and efficient manner.

APRIL 30, 2008

Real Estate Fund Formation I

London and New York

This seminar examined fundamentals and current issues in real estate funds. Topics included key considerations in structuring a real estate fund, limited partnership funds, the Luxembourg SIF, European-structured funds, and market trends.

APRIL 29, 2008

Understanding the SEC's Proposed Changes to Form ADV Part II

Webinar

The SEC has proposed to replace the old "Part II" of Form ADV (commonly referred to as the "adviser's brochure") with a new "Part 2" that would require advisers to create a wholly narrative disclosure brochure. This seminar discussed the proposed new Part 2, various items of disclosure, and special issues facing advisers to hedge funds.

APRIL 10 AND 16, 2008

Current Developments in Hedge Fund Regulation and Litigation

New York and Greenwich

This seminar surveyed the evolving legal and regulatory environment relevant to hedge fund litigation in 2008.

For more information, or should you wish to receive materials from the seminars listed above, please contact Natasha Hill at +1 202 261 7731 or via e-mail natasha.hill@dechert.com.

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