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UCITS: An Opportunity for Hedge Fund Managers


by **Christopher D. Christian** and **Stephanie A. Barkus**

In recent months, there has been a renewed interest by both U.S. and European hedge fund managers in Undertakings for Collective Investment in Transferable Securities or UCITS. Given the likely regulation of hedge funds and/or hedge fund managers in both Europe and the United States in some shape or form as well as the demand from many institutional investors for a more liquid and transparent product from certain hedge fund managers, the interest in UCITS is likely to grow on both sides of the Atlantic.

This article highlights the benefits and limitations of the UCITS structure as well as several of the driving forces behind a renewed interest in the product by hedge fund managers.

Introduction

Traditionally, the UCITS space has been dominated by long-only managers. The introduction of UCITS III, however, allowed UCITS fund managers to invest in a much wider range of eligible assets and to pursue new types of investment strategies. Specifically, Directive 2001/108/EC of the European Parliament and of the European Council (the "Product Directive"), which amended the original UCITS Directive (Directive 85/611/EC) and came into force in 2004, extended the range of eligible assets that can be invested in by a UCITS by allowing investments in money market instruments, derivatives, bank deposits, and index tracker funds, among other types of investments.

While UCITS III extended the range of assets that can be invested in by UCITS, the evolution of the

implementation of UCITS III, including the introduction of the Eligible Assets Directive adopted in 2007 as well as local regulatory guidance, has provided a road map for asset managers structuring "sophisticated UCITS" or those that use derivative financial instruments as a significant component of their strategy.

Since 2007, the traditional long-only UCITS space has been flooded with UCITS offerings utilizing hedge fund-type strategies, including long/short funds, market neutral funds, absolute return funds, commodity index funds, and currency funds.

Benefits of the UCITS Structure

The UCITS structure provides several benefits to a hedge fund manager.

First, recent market turmoil has drawn investor attention to fund liquidity, transparency and operational control issues that are common in unregulated structures. A UCITS offering addresses these concerns and meets investor demand for use of alternative strategies in a regulated, liquid product.

Since 2007, the traditional long-only UCITS space has been flooded with UCITS offerings utilizing hedge fund-type strategies, including long/short funds, market neutral funds, absolute return funds, commodity index funds, and currency funds.

Second, a UCITS vehicle allows a hedge fund manager to gain access to distribution and to a larger investor base. Within Europe, one of the main benefits of a UCITS III fund is that it can be sold to retail investors and distributed throughout the EU on the basis of the so-called "UCITS passport." The UCITS passport allows the fund to be marketed freely across Europe, including in countries where the ability to privately place investment funds is limited (*e.g.*, France). Outside of Europe, the UCITS brand allows a manager to target investors in fast-growing markets in Asia, the Middle East, and Central and South America where the UCITS name has brand recognition.

Finally, the UCITS market is expected to grow to EUR 8 trillion by 2012. The growth in the market provides the potential for alternative asset managers to participate in this tremendous growth in assets under management.

Limitations of the UCITS Structure

While the advantages noted above make the UCITS an attractive vehicle for hedge fund managers, there are limitations to its utility as a fund offering structure.

First, the prohibition on direct investment in commodities and on physical shorting may limit a hedge fund manager's ability to fully implement its current investment strategy.

Second, as the term UCITS implies, a UCITS III fund must invest in transferable securities or other liquid assets. In addition, the maximum redemption period (subject to limited exceptions) for a UCITS product is fourteen days and redemptions generally must be made at the fund's net asset value ("NAV"). As such, the ability of hedge fund managers to take positions in illiquid assets may be limited and again may restrict

a hedge fund manager's ability to replicate the manager's current strategies in an unregulated product.

As the cost of operating and distributing a UCITS decreases, more independent hedge fund managers will look to the UCITS vehicle to access a wider investor base and global distribution.

Finally, leverage in a UCITS is generally limited to 100% of (or two times) NAV and short-term borrowings are limited to 10% of NAV. In addition, counterparty exposure restraints in a UCITS vehicle may not allow a hedge fund manager to replicate the performance returns of an unregulated product. Maximum OTC derivative counterparty exposure is limited to 10% of NAV with daily valuations and rebalancing of positions in accordance with a valuation methodology and risk monitoring systems acceptable to the local regulator. While there has been some flexibility in calculating the percentage limitations using a Value-at-Risk approach ("VaR"), the Committee of European Securities Regulators is reconsidering the use and calculation of VaR.

Looking Ahead

On June 22, 2009, the European Council voted to approve a significant overhaul of the UCITS framework that was previously approved by the European Parliament on January 13, 2009. The amended UCITS Directive (known as "UCITS IV") adds or modifies provisions relating to the following: (1) new notification procedures; (2) the Key Investor Information document; (3) mergers; (4) master-feeder structures; (5) management company passport; and (6) cooperation among regulators. In general, EU Member States will be required to update their local laws to implement UCITS IV by June 30, 2011.

While there are opportunities for hedge fund managers with a UCITS structure, the limitations may cause such managers to add a UCITS offering to their product lineup rather than restructure their current offerings into UCITS.

The changes to the UCITS framework resulting from UCITS IV are designed to address a number of perceived issues with the current framework and to make the system more efficient overall. Such changes are significant in that—if implemented as envisioned—they will dramatically decrease the barriers to entry and improve the process for cross-border marketing of UCITS, thereby making UCITS a more attractive investment vehicle for advisers. As the cost of operating and distributing a UCITS decreases, more independent hedge fund managers will look to the UCITS vehicle to access a wider investor base and global distribution.

Conclusion

In recent months, there have been several high-profile hedge fund managers that have launched UCITS, and with the uncertainty surrounding the European Commission's proposed Directive on Alternative Investment Fund Managers (AIFMs), U.S. President Obama calling for regulation of hedge fund advisers, and the U.S. Congress considering hedge fund legislation, more European and U.S. managers are likely to take a hard look at the advantages and limitations of the UCITS regime. While there are opportunities for hedge fund managers with a UCITS structure, the limitations may cause such managers to add a UCITS offering to their product lineup rather than restructure their current offerings into UCITS.

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New Framework for Selling Foreign Securities to Russian Investors


by **Laura M. Brank** and **Valentin Andrianov**

Until recently, the direct *public* sale of foreign securities to Russian investors was seemingly impossible. Only the *private* sale of foreign securities was permitted, and then, only if such sale did not constitute a *placement*.[1]

On April 28, 2009, President Dmitry Medvedev approved amendments to two laws (the "Amendments")[2] which simplify and facilitate the process of selling foreign securities in the Russian market to Russian investors, including qualified investors.

General Requirements for Placement and Circulation of Foreign Securities

The Amendments allow foreign financial instruments to be accepted for circulation[3] in Russia as securities of foreign issuers ("Foreign Securities") when a foreign financial instrument:

- has received an ISIN (International Securities Identification Number) and CFI (Classification of Financial Instrument) Code; and
- qualifies as a security under the procedure specified by the Federal Service for the Financial Markets of the Russian Federation ("FSFM").

Foreign financial instruments may be qualified as shares, depository receipts for shares, unit shares or shares of investment funds, bonds and depository receipts for bonds.[4]

Foreign Securities can be admitted for placement (public[5] or private) and/or public circulation[6] in Russia provided they comply with the above-listed requirements and are issued by:

a. A foreign organisation (including companies) incorporated in (i) member states of the Organization for Economic Co-Operation and Development (OECD), or (ii) member or observer states of the Financial Action Task Force (FATF), or (iii) member states of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval);

b. A foreign organisation incorporated in a state where the securities market regulator has entered into an agreement with the FSFM;[7]

c. An international finance organisation based on a list to be adopted by the Russian Government;[8] or

d. A foreign state named in a) or b) above or by a central bank of such a foreign state.

As an alternative to the placement of Foreign Securities in Russia, a party may consider issuing Russian Depository Receipts ("RDRs"). Generally speaking, RDRs are Russian securities issued by a depository that is a Russian legal entity, which evidence title to securities of a foreign issuer. A foreign issuer may deposit Foreign Securities with a Russian depository against an issuance of RDRs and thereby offer, list and allow shareholders to hold and trade, a Russian security representing a foreign security.

Qualified Investors

Foreign Securities that are not permitted for public placement and/or public circulation in Russia, as well as foreign financial instruments that do not qualify as securities for FSFM purposes, cannot be offered in any form or by any means, including advertising, to individuals/purchasers who are not qualified investors. If Foreign Securities are not admitted for public placement and/or public circulation in Russia in accordance with Article 51.1 of Federal Law No. 39-FZ "On the Securities Market", dated April 22, 1996, as amended (the "Securities Market Law"), then all of the restrictions and requirements set forth by the Securities Markets Law for circulation of securities designated for qualified investors will apply to such Foreign Securities. Generally, according to these restrictions, acquisition and disposal of such securities may be carried out through brokers only.

Thus, if Foreign Securities are not allowed for public placement or public circulation or are not qualified as "foreign securities", they may only be sold to "qualified investors". Article 51.2 of the Securities Market Law and FSFM Resolution No. 08-12/ps-n, dated March 18, 2008 ("Resolution No. 08-12/ps-n"), defines who will be considered "qualified investors".

Qualified investors include: 1) brokers, dealers and managers; 2) credit institutions; 3) joint-stock investment funds; 4) management companies of investment funds, unit investment trusts and non-governmental pension funds; 5) insurance organisations; 6) non-governmental pension funds; 7) the Bank of Russia; 8) the State Corporation Bank of Development and Foreign Trade Activity (Vnesheconombank); 9) the Agency for Deposits' Insurance; 10) the Russian Corporation of Nanotechnologies; 11) international organisations including the World Bank, the International Monetary Fund, the European Central Bank, the European Investment Bank, the European Bank for Reconstruction and Development; and 12) other persons classified as qualified investors by federal laws.

An individual may be recognised as a qualified investor if he/she complies with any two of the requirements listed below. Such individual:

- holds securities and/or other financial instruments with a total value equal to or exceeding 3,000,000 roubles (approximately US $95,000);
- has worked in a Russian and/or foreign organisation that has conducted transactions with securities and other financial instruments, for a period of: (i) at least one year if such organisation is a qualified investor from the list above; (ii) at least three months if such organisation is a qualified investor from the list above and such person was an employee of such organisation on the date it was recognised as a qualified investor; or (iii) at least two years in other cases; or
- has conducted (i) no less than ten transactions with securities and/or other financial instruments during the last four quarters, with an aggregate amount equal to or more than 300,000 roubles, or (ii) no less than five such transactions during the last three years with an aggregate amount equal to or more than 3,000,000 roubles.

A legal entity may be recognised as a qualified investor if it is a for-profit organisation satisfying any two requirements from among those cited below. Such organisation:

- has its own capital of no less than 100,000,000 roubles;
- has conducted no less than five transactions with securities and/or other financial instruments during the last four quarters with an aggregate amount for the last four quarters of no less than 3,000,000 roubles;
- has a sales volume (proceeds from sales) of commodities, works and services of no less than 1,000,000,000 roubles for the last reporting year; or
- has no less than 2,000,000,000 roubles in assets for the last reporting year.

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A person must be recognised as a qualified investor on the basis of an application made by brokers, managers and other persons provided for by federal law ("Brokers") in the procedure established by Resolution No. 08-12/ps-n. A person may be recognised as a qualified investor in respect of one or several kinds of securities and other financial instruments and one or several kinds of services intended for qualified investors.

A Broker must notify a qualified investor about the types of securities and other financial instruments for which such investor is qualified. A Broker is obliged to keep a register of persons recognised as qualified investors in the procedure established by Resolution No. 08-12/ps-n. A qualified investor shall be excluded from the register on the basis of an application therefor, or if such investor fails to satisfy the requirements necessary for the recognition of a person as a qualified investor.

Admission for Placement and Circulation

The Amendments state that Foreign Securities may be allowed for placement in Russia, provided that the prospectus for such securities has been registered with the FSFM. Foreign Securities are allowed for public circulation in Russia provided such securities are admitted for circulation by a Russian stock exchange. Such admission will be permitted if: (i) the Foreign Securities (except for the securities of an international finance organisation) are listed on a foreign stock exchange that is included in the list of exchanges to be adopted by the FSFM; and (ii) the securities in question can be offered to the general public under the laws of the jurisdiction in which the foreign stock exchange is incorporated. Securities of an international finance organisation will be permitted for public placement and/or public circulation if their issue documents do not limit the offering or circulation of such securities.

Foreign Securities that do not meet the requirements for public circulation in Russia by a Russian stock exchange may still be allowed for public placement and/or public circulation at the FSFM's discretion. This will be possible if: (i) the Foreign Securities can be offered to the general public under the laws of the jurisdiction in which the issuer has been incorporated; and (ii) the liquidity of such Foreign Securities is not lower, and their investment risk is not higher, than similar criteria applied to securities of similar types already admitted for circulation on the Russian stock exchange.

Custody and Other Procedural Issues

In the event of a public placement and/or public circulation of Foreign Securities, custody services must be provided by licensed Russian custodians. To provide such services, Russian custodians must have a nominee account with a foreign institution that provides custody services and is included in a list maintained by the FSFM.

Circulation of Foreign Securities that have already been placed in Russia is allowed in Russia once the FSFM has been notified as to completion of the placement, with disclosure of relevant information in accordance with the procedure to be specified by the FSFM (such procedure has not been specified yet).

A prospectus for the Foreign Securities must be provided in Russian; comply with the requirements of the FSFM; and, with some exceptions, be signed by a Russian-licensed broker.

The Amendments offer potentially beneficial changes to the existing legal framework. However, some aspects of the new legislation are still unclear. It is expected that the FSFM will pass a series of implementing regulations over the coming months.

The Russian stock exchange that admits the Foreign Securities for circulation is responsible for disclosing information regarding such securities and their issuers. Information about Foreign Securities admitted for circulation in Russia must be disclosed to the same extent as is disclosed by the foreign stock exchange on which such securities are listed, or in accordance with the requirements to be set forth by the FSFM (these requirements have not been specified yet), pending a reason for admitting the Foreign Securities for circulation. When the Foreign Securities are admitted on a Russian stock exchange for circulation to qualified investors, the disclosure requirement will be set forth by such stock exchange.

The Amendments offer potentially beneficial changes to the existing legal framework. However, some aspects of the new legislation are still unclear. It is expected that the FSFM will pass a series of implementing regulations over the coming months. In addition, Russian stock exchanges will be required to amend their listing and trading rules to allow for the admission of the Foreign Securities to listing and trading. It remains to be seen how quickly the FSFM and the stock exchanges will adopt such implementing regulations and rules. Until then, the majority of the changes introduced by the Amendments are likely to be unavailable in practice.

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1 A *placement* is considered the issuance of securities by the relevant issuer to its initial shareholders (i.e. sales of newly issued securities)

2 Federal Law No.74-FZ "On the Making of Amendments to the Federal Law 'On the Securities Market'" and Article 5 of the Federal Law "On the Protection of the Rights and Lawful Interests of Securities Market Investors".

3 A *circulation* is considered the conclusion of transactions that entail the transfer of title to securities (i.e. secondary market sales).

4 However, promissory notes, checks, bills of lading and similar securities issued under foreign law are allowed to be circulated in Russia, and the above-mentioned requirements would not apply to them.

5 A *public placement* is considered the placement of securities through an open subscription (i.e. any purchaser may subscribe for offered shares) including placement on stock exchanges and other licensed organisations arranging securities trading.

6 A *public circulation* is considered the circulation on stock exchanges and other licensed organisations arranging securities trading and circulation by way of offering securities to an unlimited range of persons including, *inter alia*, by way of advertising.

7 According to the FSFM's official site, such agreements exist between Russia and the following jurisdictions: Belarus, Brazil, China, Cyprus, India and UAE.

8 Currently, the European Bank for Reconstruction and Development (EBRD), the International Finance Corporation (IFC) and Eurasian Bank for Development (EABD) are included in the list.

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Upcoming and Recent Events

JULY 16, 2009
Distribution of Funds in Asia
London
This seminar will provide an overview of the applicable regulations governing fund distribution in key centers in Asia. Seminar topics include: comparison of the different distribution centers in Hong Kong, Taiwan, Singapore and the PRC; retail fund distribution rules; private fund placement rules; current trends and initiatives and the way forward.

JUNE 29, 2009
Wealth Management in China
Hong Kong
This seminar was designed to help plan and implement strategies to access and grow a wealth management business in China, and focused on trends and potential opportunities in China.

JUNE 22, 2009
A New "European" World Order? The Draft EC Directive on Alternative Investment Fund Managers (AIFM)
London
This seminar examined topics including: the objectives of the European Union in issuing the proposals for the Directive; the scope of the proposals; and key elements of the proposals for AIFM and the funds they manage.

JUNE 4, 2009
Opportunities Offered by UCITS III and UCITS IV
London
This seminar discussed how UCITS III and the Eligible Assets Directive have expanded the types of assets and strategies eligible for investment by UCITS, as well as the changes proposed by UCITS IV and potential benefits of those changes.

MAY 7 AND 8, 2009
UCITS for U.S. Investment Managers: Opportunities Offered by UCITS IV
New York and Boston
This seminar provided an overview of UCITS for U.S. asset managers interested in structuring and marketing UCITS.

For more information, or should you wish to receive materials from the seminars listed above, please contact Beth Goulston at +1 202 261 3457 or via e-mail beth.goulston@dechert.com.

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EU and UK Developments

Draft Directive on Alternative Investment Fund Managers

by **Stuart Martin** and **Victoria Brocklehurst**

The European Commission (the "Commission") has published a legislative proposal for the establishment of an authorisation and supervisory regime for alternative investment fund managers ("AIFMs") in relation to the provision of management and marketing services to collective investment undertakings ("AIFs") both domiciled inside and outside the European Union ("EU").

The proposal is in the form of a draft Directive on Alternative Investment Fund Managers (the "Directive").

The Directive will impact:-

(i) EU-domiciled AIFMs in terms of their EU-based activities in relation to AIFs and also their business relationships with promoters and managers outside of the EU (including their affiliates); and

(ii) non-EU-domiciled AIFMs seeking to provide investment services to EU AIFs and AIFMs or seeking to promote AIFs in the EU.

The scope of the Directive is ambitious and wide-ranging in its potential impact. AIFMs are defined broadly to include not only asset managers who manage hedge funds and private equity funds, but also managers of most forms of AIFs, including hedge funds, property funds, private equity funds, commodity funds, long-only funds and fund of funds, amongst others.

The scope of the Directive is ambitious and wide-ranging in its potential impact.

The Directive lays down the rules for the authorisation, ongoing operation and transparency of AIFMs. The AIFs themselves are not required to be authorised under the proposals (although they will be impacted indirectly through requirements imposed on AIFMs). Instead, the Commission has directed its attention at the AIFMs, based on its stated view that AIFMs are responsible for all key decisions relating to AIFs, including matters relating to the appointment of administrators and the services they provide and also the appointment of custodians. In relation to custodians, the Directive seeks to impose additional legal obligations and liabilities, many of which are incompatible with the efficient functioning of global custody arrangements.

The Directive sets out rules relating to, amongst other things:

- the authorisation of the AIFM;
- capital requirements;
- operating conditions;
- delegation of AIFM functions;
- transparency;
- leverage;
- custody arrangements;
- provision of management and marketing services by AIFMs;

- specific rules relating to countries outside the EU; and
- obligations on AIFMs who manage specific types of AIFs.

As a carrot to EU AIFMs, the Directive offers the promise of a formalised private placement regime for AIFs managed by EU AIFMs. Under the proposals, AIFMs will be able to market AIFs they manage cross-border to professional investors in other Member States. It is however unclear whether the private placement regime will extend to meaningful categories of high net worth individuals.

Industry opinion has been widespread and mainly critical of the proposals.

The cross-border marketing provisions of the Directive will not benefit non-EU AIFs for a period of three years after the Directive comes into force and then only if relevant AIF domiciles comply with certain minimum criteria, including agreements to exchange tax information.

The Directive also imposes wide-ranging restrictions on delegation to non-EU-based AIFMs, on the appointment of non-EU-based administrators and valuators and on the appointment of non-EU-based sub-custodians. The Directive also appears to prohibit non-EU-based promoters from marketing AIFs in the EU at all during the three-year period after adoption of the Directive and, following this period, only permits marketing on a restricted basis subject to detailed approvals on a Member State by Member State basis.

The Directive will be sent to the European Council and European Parliament. The Commission notes that if a political approval on the proposals can be reached by the end of 2009, the Directive could come into force as early as 2011. However this seems optimistic.

Industry opinion has been widespread and mainly critical of the proposals. Charlie McCreevy, European Commissioner for the Internal Market and Services, summed up the depth of feeling the proposals are likely to generate when he said, "You will be aware that this proposal has already been the object of intense political debate. The European Parliament and the industries concerned have made their views known. For some, the proposal goes too far. For others, it does not go far enough. I look forward to the constructive debates to come." In addition, in a speech made on 24 June 2009 in Monaco, the FSA's Dan Waters expressed a number of concerns in relation to the Directive proposals, the speed at which they have been formulated and the proportionality of the proposals as they apply to the asset management industry. In relation to the third country aspects of the Directive, Mr. Waters said:

> To impose an outright ban on third country funds and managers would extinguish valuable, open and successful markets without justification. It would also appear protectionist and would offend the principle of subsidiarity. It would moreover invite retaliation from other global markets, which would be precisely the opposite dynamic that we would wish to create in the current febrile market circumstances.

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Dechert will be publishing an in-depth analysis of the draft Directive and the implications for clients. Our regular OnPoints and Client Alerts on this and related topics are available at http://www.dechert.com/practiceareas/practiceareas.jsp?pg=legal_update&pa_id=19&pn=1.

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Turner Report

by **Lucy Frew**

In October 2008 the U.K. Chancellor of the Exchequer asked Lord Turner, Chairman of the U.K. Financial Services Authority ("FSA"), to review the causes of the recent crisis, and to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system. The Turner Review: A regulatory response to the global banking crisis (the "Review") published on 18 March 2009, responds to that remit.

The recommendations in the Review include increased quality and quantity of capital, particularly against trading activities; a strongly countercyclical capital adequacy regime; a maximum gross leverage ratio; enhanced regulation and supervision of liquidity; enhanced supervision of rating agencies; codes covering remuneration in systemically significant institutions; and centralised clearance of the majority of trades in credit default swaps.

Also recommended is a big shift in regulation by the FSA towards high-impact businesses by focussing on the economic substance of an entity's activities rather than its legal form; and an end to the "untenable present arrangements" for cross-border banks – the "Iceland problem". This would mean a greater international co-operation among regulators, with a new EU body that would have rule making powers and oversight of regulation within the EU, together with more national powers for EU Member States hosting branches, particularly in the oversight of capital and liquidity for banks operating in their country.

Also recommended is a big shift in regulation by the FSA towards high-impact businesses by focussing on the economic substance of an entity's activities rather than its legal form; and an end to the "untenable present arrangements" for cross-border banks.

Lord Turner commented at the Review's launch that "there's a danger that as we tighten regulation on banks, activities might move to non-regulated sectors"; that "we do not again allow off balance sheet SIVs to run large risks without adequate controls or investment banks to escape leverage ratio constraints" and that "if there are activities, such as hedge funds, which are not at present bank-like or clearly systemically important, but could evolve in that direction in future, we need to gather the information required for regulators and central banks to assess the systemic impact of these institutions, and powers to extend prudential regulation to them if needed".

Lord Turner makes two recommendations as to the appropriate approach to hedge funds:

- regulators and central banks need to gather much more extensive information on hedge fund activities, and need to consider the implications of this information for overall macro-prudential risks; and
- regulators need the power to apply appropriate prudential regulation (capital and liquidity rules) to hedge funds if at any time they judge that the activities have become bank-like in nature or systemic in importance.

The shift in the FSA's focus was discussed further in a speech by David Strachan, Director of Financial Stability at the FSA, on 1 April 2009. He said that regulators "need to understand when developments outside the regulatory boundary threaten financial stability and be ready to react rapidly to them". As a consequence, regulators needed to understand and act upon, where appropriate:

- unregulated activities within otherwise regulated groups;
- exposures between regulated and unregulated firms; and
- risks developing in the unregulated sector to financial stability and the regulated sector itself – likely to be from the sheer scale of the assets held in unregulated sectors.

Where this will lead in terms of definitive legal or regulatory change is currently unclear, but the Review does pave the way for a radical tightening in regulation and supervision of the financial system that will have a major impact on both the unregulated and the regulated sectors.

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Hong Kong/Greater China Developments


One China

by **Angelyn Lim** and **Kher Sheng Lee**

The impasse

While Mainland China and Taiwan have technically been at war since 1949, the Mainland regards independently governed Taiwan as just another of its far-flung provinces awaiting reunification, in much the same way as Hong Kong and Macau have now returned to the Motherland. During the presidency of pro-independence Chen Shui-bian from 2000 to 2008, political differences between the two sides were brought into sharp focus. Tensions have, however, eased dramatically in the past year since President Ma Ying-jeou succeeded Mr. Chen on a campaign platform to improve the economy through better relations with the Mainland.

Rapidly improving ties…

Contact officially resumed between Taiwan and the Mainland in mid-2008, and last December, full direct shipping, air, and postal links were restored. A number of agreements were entered into to boost business and economic ties. The latest, signed on April 26th 2009 between the Chinese and Taiwanese chief negotiators on cross-strait relations,[1] in principle, opens up Taiwan to Mainland investment. A framework for financial cooperation was also agreed, covering supervision of firms and regulating conduct, currency exchange and clearance, and allowing financial institutions to establish a business on either side of the Taiwan Strait. The agreement is expected to clear the way for direct discussions between Chinese and Taiwanese financial regulators on greater co-operation to develop more detailed industry-specific memoranda of understanding in the future.

In the short-term, [recent regulatory developments] have brought a much-needed cheer to the Taiwan stock market this year.

…growing investment flows and opportunities

Some of the significant recent developments in the Greater China region arising from this detente include the following:

In mid-April 2009, it was reported that Taiwan would allow its local Financial Supervisory Commission ("FSC")-approved mutual funds to invest up to 10% of their respective net asset values in any combination of Mainland-listed stocks and futures.[2] Previously, Taiwanese funds had been permitted to invest in Mainland-listed stocks but not in any of the three futures markets in the cities of Shanghai, Dalian and Zhengzhou. This development follows recent Taiwanese regulatory liberalisation to allow, for the first time, the establishment of local futures funds. Against the backdrop of the improved political climate, the relatively developed Taiwanese futures industry expects to be able to forge closer cooperative ties with its nascent Chinese counterpart. This may have significant repercussions in the future; in 2008, the Taiwan Futures Exchange was ranked ahead of both the Singapore and the Hong Kong futures markets in terms of trading volume.[3]

Shortly afterwards, the Mainland's leading mobile phone network provider, China Mobile, announced that it would acquire 12% of a major Taiwanese mobile operator, Far EasTone Telecommunications for NT$ 17.77 billion (US$540 million) – which will represent the first Mainland Chinese investment in a listed Taiwan company. Notwithstanding that the transaction is subject to official approval from both governments,[4] the announcement of the proposed acquisition on April 29th helped to drive the benchmark Taiex index up more than 15% that day. As an increasing reflection of the Greater China investment theme which drives deal flows in the region, China Mobile has stated that a key objective of the transaction is to "facilitate the expansion of the [c]ompany's business in Mainland, Hong Kong and Taiwan and help the [c]ompany provide more comprehensive services to its customers, which is vitally important for the company's future development as cross-strait communication grows".

Also on April 29th, the FSC promulgated regulations to permit direct investment by Mainland Chinese investors in the local securities and futures markets. The Executive Yuan (the executive branch of government) has approved these regulations, and Mainland

Chinese investors are expected to be allowed to invest in local markets in the near future. Key points of, and certain issues arising from, the regulations are as follows:

- Three categories of Mainland Chinese investors will be permitted to participate in the securities and futures markets in Taiwan: (i) China's qualified domestic institutional investors ("QDII"); (ii) Mainland Chinese nationals who are employed by companies that are exchange-listed or over-the-counter ("OTC")-listed in Taiwan; and (iii) Mainland Chinese shareholders of overseas companies that are exchange-listed or OTC-listed in Taiwan.

- Mainland Chinese investors who fall within categories (ii) and (iii) above may subscribe for, or be allotted, the relevant securities directly from or by (as the case may be) the issuer. They may only sell such securities and may not purchase them on the market. The rationale behind the granting of market access to investors in category (ii) is to facilitate the recruitment of Mainland Chinese talent by allowing such employees to subscribe for, or to be allotted, shares of the companies they work for. Accessibility to investors in category (iii) aims to position Taiwan as a more active fund raising centre in Asia, attractive to overseas companies with Mainland Chinese investors, which companies may consider a listing in Taiwan. The Hong Kong and Singapore bourses have been successful in attracting Mainland and overseas listings and Taiwan, no doubt, also wishes to compete for a piece of the cross-border listings pie.

- As a first step, it would make sense for Taiwan to seek to attract overseas-listed Taiwan businesses to return to list on the domestic stock exchange. Former president Chen's administration had been hostile to Taiwanese businesses that conducted business on the Mainland. Consequently, there are now 65 Taiwanese companies listed on the Hong Kong stock exchange while Taiwan's bourse has no foreign listings. As a possible precursor to similar developments under the relaxed regulations, Hong Kong-listed Want Want China Holdings Ltd., the largest maker of rice crackers and flavoured milk in the Mainland, became the first Taiwanese company to "return home", with a US$100 million Taiwanese depositary receipt listing in late April 2009.

- A QDII shall register and engage a custodian bank to invest in securities and futures on its behalf.

- The securities that can be purchased by QDIIs are: (i) stocks traded on the Taiwan Stock Exchange ("TWSE") or Gre-Tai Securities Market; (ii) beneficiary certificates of securities investment trust funds or futures trust funds; (iii) government bonds, financial bonds, corporate bonds issued by public companies; and (iv) asset-based securities and warrants.

- QDIIs may not invest in emerging stocks or OTC derivatives. They also may not borrow funds or securities, lend securities through competitive lending auctions, engage in margin trading, or open an omnibus trading account.

- The amount of investment by QDIIs is subject to the relevant normal foreign ownership cap set by the competent authority for each target industry.

- Mainland investors engaging in securities and futures trading may not substantively control or influence the management of companies in which they invest. They cannot be elected as company directors or supervisors and must appoint a local agent or representative to Taiwan to conduct transactions on their behalf. Their voting rights may only be exercised via their local agents or representatives, who may be required to disclose the ultimate economic beneficial interest holders.

In April, it was also reported that the TWSE and the Shanghai Stock Exchange ("SSE") have begun talks to forge closer ties.[5] Items on the agenda include dual listings of jointly developed exchange-traded funds ("ETFs") and the potential establishment of a trading platform that will make it possible for stocks already listed on the individual markets in Taiwan, the Mainland and Hong Kong, to be traded. Preliminary discussions have also been held between the TWSE and the China Securities Index Co. Ltd., a subsidiary of the SSE, to jointly compile indices based on stocks from Taiwan, the Mainland and Hong Kong. It is entirely possible that, in the not-too-distant future, ETFs providing investors with exposure to all three Greater China markets via a single investment may be developed on the basis of such indices.

On May 21st, Hong Kong's Securities and Futures Commission ("SFC") and Taiwan's FSC jointly announced that they had entered into a side letter ("Side Letter") to an existing bilateral memorandum of understanding to facilitate cross listing of ETFs in the two markets. Under the terms of the Side Letter, ETFs listed on the Hong Kong Stock Exchange (or the TWSE, as the case may be) and that are managed by fund managers licensed by their respective local regulators (i.e. the SFC or the FSC) will be mutually recognised in the other jurisdiction for the purpose of cross listing and offerings. On May 22nd, Taiwan's FSC issued a ruling recognising Hong Kong as a acceptable jurisdiction, as it relates to the jurisdiction under which the offshore ETF and manager are registered and licensed, respectively, for the purposes of offering an offshore ETF. As such, an offshore ETF authorised and listed in Hong Kong may, after obtaining approval from the FSC, file an application with the TWSE to be listed and traded on that exchange.

On May 26th, Chinese President Hu Jintao and Taiwan's ruling Nationalist Party (KMT) Chairman Wu Poh-hsiung agreed to begin discussing a broad free trade agreement-style deal later in the year that would lead to tariff cuts and other measures serving to boost the island economy, including allowing Taiwan (mired in recession as exports slump in the global downturn) to benefit from China's trade agreements with other parts of the world.[6]

Hong Kong financial services firms allowed to further expand in China

While engaging in reconciliatory dialogue with Taiwan, the Mainland also announced new measures under which Hong Kong financial services firms will soon be able to gain greater access to the Mainland markets. According to a supplement to the Closer Economic Partnership Arrangement ("CEPA") that was signed on May 9th 2009, Mainland securities firms and qualified Hong Kong financial services companies will be allowed to set up joint-venture advisory companies in the Guangdong Province. In addition, the introduction of ETFs with exposure to Hong Kong-listed stocks will be explored on the Mainland, which would allow Chinese investors to invest in "offshore" products while offering much welcome liquidity to the Hong Kong market.[7]

The investment promise of One China

These recent regulatory developments, following upon improved cross-strait relations, have infused and energised regional business and investment sentiments. In the short-term, they have brought a much-needed cheer to the Taiwan stock market this year, making it the world's second best performer after the Shanghai Stock Exchange. Taiwan stocks are up 28% through May 2009.[8] At a minimum, Taiwan should be increasingly regarded as part of any China-focused investment strategy. Some observers are hoping that the improving relations signal a gradual widening of investment opportunities in the Greater China region of mainland China, Taiwan and Hong Kong and its eventual integration as one singular growth triangle.

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1 As there is no mutual diplomatic recognition, negotiations between the two sides are conducted through two semi-official bodies, China's Association for Relations Across the Taiwan Strait (ARATS) and Taiwan's Straits Exchange Foundation (SEF). China's ARATS is headed by Chen Yunlin, and Taiwan's SEF is chaired by Chiang Pin-kung. Mr. Chen and Mr. Chiang are the two sides' respective top cross-strait negotiators.

2 China Daily report "Taiwan to allow investments in mainland futures", April 15th 2009.

3 Taiwan Central News Agency report "Cross-strait MOU expected to benefit local futures industry", April 19th 2009.

4 Whether the deal receives the regulatory go-ahead on both sides will be a litmus test of the thaw in relations. Taiwan's top government officials have been reported in various pronouncements subsequent to the deal announcement to have expressed concerns that the deal violated a law preventing Chinese investment in Taiwanese telecoms firms. National security concerns about allowing Chinese access to telecoms networks have also been expressed.

5 Taiwan Government Information Office's Taiwan Journal report "Cross-strait stock markets edge closer", April 24th 2009.

6 Financial Times report "China and Taiwan push trade deal", May 27th 2009.

7 For further background and a fuller treatment of this issue, please refer to "Hong Kong Financial Services Firms to Have Better Access to the Mainland Through Enhanced Closer Economic Partnership" in this Quarterly Report.

8 Reuters report "Taiwan, China in landmark financial services deal", April 26th 2009.

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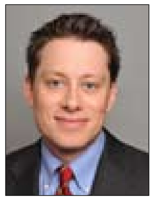
Hong Kong Financial Services Firms to Have Better Access to the Mainland Through Enhanced Closer Economic Partnership





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

The Mainland and Hong Kong have recently agreed to new measures under their existing Closer Economic Partnership Agreement ("CEPA"), which will provide Hong Kong financial services firms more access to Mainland markets. This move is the latest in a series of developments designed to foster deeper ties between Hong Kong and the Mainland, and may offer Hong Kong financial services firms a significant business opportunity. These new measures, which are the sixth supplement to CEPA ("Supplement VI"), will take effect on October 1 of this year.

Under Supplement VI, qualified Hong Kong financial services companies may establish joint ventures with Mainland securities companies in the Guangdong Province to provide investment advisory services. Such a Hong Kong financial services company will be permitted to hold up to a third of the shareholdings in the joint venture. Although Supplement VI is limited to the Guangdong Province, this province is one of China's most economically prosperous and populous, and includes the cities of Guangzhou and Shenzhen, among others. As such, these measures may provide Hong Kong financial services companies a much-needed opportunity to expand their businesses in the midst of the current financial crisis. These measures also will permit Mainland companies to leverage the expertise and experience of Hong Kong firms as the Mainland develops its financial services infrastructure.

In addition to these measures, Supplement VI provides that qualified Mainland securities companies approved by the China Securities Regulatory Commission ("CSRC") may set up subsidiaries in Hong Kong. Supplement VI also contains a pledge to actively explore the introduction into the Mainland of "open-end index-tracking" exchange traded funds with portfolios constituted by Hong Kong listed companies.

Supplement VI is another important step in what has been a very active year for Hong Kong and Beijing in terms of facilitating closer cooperation in the financial services sector. During a recent speech, Alexa Lam, Executive Director and Deputy Chief Executive Officer of the Hong Kong Securities and Futures Commission (the "SFC"), pointed out several developments in this area, including a recent agreement to permit Hong Kong and Mainland securities and futures firms to operate in each jurisdiction under local regulation, and the CSRC's recent decision to permit Mainland asset management firms to set up office in Hong Kong. To date, the SFC has granted asset management licenses to six Mainland firms. As noted further by Ms. Lam, the SFC has been in close dialogue with these firms and has encouraged them to utilize the Qualified Foreign Institutional Investor and Qualified Domestic Institutional Investor regimes to create new fund products for Hong Kong and international investors.

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SFC Gets Tough on Grey Market Trading


by **Angelyn Lim** and **Carmen Cheng**

In March 2008, the Hong Kong Securities and Futures Commission (the "SFC") commenced proceedings in the High Court of Hong Kong (i) seeking orders restraining certain unlicensed persons from dealing in "grey market" securities; and (ii) seeking a declaration that such dealing is a regulated activity under the Securities and Futures Ordinance (the "SFO").[1] The SFC's action arose from the alleged business activities of two unlicensed individuals who had, between March and June 2006, carried on a business of offering H Shares [2] of Bank of China to investors prior to the date on which these shares were issued and listed on the Hong Kong Stock Exchange.[3]

Grey market trades occur prior to an initial public offering where there is public expectation that the share price will rise significantly on the first day of trading of the shares. To take advantage of the anticipated price appreciation, some investors will enter into agreements with their brokers to sell their shares on the grey market during the short period of time between (i) the announcement of the allotment of shares; and (ii) the commencement of trading of the shares on the Hong Kong Stock Exchange. Historically, it has not been clear whether such grey market trading does, in fact, constitute the regulated activity of "dealing in securities", which is broadly defined in the SFO.

On 26 May 2009, the Court of First Instance concluded the case by issuing a declaration that the parties, by carrying on a business of dealing in securities in a grey market without a license granted by the SFC, had breached the SFO, regardless of whether the relevant securities had been issued or listed at the point of dealing.

The finding of the court has now clarified the shades of grey, and, for the first time since the SFO was enacted, it is now clear that any person carrying on a business of offering shares in a grey market must be appropriately licensed to "deal in securities". Consequently, such persons must also comply with all ongoing obligations of SFC licensees arising under the SFO and its relevant subsidiary legislation, codes of practice and guidelines issued from time to time.

For the first time since the SFO was enacted, it is now clear that any person carrying on a business of offering shares in a grey market must be appropriately licensed to "deal in securities".

The SFC's action, and the finding of the court, is indicative of the increased emphasis by the regulators and government bodies on the enforcement of existing regulatory requirements and expectations. In light of the current financial market conditions, this emphasis may be seen as part of a bid to strengthen Hong Kong's financial regulatory regime and enhance investor protection and confidence. The latest enforcement statistics available from the SFC show that, from January 2 to April 15, 2009, the SFC sent out 25 compliance advice letters, completed 64 enforcement cases (including the issuance of 20 disciplinary notices of decision) and commenced six criminal and one civil proceedings against individuals and corporations on issues including insider dealing, market manipulation, false trading and corporate governance. There is every indication that this increased disciplinary action is on the upward trend.

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1 The SFO defines certain types of activities as "regulated activities" and sets out nine categories of "regulated activity" including "dealing in securities" and "advising on securities".

2 H-share companies are companies incorporated in China and approved by the China Securities Regulatory Commission for a listing in Hong Kong. Shares in these companies are listed on the Hong Kong Stock Exchange, subscribed for and traded in Hong Kong dollars, or other currencies.

3 The listing of Bank of China shares in 2006 was heavily oversubscribed and remains one of the biggest initial public offerings in the world to date.

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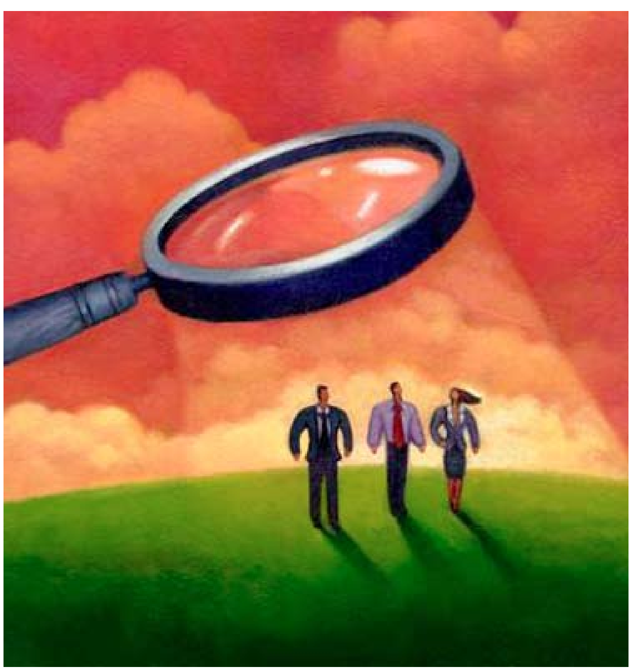
SEC Examination of Investment Advisers*



by **Julien Bourgeois**, **Michael L. Sherman**, and **Philip T. Hinkle**

Now is an opportune time for registered investment advisers to reconsider the effectiveness of their current compliance program and the potential for an SEC examination. The SEC and its staff have recently faced criticism in connection with their examination program and, as a result, the SEC has instituted and will likely continue to institute changes to the examination process to react to recent scandals and, if possible, to prevent future ones. As a result, advisers should continue to keep abreast of developments in this area. The following excerpted article provides a brief overview of the SEC's examination program.



Section 204 of the Investment Advisers Act of 1940 authorizes the SEC to conduct examinations of all records maintained by registered investment advisers as it deems necessary or appropriate in the public interest or for the protection of investors. Under this provision, the Office of Investment Adviser/Investment Company Examinations of the SEC's Office of Compliance Inspections and Examinations ("OCIE") and the SEC's regional and district offices conduct examinations of advisers, including advisers to mutual funds. The SEC's examination process is designed to (1) detect fraud and violations of the securities laws, (2) foster regulatory compliance, and (3) ensure that the SEC is aware of securities industry developments and risks.

In response to the recent financial downturn and the related market disruptions, members of the SEC's staff have focused increased attention, in speeches and writings, on the importance of advisers' compliance obligations under the federal securities laws. The SEC staff has also begun to provide more insight into the examination process, including a number of steps that OCIE is undertaking to improve the process. On March 5, 2009, Chairman Mary L. Schapiro announced the agency's "continu[ing effort] to reinvigorate our enforcement efforts" by specifically noting the importance of "mov[ing] very aggressively to improve the SEC staff's use of tips and complaints from investors and whistleblowers." Additionally, Robert Khuzami, Director of the SEC's Division of Enforcement, noted that the Division "will relentlessly pursue and bring to justice those whose misconduct infects our markets, corrodes investor confidence, and has caused so much financial suffering."

Recent events should reinforce the importance of the requirement that all registered advisers adopt, implement, maintain, annually review, and enforce effective compliance programs, pursuant to Rule 206(4)-7 under the Advisers Act (the "Compliance Rule"). A compliance program is a set of written policies and procedures designed to prevent violations of the Advisers Act and the rules thereunder. Paying proper attention to the obligations imposed by the Compliance Rule can help an adviser avoid adverse consequences as a result of an SEC examination but, more importantly, can help an adviser to prevent compliance breaches in the first place or, at least, discover and mitigate such breaches before they become a scandal.

The SEC staff conducts three types of examinations of advisers. The first and most common type is a routine compliance examination in which the SEC staff uses a risk-based approach to test advisers' compliance with applicable federal securities laws and regulations and ensure that advisers have proper compliance systems and procedures in place. Under the risk-based approach, the SEC staff endeavors to examine higher-risk advisers every three years and also to examine a random selection of the remaining lower-risk advisers each year. Generally, the SEC staff deems "higher risk" those firms that present complex compliance issues (e.g., advisers that charge a performance-based management fee, sell products in addition to investment advisory services, engage in principal transactions or cross transactions, hold custody of client assets, or have a disciplinary history) and the largest firms for which a compliance issue would affect a very large number of investors. In 2008, OCIE's director, Lori Richards, noted that about 1,000 of the approximately 11,300 registered investment advisers are deemed to pose a high risk. The SEC staff also routinely conducts more limited examinations of certain newly registered advisers, through telephonic or short, in-person visits, accompanied by an abbreviated document request. In 2006, OCIE also began an on-site examination program tailored to examining the largest mutual fund firms. Under this program, the SEC staff works on-site with the advisory firm to settle compliance issues in lieu of the standard routine examination process. There is only very limited public information about the mutual fund examination program and the SEC has not made a practice of revealing what its staff finds during these special on-site examinations.

SEC examinations of investment advisers are often unpredictable, and the SEC staff has the authority to inquire about almost any aspect of an adviser's business.

In addition to routine examinations, the SEC also conducts (1) "cause examinations" when it receives tips or client complaints that an adviser may be involved in questionable conduct or otherwise becomes aware of a potential compliance concern, and (2) "sweep examinations" in which the SEC staff examines a specific risk area across a sample of advisers. Recent examples of specific risk areas the SEC staff has examined through sweep examinations include: adviser practices relating to the malicious creation, spread, or use of false or misleading rumors with the intent to manipulate securities prices; money market fund holdings; practices with regard to fair valuation; safekeeping of client assets; and proxy voting on behalf of mutual funds.

SEC examinations of investment advisers are often unpredictable, and the SEC staff has the authority to inquire about almost any aspect of an adviser's business. Investment advisers must be familiar with the examination process and have in place strong compliance programs and internal control procedures to ensure compliance with the Advisers Act and other applicable securities laws. Investment advisers should not overlook any compliance areas, but should pay particular attention to areas that have recently been the subject of particular scrutiny or which present increased risk to the firm. Proper preparation greatly increases the chance that an adviser will escape serious deficiencies or enforcement action as a result of an examination.

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* This article is excerpted from an article that appeared in the June 17, 2009 issue of *The Review of Securities & Commodities Regulation*, and is reprinted with the permission of RSCR Publications LLC. The complete article, which includes greater detail about the SEC's examination program and "hot topics" of current interest to examiners as well as some practical tips to help advisers prepare for and manage an examination, is available at http://www.dechert.com/practiceareas/practiceareas.jsp?pg=lawyer_publications_detail&pa_id=19&id=10887.

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Fast-track Procedure for Side-pocketing in Luxembourg Funds


by **Marc Seimetz** and **Kristel Gilissen**

Side-pocketing is a technique commonly used by hedge funds in order to isolate, from the rest of the portfolio, assets of such funds that are illiquid or difficult to value. Due to the recent financial turmoil, funds all over the world have encountered problems when calculating their net asset values, a fact which explains the increased request to use the side-pocketing technique over the past year, as has also been the case in the Grand Duchy of Luxembourg.

On 24 March 2009, the Luxembourg regulatory authority (the "CSSF") approved a fast-track authorization procedure for the implementation of side-pocketing for Luxembourg investment funds (other than UCITS) that are subject to part II of the law of 20 December 2002 on undertakings for collective investment, as amended, or the law of 13 February 2007 on specialized investment funds, as amended. The fast-track procedure is available for such funds if side-pocketing is implemented through the following two types of reorganization:

i) Spin-off from an existing share/unit class to a new share/unit class; or

ii) Spin-off from an existing sub-fund to a new sub-fund.

In both cases, the illiquid assets will be transferred from an existing class/sub-fund to a new class/sub-fund of the fund. The investors in the existing class/sub-fund will receive shares/units of the new class/sub-fund and the new class/sub-fund will be closed for subscriptions and suspended for redemptions and deemed to be in liquidation. The assets that have been side-pocketed are to be sold/realized in the best interest of the investors and upon such sale/realization, the shares/units of the new class/sub-fund will be redeemed/cancelled.

There are several conditions that the fund in question must fulfill:

- The assets isolated by the side-pocketing may not represent more than 20% of the total assets of the fund or sub-fund.
- The side-pocketing may not be contrary to the fund's articles of incorporation or the fund's management regulations.
- The central administration of the fund must be technically capable of servicing the envisaged side-pocketing.
- The side-pocketing may not be used to solve temporary valuation problems of the fund's assets.
- The potential or presumed illiquidity of an asset is not sufficient for such asset to be part of the side-pocketing.
- The fund must undertake to promptly realize the side-pocketed asset as soon as the asset becomes liquid again.

Before the CSSF can approve the side-pocketing, the fund in question must provide the CSSF with information regarding:

- the illiquid assets (e.g. percentage of assets of the fund that are isolated by the side-pocketing, reasons for the illiquidity);
- the reasons for choosing one of the spin-off options described above;
- the fees to be charged to the side-pocket;
- the way the fund will communicate to investors the implementation of the side-pocket; and
- any registration of the fund in other countries and the extent to which it may be necessary to inform the financial authorities of such countries regarding the side-pocketing.

In addition, the fund must provide the CSSF with the confirmation that annual reports or semi-annual reports, if any, of the fund will describe the side-pockets, that the CSSF will receive quarterly information regarding the status of the side-pockets and that the CSSF will be informed once a side-pocket has been paid out or terminated.

Funds wishing to use side-pocketing in situations other than the types of spin-off described above should submit a formal request to the CSSF, which will analyze such requests on a case-by-case basis.

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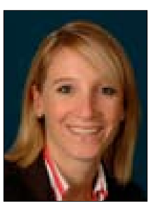
Changes to the Approval Process for Investment Managers in Germany

by **Angelo Lercara** and **Nicole Alexander**

Recent Change to the Investment Act

Operation of an investment manager in Germany requires a written permission from the Federal Financial Services Authority ("BaFin"). Such permissions are granted under section 7 of the German Investment Act ("InvG"). Prior to 17 March 2009, it was possible to obtain permissions on a restricted basis permitting management only of certain asset classes (such as securities funds or real estate funds). Thus, an investment manager could obtain a permission even where its directors possessed expertise only in relation to one kind of investment class. In such cases, the permission would be restricted to conducting management of investment within the area of expertise.

From 18 March 2009, restricted permissions can no longer be obtained by virtue of the Law Implementing Directive 2007/44/EG, which amends the InvG. However, BaFin has now published a Circular (BaFin Circular 10/2009 (WA) on the Permission Procedure according to sections 7 et seq. of the Investment Act of 27 April 2009) which provides some scope for investment managers with limited expertise to nonetheless obtain permissions.

Consequences for the Administrative Practice of the BaFin

Background

As amended, the InvG still requires the directors to have relevant expertise in relation to all investment assets for which the license is to be granted. BaFin's approach, however, has changed following the amendment of the law.

The changes to the InvG are potentially positive for the funds industry in Germany. Under the new law, new permissions will always be unlimited.

Under German law, an investment manager is required to have at least two directors. In addition, section 33 paragraph 2 of the German Banking Act requires the directors of an investment manager to have sufficient theoretical and practical knowledge in the relevant business as well as management experience before a permission is granted. The expertise requirement is generally satisfied if the director can demonstrate three years of experience with an institution of comparable size and business activity. Without the relevant expertise, an unrestricted permission may not be granted (section 7 b No. 3 InvG).

Grant of an Unrestricted Permission

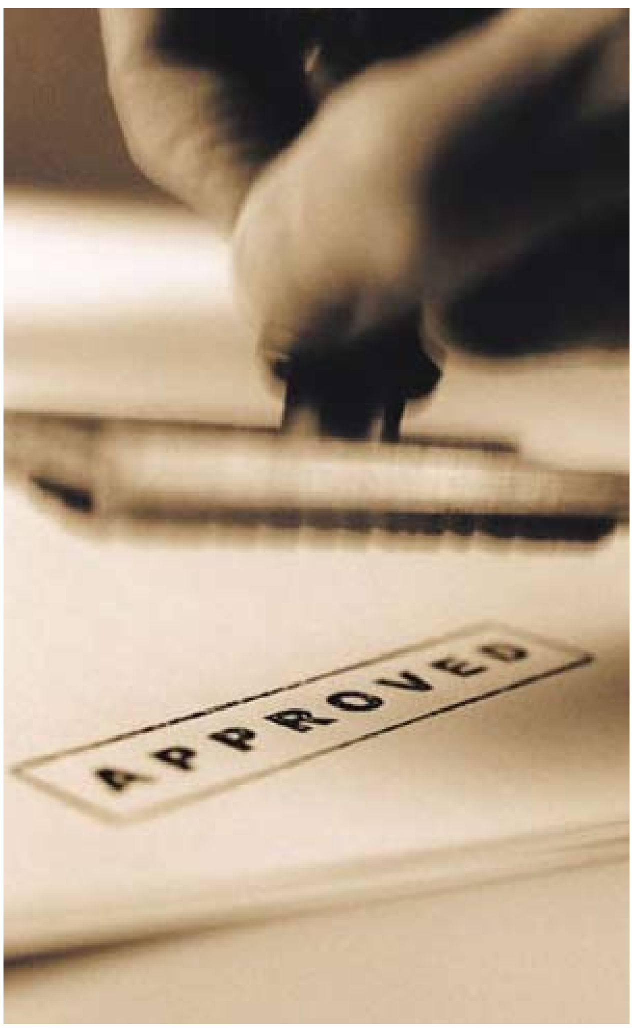
Since the change to the InvG, it is sufficient for only one of two directors to possess expertise in any asset class. Therefore, an investment manager that manages both equity and real estate funds may have one director with expertise in equity funds and one with expertise in real estate funds.

Restrictions on the Permission Instead of Refusal

It is still the case that where the directors together do not have expertise covering all areas of the company's business, a permission is not granted. However, where the directors' combined expertise covers all the proposed activities of the company, BaFin may confer an unlimited permission to such investment manager.

In such cases, BaFin will not refuse the permission provided the articles of association of the investment manager limit its activities to the management of investment fund types for which at least one of its directors has the relevant expertise.

BaFin considers the restriction on the activity in this way preferable to refusal of the permission. The BaFin will then impose a condition on the investment manager that its business activities are limited to the activities described in the articles of association.



In order to obtain the permission, the investment manager is required to file draft articles of association with the BaFin one month before their notarisation, and the BaFin will then assess whether the proposed activities are within the combined expertise of the directors. BaFin may require the investment manager to appoint additional directors with relevant expertise before approving a change to the articles of association. In addition, a certified copy of any changes to the articles of association must be filed with BaFin after their notarisation, and the relevant entry into the commercial register is required to be demonstrated by filing notarised extracts from the commercial register.

Consequences for the Funds Industry and Situation for Existing Permissions

The changes to the InvG are potentially positive for the funds industry in Germany. Under the new law, new permissions will always be unlimited and an investment manager that wishes to extend the scope of its activities need not apply for an extension of its permission. Rather, such a change can be effected by filing an updated version of the Company's articles of association with the BaFin, so that the BaFin can assess whether the directors possess the necessary expertise (as outlined above). This will eliminate the time-consuming administrative procedures and the EUR15,000 fee associated with the extension of a permission and will provide greater flexibility for investment companies.

However, for investment managers with existing restricted permissions granted prior to 18 March 2009, these will continue as restricted permissions and will therefore be subject to the administration fee of EUR 15,000.

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Regulators Seek to Add Greater Transparency to Agency Debt Market


by **Edward L. Pittman** and **Brenden P. Carroll**

Historically, many segments of the market for fixed income securities have been far less transparent than the equities markets. In 1998, in response to the disparity between the reporting of transactions in fixed income and equity securities, then-Securities and Exchange Commission ("SEC") Chairman Arthur Levitt requested that the National Association of Securities Dealers, Inc. ("NASD"), the predecessor to the Financial Industry Regulatory Authority ("FINRA"), develop a system to foster transparency in the corporate bond market. On July 1, 2002, NASD launched the Trade Reporting and Compliance Engine ("TRACE"), a system now operated by FINRA, that requires reporting of over-the-counter secondary market transactions in eligible fixed income securities.

Fixed Income Transaction Reporting

The TRACE rules, found in the 6700 series of the FINRA Manual, require all broker-dealers that are FINRA member firms to report secondary market transactions in U.S. dollar denominated bonds, notes or other debt instruments that are issued by U.S. or foreign private issuers.[1] Notably, however, transactions involving U.S. Treasury and other U.S. government agency securities, as well as asset- and mortgage-backed securities, are excluded from TRACE reporting obligations. Subject to certain exceptions, FINRA member firms are required to report transactions in TRACE-eligible securities within 15 minutes of execution of such transactions.

TRACE offers real-time, public dissemination of transaction and price data of TRACE-eligible securities, including intra-day transaction data and aggregate end-of-day statistics such as most active bonds, total volume, advances and declines, and new highs and lows. According to at least one study, transparency added by TRACE has reduced the bid-ask spreads of TRACE-eligible securities.

Corporate Bonds, Collateralized Debt Obligations, and Agency Bonds

In March 2009, FINRA submitted a proposed rule filing to the SEC that would, among other things, expand the scope of securities reportable to TRACE.[2] FINRA's recent proposal is part of a broader movement by U.S. regulators and industry groups to add greater transparency, through trade reporting, to many segments of the securities markets, including derivatives, municipal securities, and asset- and mortgage-backed securities. Other recent efforts focused on fixed income securities include the expansion of the reporting obligations for transactions in municipal securities to include variable rate demand notes and auction rate securities, as well as significant enhancements to the trade reports and offering disclosure made available to the public on the website of the Municipal Securities Rulemaking Board. On a global scale, industry initiatives are underway to restore confidence and improve transparency in the market for asset- and mortgage-backed securities.[3] Moreover, one element of President Barack Obama's comprehensive plan for regulatory reform, announced on June 17, 2009, specifically states that the SEC and FINRA should expand TRACE reporting requirements to include asset-backed securities.[4]

FINRA's rule proposal departs from the current system in two significant ways. First, the rule proposal expands the scope of TRACE-eligible securities to include debt securities issued or guaranteed by U.S. government agencies and U.S. government-sponsored enterprises.[5] Second, the rule proposal requires broker-dealers to report primary market transactions, in addition to secondary market transactions.

Expansion of TRACE-Eligible Securities

The rule proposal expands the scope of TRACE-eligible securities to include debt securities (i) issued or guar-

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anteed by U.S. government agencies, including the Commodity Credit Corporation and the Export-Import Bank of the United States, and (ii) issued or guaranteed by U.S. government-sponsored enterprises, including the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "Agency Debt Securities"). The proposed reporting requirements do not extend to (i) securities issued by the U.S. Department of the Treasury or (ii) asset-backed securities[6] with respect to which a U.S. government agency or U.S. government-sponsored enterprise is the sponsor of the trust or other entity that issued the asset-backed security, or is the guarantor of the asset-backed security. According to FINRA, if the rule proposal is approved by the SEC, it would nearly double the approximately 30,000 securities now reportable through TRACE.

FINRA's recent proposal is part of a broader movement by U.S. regulators and industry groups to add greater transparency, through trade reporting, to many segments of the securities markets, including derivatives, municipal securities, and asset- and mortgage-backed securities.

Inclusion of Primary Market Transactions

FINRA also is proposing that broker-dealers report primary market transactions, in addition to secondary market transactions. Generally, the period immediately following a primary offering is the most active period of trading in fixed income securities. FINRA believes that including primary market transactions will enable it to provide a more comprehensive audit trail and improve market surveillance.

Reaction to the Rule Proposal

Buy-side commenters generally favored the proposal, because they believe it will improve price discovery in connection with trading and provide additional source materials to enhance the quality of valuations. In addition, they suggested that transparency should be promoted in other areas of the fixed income markets that are less liquid. At the same time, however, sell-side firms have noted that the market for Agency Debt Securities, in particular, already is very efficient and has narrow spreads, and that further compression of spreads may affect the willingness of firms to commit capital. They also have questioned whether the costs associated with infrastructure development and compliance will outweigh any potential benefits. Among other things, they recommend that the entire TRACE system be modernized to reduce costs.

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1 See FINRA Rule 6710.

2 See Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto to Expand TRACE to Include Agency Debt Securities and Primary Market Transactions (April 8, 2009), Securities Exchange Act Rel. No. 59733, File No. SR-FINRA-2009-010.

3 See, e.g., Restoring Confidence in the Securitization Markets (December 2008) (joint report by the Securities Industry and Financial Markets Association, American Securitization Forum, European Securitisation Forum, and Australian Securitisation Forum).

4 See U.S. Department of the Treasury, Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation (June 2009).

5 In April 2009, the SEC approved a similar FINRA rule proposal that expanded the scope of TRACE-eligible securities to include debt securities that are eligible for public sale in the secondary market but are excluded from TRACE reporting obligations.

6 Under the rule proposal, asset-backed security is defined broadly to mean "asset-backed security as used in [the] Securities Act [of 1933] Regulation AB, Section 1101(c), and other debt securities that are structured securities, synthetic asset-backed securities and/or instruments involving or based on the securitization of mortgages or other credits or assets. The term includes but is not limited to mortgage-backed securities, collateralized mortgage obligations, collateralized debt obligations, collateralized bond obligations, collateralized debt obligations of asset-backed securities and collateralized debt obligations of collateralized debt obligations."

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