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Dechert LLP

The Shape of U.S. Financial Regulatory Reform: Early Indications Based on the Obama Administration's Proposals

by **David J. Harris***

Many would say that the financial crisis reached its high point (or depending upon your perspective, low point) more than a year ago with the failure of Lehman Brothers, which was quickly followed by The Reserve's Primary Fund "breaking the buck" and the U.S. Government's acquisition/bailout of AIG. Not surprisingly, given both the severity of the financial crisis and the billions of tax dollars spent in an effort to prevent the crisis from worsening, calls for substantial regulatory reform have been heard from virtually all sides of the political spectrum. While it is still too early to predict with precision the final shape of the financial services regulatory structure that will be in place following these reforms, especially in the current political environment, there has been enough legislative activity that one can discern the basic outline of the reforms and where the major battle lines are likely to be drawn.

The clearest picture of the likely reforms is found in the Obama administration's financial reform proposals. These proposals were previewed in a Treasury white paper "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation" released in mid-June, and fleshed out in more than 600 pages of legislative text, comprising 13 separate titles, that were released over the ensuing weeks. This article provides a brief summary of those 13 titles, while highlighting those provisions most likely to be of interest and relevance to the investment management industry.

Title I, the "Financial Services Oversight Council Act of 2009," would establish a Financial Services Oversight Council (the "Council"), whose members consist of the Secretary of the Treasury (who would also chair the Council); the

Chairman of the Board of Governors of the Federal Reserve System (the "Federal Reserve"); the Comptroller of the Currency ("Comptroller") until the Comptroller's functions are transferred to the Director of the new National Bank Supervisor (the "NBS") (see Title III below), at which time the Director of the NBS would succeed to the Comptroller's membership; the Director of the Office of Thrift Supervision ("OTS") until the OTS Director's functions are transferred to the NBS Director; the Director of the new Consumer Financial Protection Agency ("CFPA") (see Title X below); the Chair of the Securities and Exchange Commission ("SEC"); the Chair of the Commodity Futures Trading Commission ("CFTC"); the Chair of the Federal Deposit Insurance Commission ("FDIC"); and the Director of the Federal Housing Finance Agency ("FHFA").

The Council is in many respects a broader, more formalized version of the currently functioning President's Working Group on Financial Markets ("PWG"). The Council would advise, and make recommendations to, Congress on financial markets, monitor the financial services marketplace to identify potential threats to the stability of the U.S. financial system, facilitate information sharing among members of the Council, advise the Federal Reserve on the designation of Tier 1 financial holding companies ("FHCs") (see Title II below), and provide a forum for discussion of emerging market developments and regulatory and jurisdictional issues.

Importantly, the Council would not be the so-called "systemic risk regulator," as that role and responsibility would be assigned to the Federal Reserve. The Council, however, would play an important advisory role to the Federal Reserve, which would be required to consult with the Council before implementing material rules and regulations regarding the designation and regulation of Tier 1 FHCs, financial market utilities and systemically important clearing, settlement and payment activities (see Title VIII below).

The identity and scope of authority of the "systemic risk regulator" is likely to be an area of significant debate, as many have questioned whether the Federal Reserve should be granted significant additional authority over the financial system in light of perceived supervisory failures leading up to the financial crisis. The alternative most often suggested is to provide the Council with this systemic risk responsibility and authority, although that approach has been criticized as well on the grounds that arguably no single agency would have ultimate responsibility.

Title II, **the** "**Bank Holding Company Modernization Act of 2009**," would address the failures in the supervision and regulation of large, highly leveraged, and substantially interconnected financial companies that many considered to have been a significant factor in the financial crisis. Currently, many of these firms are regulated by various agencies, and many facets of their operations are essentially unregulated. The proposal would seek to implement a comprehensive, consolidated supervision and examination regime for these companies, with the hope of avoiding or mitigating similar crises in the future.

Title II would create a "United States financial company" designation that would apply to any company, including a bank holding company ("BHC"), that is organized in the United States or its territories and is "in whole or in part engaged in, directly or indirectly, activities in the United States that are financial in nature." One primary purpose of this designation would be to address gaps in regulation and supervision with respect to many complicated financial institutions that have avoided "bank holding company" status by either not owning an insured depository institution or by owning so called "non-bank banks" – insured depository institutions that are not considered "banks" under the Bank Holding Company Act of 1956 ("BHCA").

Under Title II, the Federal Reserve would be granted the authority to designate any United States financial company as a "Tier 1 financial holding company" upon its determination "that material financial distress at the company could pose a threat to global or United States financial stability or the global or United States

economy during times of economic stress" based on the amount and nature of the company's assets and liabilities, or other factors the Federal Reserve may determine to be appropriate. The Federal Reserve would have similar power over foreign FHCs under the proposal. From the perspective of the investment management industry, one of the concerns is that the Federal Reserve's authority to designate Tier 1 FHCs is broad enough to encompass large investment funds.

Each Tier 1 FHC would be required to register with the Federal Reserve and meet certain prudential standards that would be designed by the Federal Reserve to mitigate risks to the financial system, including: (1) risk-based capital requirements; (2) leverage limits; and (3) overall risk management requirements. With respect to foreign Tier 1 FHCs, the Federal Reserve would be required to take into account principles of national treatment and equality of competitive opportunity when devising these standards. Those companies deemed to be Tier 1 FHCs by the Federal Reserve that had avoided designation as BHCs (and the related limitations on activities) by holding so-called "non-bank banks" would have five years from the date of their designation as a Tier 1 FHC to conform their activities to those permitted for an FHC.

Under the proposal, the Federal Reserve would be granted broad examination authority over Tier 1 FHCs and the authority to require such companies to submit reports regarding their operations and financial conditions. In addition, the Federal Reserve would be granted the same broad enforcement authority that federal banking regulators currently have over the banks they supervise. This enforcement authority includes the ability to assess significant civil money penalties, to seek to impose cease and desist orders against companies and their employees and officers, and to seek to prohibit employees and officers from further participation in the banking industry. Finally, the Federal Reserve would have "Prompt Corrective Action" authority to address serious undercapitalization of Tier 1 FHCs that is similar to the authority the federal banking regulators currently have over depository institutions.

Title III of the Obama administration proposals would create a new National Bank Supervisor as a bureau of the Department of the Treasury. The Office of the Comptroller of the Currency ("OCC") and the OTS would be abolished. All powers of the OCC would be passed to the NBS, as would all powers of the OTS, except for functions relating to the supervision and regulation of state savings associations, which would be passed to the FDIC. Title III would also eliminate the federal thrift charter, and each savings association under the authority of the OTS would be required, within six months after the date of enactment, to elect to become a national bank, mutual national bank, state bank, or state savings association. If the savings association fails to do so, it would become a national bank or mutual national bank by operation of law effective at the end of the one-year period beginning on the date of enactment.

While similar proposals in the past have met strong opposition from the banking industry, the expectation is that this limited consolidation of banking supervisors will be included in the final reform legislation.

The powers of the OCC and OTS would be transferred to the NBS one year after the date of the enactment of Title III, during which time the Director of the NBS would have certain interim powers, while the Comptroller and the Director of the OTS would continue to have certain interim powers as well. All orders, resolutions, determinations, agreements, regulations, interpretive rules, other interpretations, guidelines, procedures, and other advisory materials of the OCC and the OTS would continue to be effective, although the NBS would have the authority to identify which regulations it would continue to enforce before the date of the transfer.

While similar proposals in the past have met strong opposition from the banking industry, the expectation is that this limited consolidation of banking supervisors will be included in the final reform legislation.

Title IV, **the "Private Fund Investment Advisers Registration Act of 2009,"** would amend the Investment Advisers Act of 1940 (the "Advisers Act") to require investment advisers to certain pooled investment vehicles, including hedge funds, private equity funds and venture capital funds ("Private Funds"), to register with the SEC. Title IV would define a "Private Fund" to include an investment fund that (a) would be an investment company as defined under Section 3 of the Investment Company Act of 1940 (the "Investment Company Act") but for the exclusions from the definition of investment company provided in either Section 3(c)(1) or Section 3(c)(7) of the Investment Company

Act, and (b) either (i) is organized or is otherwise created under the laws of the United States or of a state; or (ii) has 10% or more of its outstanding securities owned by a U.S. person. Thus, most domestic, and many offshore, hedge funds, private equity funds, and venture capital funds would fall under the definition of "Private Funds" as set forth in Title IV.

Three exemptions from the registration requirements of the Advisers Act that have historically been available to investments advisers to Private Funds would be eliminated. Most notably, Title IV proposes to eliminate in its entirety the current exemption from registration for any investment adviser who during the prior 12 months has had fewer than 15 clients and who neither holds itself out generally to the public as an investment adviser nor acts as the investment adviser to a registered investment company or a business development company. The current exemption would be replaced by a blanket exemption from SEC registration for any investment adviser that is a "foreign private adviser," which is defined as any investment adviser who (a) has no place of business in the United States; (b) during the preceding 12 months has had (i) fewer than 15 clients in the United States, and (ii) assets under management attributable to clients in the United States of less than $25 million (or such higher amount as the SEC may establish by rule); and (c) neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to any registered investment company or business development company. Because each of the foregoing provisions must be satisfied in order to fall within the definition of a "foreign private adviser," this exemption may have a relatively narrow application. Title IV would also eliminate the ability of an investment adviser to a Private Fund to rely on either the Advisers Act's current "intrastate" or commodity trading adviser exemptions, although these exemptions will remain available to investment advisers who do not advise any Private Funds.

In addition to imposing registration requirements on investment advisers to Private Funds, Title IV would give the SEC a broad mandate to require any investment adviser to a Private Fund to maintain such records and submit to the SEC such reports regarding Private Funds as are necessary or appropriate in the public interest and for the assessment of systemic risk by the Federal Reserve and the Council. Specific information that an investment adviser to a Private Fund would be required to file with the SEC concerning such Private Fund includes, but is not limited to:

- amount of assets under management;
- use of leverage (including off-balance sheet leverage);
- counterparty risk exposures;
- trading and investment positions; and
- trading practices.

All records of a Private Fund maintained by an investment adviser would be subject to review and examination by the SEC. Moreover, the SEC would be required to provide to the Federal Reserve and the Council copies of all reports, documents, records, and information filed with or provided to the SEC by an investment adviser to a Private Fund as the Federal Reserve or the Council may consider necessary to assess the systemic risk of a Private Fund or to determine whether it should be treated as a Tier 1 FHC. While Title IV specifically provides for the confidential treatment of information required to be filed with the SEC by investment advisers with respect to Private Funds, this provision would not (i) authorize the SEC to withhold information from Congress or (ii) prevent the SEC from complying with (a) a request from any other Federal department or agency or self-regulatory organization that makes a request for purposes within the scope of its jurisdiction, or (b) a court order of a court of the United States in an action brought by the United States or the SEC.

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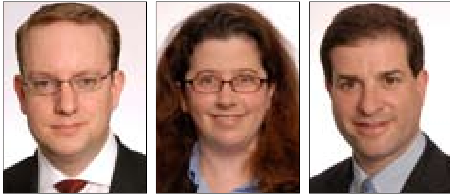
Dechert Responds to Call for Evidence Regarding Draft EU Directive on AIFM



by **Gus Black**, **Jennifer Wood** and **Adam Levin***

The EU Commission Proposal for a Directive on Alternative Investment Fund Managers (the "Directive"), which was published on 30 April 2009 following very little consultation, has already achieved widespread notoriety for the wide-ranging impact that it will have on alternative investment fund managers ("AIFM") and other service providers. In its present form, it will affect all collective investment funds which do not come under the UCITS umbrella.

The EU Commission Proposal for a Directive on AIFM has already achieved widespread notoriety for the wide-ranging impact that it will have on alternative investment fund managers and other service providers.

There has been a growing response and lobbying operation from funds, investors, trade bodies, and local and national governments, all of which are hoping to influence the Directive before its ultimate adoption by the European Council and Parliament and final implementation by individual EU Member States.

To this end, the Economic and Financial Affairs and International Trade Committee of the UK House of Lords (the "Committee") published a call for evidence at the beginning of August 2009. A working group from Dechert's London office prepared a submission for the Committee, parts of which follow.

To what extent is there a need to create a single regulatory regime for Alternative Investment Fund Managers in the European Union?

There is already a (recently implemented) pan-EU regulatory regime covering alternative investment fund managers (AIFM) in Europe in the form of the Markets in Financial Instruments Directive (2004/39/EC).

Whilst we appreciate the drivers behind further regulation in the financial services industry following recent events, we do not consider that a case has been made to single out AIFMs for special regulatory attention. It is widely acknowledged that the alternative investment fund (AIF) industry was not the cause of the recent financial crisis. Further, many of the risks that are perceived to be associated with AIFs as regards their activities are simply not applicable to many AIFs, or are also found in other quarters of the investing community that undertake those activities and which are ignored by the Directive.

Financial services regulation generally seeks to regulate behaviour or outcomes that are thought to be problematic. If certain behaviour – be it directional shorting, 'excessive' leverage or opacity – is thought

to present, for example, a systemic risk (an argument which is far from conclusively made out by the Directive's explanatory notes), there seems to us to be no logical basis to single out only one specific group of market participants that could engage in such behaviour – i.e. AIFMs – for regulation.

Whilst we appreciate the drivers behind further regulation in the financial services industry following recent events, we do not consider that a case has been made to single out AIFMs for special regulatory attention.

To the extent that further regulation in the sector is found to be necessary (following proper consideration and consultation), as a general matter we would agree that it makes sense to have common standards across the EU as far as possible.

Does the Directive achieve its objectives? Should the objectives of the Directive be modified?

The Directive appears to go well beyond financial regulatory objectives, muddling these with a political agenda. We comment on certain objectives – as we understand them from the Impact Assessment to the Directive (SEC (2009) 576) and the text of the draft Directive – below.

Risk monitoring and management

We do not see how the Directive's objectives of monitoring and/or managing macro and micro prudential risks in financial markets can be achieved by requirements that apply in respect of AIFMs and AIFs but which do not apply to other large sections of the investing community such as banks, insurance companies and occupational pension funds – which nevertheless engage in exactly the same types of activity, often to a greater degree.

Consumer protection?

The Directive states at point 29 of the preamble that its objective is to ensure a high level of consumer and investor protection by laying down a common framework for the authorisation and supervision of AIFMs. We are surprised at the focus on consumers: AIFs are neither intended for, nor generally available to, "consumers" as the word is generally used in the industry: i.e., retail customers.

Consumers do ultimately benefit from AIFMs indirectly (for example, through investment of their pension funds or other investment products). Crucially, however, in such cases there is an interposed professional manager, who is best placed to take a view on the risks involved and will often only invest in AIFs following sophisticated legal and operational due diligence processes.

In our view the Directive as currently drafted will restrict not only the choice of investment opportunities available to such professional managers, but also competition within the industry. These are not outcomes usually associated with a pro-consumer agenda. Further, to the extent that these outcomes diminish AIF returns, they will ultimately be felt by consumers via their individual pension plans and savings products. Accordingly we consider that the Directive as it stands fails consumers rather than protects them.

The Directive appears to go well beyond financial regulatory objectives, muddling these with a political agenda.

Accountability of AIFM, etc.

We understand them from the Impact Assessment to the Directive that one of the Directive's objectives is the greater public accountability of AIFMs investing in and managing companies. Again, it is not clear why AIFMs should be singled out. Why, for example, should investors who join together to make private investments be required to disclose onerous levels of information to regulators, shareholders, etc. – when investors acting alone, or other types of investors, are not?

Will the passport system help create a single market in investments funds within the EU? How will the passport system established affect the EU and the UK industry and particularly their position in the global market?

In principle, a passport system would help to create a single market. Its potential to open up capital markets and to simplify what can be a significant and costly

compliance burden, dealing with the existing patchwork of regulatory approaches is, in theory, to be welcomed.

The alternative fund industry, however, is a global industry. Provided there is "equivalent" regulation in other non-EU states it ought to be possible for managers in such states to access the EU market and vice-versa. Unfortunately, as the Directive currently stands it is not clear that any third country, including the United States, would meet the proposed standards for equivalence. Ultimately, the passport system will help neither the interests of the UK nor EU market if it effectively serves to deprive the market of access to third country managers and funds. Mutual market access should be negotiated at an EU level based on a minimum best practice acceptable to both the EU and elsewhere.

We believe it is important to distinguish the perceived risks associated with AIFs and the real risks.

What risks arise from Alternative Investment Funds? Is the Directive proportionate given the role of AIF in the financial crisis? Will the Directive introduce over–stringent regulations or does it not go far enough?

The lack of causation between AIFs and the recent financial crisis is well documented by the major reports (see, for example The High-Level Group on Financial Supervision in the EU Report (chaired by Jacques de Larosière) etc.) and we will not dwell on this. Similarly, a number of industry representatives and trade bodies have highlighted some of the costs likely to arise from the Directive, which go to proportionality (or lack thereof).

We believe it is important to distinguish the perceived risks associated with AIFs and the real risks. In our view AIFs pose little systemic risk when compared with other industry players, specifically banks. For example, evidence points to the fact that in overall terms neither hedge funds' nor private equity funds' levels of leverage have been excessive:

- Dan Waters, FSA Asset Manager Sector Leader, said in a speech to the International Fund Forum on 24 June 2009, "Some four years ago we set up a specialist supervision team to focus explicitly on hedge fund managers, and began gathering comprehensive data from the prime brokerage community that lends to them, giving us a good grip on their levels of leverage – which in recent years – including the run up to the crisis – have very typically been modest, especially in comparison to banks."
- Insofar as private equity is concerned, the World Economic Forum on the Global Economic Impact of Private Equity found, in 2008, that private equity-backed companies had a default rate of 1.2% per year, compared to an average default rate of 1.6% for US corporate bond issuers.

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Greater China and Asian Developments

Chinese Regulators Expand the Onshore Segregated Account Management Business

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

Until very recently, fund management companies in the People's Republic of China ("PRC") had not been permitted to offer discretionary investment management services to PRC investors other than through authorized retail mutual funds. However, PRC regulators have promulgated new rules that permit fund management companies (including foreign asset management joint ventures[1]) to provide segregated account management services to multiple clients on a "collective account" basis ("Collective Investment Accounts"). Through Collective Investment Accounts, fund management companies may offer non-retail, alternative investment strategies to a limited number of qualified PRC investors. This development has been hailed by the PRC fund management industry as a means by which managers may expand and diversify their businesses to provide sophisticated strategies to the PRC's burgeoning institutional and high net worth investor communities.

Background

In November 2007, the China Securities Regulatory Commission ("CSRC") promulgated the Trial Measures for Fund Management Companies to Provide Asset Management Services for Specific Clients ("Account Management Measures"). The Account Management Measures, which became effective on 1 January 2008, allow fund management companies to provide wealth management services to certain qualified investors through segregated account platforms. In addition to Collective Investment Accounts, accounts may also be established for individual clients. To facilitate the establishment of Collective Investment Accounts, the CSRC released the Rules on Relevant Issues in Relation to Fund Management Companies Conducting Specific Multiple Client Asset Management Business ("Management Rules") on 5 May 2009, and the Standards Concerning the Content and Format of Multiple Client

Asset Management Contracts (“Contract Rules”) on 4 August 2009.

Requirements for Establishing Collective Investment Accounts

In order to provide Collective Investment Account services, a fund management company must apply to the CSRC for approval and meet certain quantitative and qualitative standards. Currently, the CSRC only permits fund management companies that are qualified under the Qualified Domestic Institutional Investor (“QDII”) program to provide Collective Investment Account services. In addition to meeting the QDII requirements for assets under management, fund management companies generally must have at least two years of experience managing investment funds, properly qualified personnel, appropriate compliance policies and risk management procedures and a clean record.

Once approved by the CSRC, a fund management company may establish Collective Investment Accounts. Although CSRC approval is not required on an account-by-account basis, the fund management company must file various account documents with the CSRC for record-keeping purposes. Each account may have up to 200 investors, who are “qualified clients.” Pursuant to the Management Rules, a client is “qualified” if it is able to invest not less than renminbi (“RMB”) 1 million in the Collective Investment Account, and is able to identify, judge and accept the investment risks. Collective Investment Accounts must also have initial assets of at least RMB 50 million before they can begin operations.

Management of Collective Investment Accounts

Fund management companies must provide asset management and other services to Collective Investment Accounts pursuant to a written asset management contract, the contents of which are prescribed by the Contract Rules. With respect to fees, the Account Management Measures prescribe minimum management fees and maximum performance fees. For example, management fees for Collective Investment Accounts cannot be lower than 60% of the corresponding fee rate for similar retail funds offered by the same manager, while performance fees cannot exceed 20% of net profits.

Collective Investment Accounts may invest in a broad array of securities and instruments (i.e., stocks, bonds, investment funds, asset-backed securities and financial derivatives) and have the same permitted investment scope as public QDII funds. While Collective Investment Accounts will not be subject to the diversification and concentration limitations applicable to public QDII funds, the Management Rules impose general diversification requirements.[2] In addition, the CSRC has recently permitted fund management companies to use their excess or unused QDII quotas for segregated account overseas investment.[3]

This development has been hailed by the PRC fund management industry as a means by which managers may expand and diversify their businesses to provide sophisticated strategies to the PRC’s burgeoning institutional and high net worth investor communities.

The Account Management Measures and the Management Rules also contain several provisions with respect to the operations of Collective Investment Accounts. For example, fund management companies must take steps to mitigate conflicts of interest, including conflicts inherent in side-by-side management of retail and non-retail products. Furthermore, in order to ensure adequate transparency, the Collective Investment Accounts and their managers must observe various record-keeping and reporting requirements (e.g., the fund management company must file quarterly reports, and must calculate and disclose to investors the net asset value at least monthly).

Distribution of Collective Investment Account Interests

Collective Investment Accounts are prohibited from conducting public marketing activity. Accordingly, investors should be solicited strictly on a traditional private placement basis (e.g., fund management companies and their sales agents should refrain from marketing interests via newspaper, television, radio, internet or any other public medium). In addition, subscription materials and know-your-client procedures should be used to properly screen investors.

The Management Rules also permit fund management companies to engage properly licensed third-party distributors to market Collective Investment Account interests.

Conclusion

Through Collective Investment Accounts, fund management companies (including foreign asset management joint ventures) may offer sophisticated PRC investors exposure to various alternative investment strategies and asset classes, while the regulations seek to ensure that fund management companies implement appropriate procedures with respect to the offering and operation of these products. These developments provide a welcome opportunity for the continued expansion of the onshore asset management business in the PRC.

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[1] Foreign asset managers may establish a presence in China by setting up a foreign asset management joint venture. According to industry reports, there are approximately 32 such joint ventures, and the number is expected to increase. Dechert LLP is preparing and will publish an OnPoint that provides detailed information with respect to foreign asset management joint ventures.

[2] According to industry reports, the CSRC issued the Reply for Opening Offshore Asset Management Business for Segregated Accounts by Fund Management Companies (the "Reply") on 9 March 2009, which provides guidelines with respect to overseas investments by Collective Investment Accounts. The Reply is a non-public letter that was issued to the Bank of Communications Schroder Fund Management in response to its queries.

[3] QDII funds sponsored by fund management companies are permitted to invest in a wide range of offshore investment products. However, such QDII funds are subject to restrictions on "investment proportions" (e.g., no more than 10% of a QDII fund's assets may be invested in the securities of a single issuer, or in illiquid securities).

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Cross-Border Fund Raising within ASEAN

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

Background

In October 2008, the ASEAN Capital Markets Forum ("ACMF")[1] adopted the ASEAN and Plus Standards Scheme (the "Scheme"), applicable to cross-border offerings of securities within the ASEAN[2] nations. The Scheme seeks to facilitate multi-jurisdictional share or debt offerings across the different ASEAN nations.

The timeframe for the adoption of the Scheme allows each member nation to opt-in on a when-ready basis. In June 2009, Malaysia, Singapore and Thailand (being three out of four of the region's largest economies, with Indonesia yet to opt-in) became the first three member nations to opt into the Scheme. This article highlights salient features of the Scheme and what this may mean for global investors and asset managers.

Drive Toward Economic Integration

The Scheme has been introduced against the political backdrop of ASEAN's stated vision to achieve European-style economic integration. ASEAN leaders approved a roadmap for an integrated ASEAN market at the 40th-anniversary summit of ASEAN in 2007, targeting the creation of an ASEAN Economic Community ("AEC") by 2015. The aim of the AEC is to allow the free movement of goods, services, investment and skilled labour, and freer flow of capital by the target-date.

Tangible efforts have already been undertaken on some fronts to create a single integrated marketplace. ASEAN member nations have been progressively reducing intra-group trade barriers. On 1 January 2010, ASEAN will take a big step toward becoming a free trade area, with zero tariffs on most products originating from Indonesia, Malaysia, the Philippines, Singapore, Thailand and Brunei Darussalam[3].

In the 1990s, the economies of South-east Asia – led by the region's five main "Asian Tiger" economies of Indonesia, Malaysia, the Philippines, Singapore and Thailand – were humming along as the world's fastest-developing region. However, since the Asian financial crisis of 1997-1998, and with the recent rise of China and India, ASEAN has been perceived to be in a collective state of drift.

As such, the recent developments are perceived to have been driven by the realisation amongst ASEAN leaders that the region needs to repackage itself once again into an attractive financing and investment destination, in order to stay economically relevant to global investors and asset managers, or risk trailing further behind China and India. The Scheme has been promoted by the ACMF as one of the capital market initiatives under a broader plan to drive the AEC vision forward.

Brief Features of the Scheme

The Scheme applies to multi-jurisdiction offerings within ASEAN that require the registration of prospectuses or registration statements and applies to any issuer (whether or not based in ASEAN) making such offerings within ASEAN. It aims to facilitate cross-border offerings of securities within the ASEAN region by harmonising disclosure requirements. The Scheme currently only applies to offers of equity and debt securities.

The Scheme introduces two disclosure standards to be complied with by issuers:

- The first is a baseline set of common requirements called the ASEAN Standards. The ASEAN Standards are based closely on standards of cross-border offerings set by the International Organization of Securities Commissions ("IOSCO").[4] It fully adopts the International Financial Reporting Standards and the International Standards on Auditing.
- The second is a set of additional standards called the Plus Standards that may be prescribed by the respective ASEAN jurisdictions to accommodate local market practices, laws or regulations that cannot yet be harmonised or reduced to the ASEAN Standards. This will serve as the jurisdiction-specific "wrapper" to accompany the baseline disclosures in the ASEAN Standards.

An offer by an issuer in one ASEAN member country which has adopted the Scheme, say Malaysia, and at least one other ASEAN member country, say Singapore, which has adopted the same, will have to comply with the baseline ASEAN Standards as the starting point. For the offer in Malaysia, the issuer must additionally comply with Malaysia's Plus Standards in respect of disclosures to investors in Malaysia. Similarly for the offer in Singapore, the issuer needs to also comply with Singapore's Plus Standards in respect of disclosures to investors in Singapore.

This is in contrast to the current situation where an issuer seeking to conduct multi-jurisdiction offerings in ASEAN must separately comply with each jurisdiction's full list of disclosure requirements. The ACMF envisages that the Scheme will improve efficiency and bring about cost savings for such multi-jurisdiction offerings.

In implementing the Scheme, there are likely to be early problems as overly cautious local regulators and securities exchanges may choose (taking into account the specific issuer profile and characteristics of the offer) to impose disclosure requirements above and beyond the minimum which have been promulgated. This may mean, depending on the additional requirements for which compliance is requested or directed by local regulatory authorities, that an issuer may have to contend with local specific disclosures in addition to the relevant Plus Standards.

Further, while the Scheme appears to usher in a set of pan-ASEAN disclosure standards, the track record to date of ASEAN regulatory bodies in competing against, rather than co-operating with, one another may be an impediment to the success of the Scheme. The ideal result would be to have a single set of global and comprehensive standards for pan-ASEAN application. But as this cannot yet be achieved, the Scheme may be an expedient step towards creating an overarching framework for ASEAN regulatory bodies to recognise each other's regimes, so as to reduce the overall costs to issuers contemplating multi-jurisdictional offerings.

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A New Economic Era for ASEAN?

Sandwiched geographically between the two prospering Asian giants of China and India, ASEAN is well positioned to broaden and complement the trade and investment flows in Asia. It is resource-rich, and has abundant labour and plentiful land. If the AEC 2015 vision does take shape in one form or the other[5], the ten-nation strong ASEAN bloc with a combined market of more than half a billion people (larger than Europe's population) could become a force to reckon with on the global stage.

The recent robust increase in domestic demand and the emergence of a larger middle class of consumers are likely to create increased financing and investment opportunities in the coming years. As such, ASEAN can represent an outstanding source of growth and diversification for global investors and asset managers. As ASEAN forges its own path to grow alongside China and India, global players may wish to adopt a "prepare-and-decide" ASEAN strategy, by adopting toehold positions, building positions where appropriate, anticipating strategic shifts, and being prepared to move early to implement investment policy.

If the AEC 2015 vision does take shape in one form or the other, the ten-nation strong ASEAN bloc with a combined market of more than half a billion people (larger than Europe's population) could become a force to reckon with on the global stage.

There are already signs that institutional investor interest may be returning to ASEAN. The recent re-election of pro-business President Susilo Bambang Yudhoyono has brought Indonesia into focus[6]. Economic policy liberalisation and restructuring measures announced in Malaysia under the new reform-minded prime minister, Najib Razak (including dismantling of race-based investment quotas and opening up the financial services sector to increased foreign participation) have also been welcomed in financial circles.

In this context, the Scheme is an important milestone towards fulfilling the broader AEC 2015 vision by deepening the combined ASEAN capital markets, and making these markets more accessible to global issuers. It should also make ASEAN securities more attractive as an asset class to global investors and asset managers, by harmonising and raising disclosure standards amongst member nations to an international level as embodied by the IOSCO standards.

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1 The ACMF was established under the auspices of the ASEAN Finance Ministers in 2004 to serve as a forum for the heads of securities regulators in the ASEAN region to discuss policy issues relating to capital markets development including the goal of harmonising differences in securities law.

2 The Association of South-East Asian Nations, or ASEAN, is a ten-member regional group of nations which currently comprises Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei Darussalam, Vietnam, Lao PDR, Cambodia and Myanmar.

3 As another illustration of concrete measures toward closer integration, ASEAN has also pledged to introduce a full open-sky arrangement to the region by 2015. In the meantime, airspace and travel restrictions have been eased to allow destinations to be serviced by more flights which, in turn, has spawned the arrival of low-cost air travel, thereby boosting the tourism and leisure industries.

4 International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (1998) in respect of offerings of equity securities, and International Disclosure Standards for Cross-border Offerings and Listings of Debt Securities by Foreign Issuers (2007) in respect of offerings of debt securities.

5 ASEAN is seldom held up as a model of implementation due to its adherence to the principles of consensus and non-intervention in member states' affairs. Doubts have been expressed by some pundits as to whether the AEC 2015 vision can be successfully realised by the ambitious target-date or it will be a victim of political backsliding.

6 There have been suggestions to add Indonesia, which is the largest ASEAN nation by territory and population, to the term BRIC (first used in 2001 to refer to the new wave of emerging markets of Brazil, Russia, India and China), or to coin a new term "Chindonesia", grouping China, India and Indonesia together, since they generate economic activity close to approximately 45% of the U.S. economy.

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The Minibond Saga: The Final Installment?

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

Background

The sale to retail investors in Asia (primarily, in Hong Kong, Taiwan and Singapore) of structured credit derivatives linked to Lehman Brothers and the ensuing events have been described in our previous client bulletins and quarterly reports.[1] Briefly, the collapse of Lehman Brothers in September 2008 resulted in the Minibonds losing almost all of their value, investors taking to the streets in protest and regulators being brought to task.

In Hong Kong, the matter was further politicised by the Legislative Council exercising its special investigative powers to focus on the role played by regulators in allowing the products to be made available on the retail market. In turn, the relevant regulators, the Securities and Futures Commission ("SFC") and the Hong Kong Monetary Authority ("HKMA") – the latter being the primary regulator of banks that had been the main distributors of the Minibonds – swung into action to begin investigations into the distribution processes, internal control measures and other operational issues within the banks and other intermediaries that had distributed the Minibonds.

The investigations were high-profile and resulted, beginning in January 2009, in the first of a series of intermediaries and banks that had distributed these products to retail customers, agreeing with the regulators to provide complete or substantial restitution to the aggrieved investors and improving their internal control measures in order to reach a "settlement" of sorts in relation to the investigations.

In July of this year, the SFC and the HKMA reached an agreement with a group of 16 banks in Hong Kong under which the banks would make partial compensation to those of their customers who had invested in the Minibonds, in an aggregate amount of HK$6.3 billion (approximately US$ 808 million). This is the first time a mass settlement of this nature has been reached in Asia and is also significant given the amount of compensation agreed to.

Terms of the Settlement/Repurchase Scheme

The terms of this latest settlement are as follows:

- The 16 banks will repurchase from investors all outstanding Lehman Brothers Minibonds at 60 to 70% of their original value – Minibond holders under the age of 65 years will receive 60%, and those over 65 years of age will receive 70%, of the value of their initial investment, and all will be entitled to retain any coupon payments made to date.
- In the event that the banks/distributors eventually recover any of the underlying collateral, they must pay up to an additional 10% of the nominal value of Minibonds to eligible customers.
- Commissions earned by the banks from the sale of the Minibonds (reportedly amounting to approximately HK$200 million) will be paid to a fund to be utilised to assist in the recovery of the underlying collateral.
- The banks will implement "special enhanced complaints handling procedures" regarding other structured products.
- Each bank is to appoint an independent reviewer (to be approved by the SFC and HKMA) and qualified third parties to review the bank's systems and processes relating to the sale of structured products, issue a report to the SFC and the HKMA and commit to the implementation of all recommendations by the independent reviewer.

Lessons Learnt?

Since the events unfolded in Hong Kong in September of last year, the regulators have sought to scrutinize the distribution and internal processes of all known distributors of the Minibonds in light of investor complaints of unacceptable selling techniques and alleged misrepresentation by banking staff as to the true nature of the Minibonds. The investigations revealed that there was some truth in many of the allegations, exposing lapses in compliance with regulatory requirements already imposed (under existing SFC practice codes and guidelines) on distributors of investment products to ensure appropriate investor and product vetting, and, by extension, product suitability for each relevant investor.

Given the details of the compensation package agreed to by the 16 banks (with each investor receiving at least 60% of his initial investment), it would be reasonable to assume that the allegations had exposed a weak spot in the banks. With the distribution of retail products generally coming under public scrutiny, and given the extent of losses incurred by retail investors in the Minibonds, many banks (including unaffected ones) had already commenced their own investigations into their internal processes in anticipation of more formal regulatory probes. There have been murmurings that the practices that led to the mis-selling of the products scandal resulted from somewhat less stringent requirements being imposed by the HKMA on banks than by the SFC directly on SFC-licensed distributor intermediaries.

With the settlement, some of the pressure should ease off the banks from both the investors and regulators (although some investors are holding out for greater or full compensation). Executive man-hours previously spent managing the investigation and related issues can now be more productively spent on business needs. The share price of most listed distributors rose after the settlement was announced since the SFC had not only ended its inquiry into Minibonds at the 16 banks, but had also suspended investigation of other products from those banks. The investigations of three other banks, which were not part of the payout settlement because they sold Lehman-related products other than Minibonds, continue.

Going forward, it is now accepted that the regulation of financial intermediaries and retail products will only increase.

The mass settlement sets a precedent for the regulators, raising the prospect of similar settlements with distributors of similar products such as equity-linked notes and accumulators where retail investors have also suffered losses following alleged mis-selling by distributors.

There is certainly more caution in the air now in Hong Kong as regards retail product distribution, and bonds in particular. A recent proposed offering of Renminbi-denominated bonds did not prove as popular as had been anticipated. As far as mutual funds are concerned, the SFC imposed an enhanced disclosure regime on all authorized retail funds that is widely regarded as a reaction to the Minibond crisis.

Going forward, it is now accepted that the regulation of financial intermediaries and retail products will only increase. A long overdue initiative by the SFC to regulate structured products that commenced this year was most likely also, at least in part, a reaction to the events surrounding the Minibond scandal. A consultative draft of a new Code on Unlisted Structured Products was issued at the end of September. This is the first designated regulation of unlisted structured products in Hong Kong.

The SFC has also, at the same time, issued for public consultation, drafts of proposed revisions to the existing Code on Unit Trusts and Mutual Funds and Code on Investment-Linked Assurance Schemes. The SFC has announced an intention to align all three codes such that standards required of players across these products will be consistent, with a view to ensuring that no retail products fall between the cracks.[2]

In addition to the increased focus on staff training and internal risk and compliance controls, there has been commentary suggesting that there should be a super-regulator in Hong Kong to ensure a level playing field for all financial services intermediaries. The general sense in the industry, however, is that this is unlikely to materialize in the near future.

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[1] Please refer to http://www.dechert.com/library/Financial%20Services%20Report%20-%2003_09.pdf and http://www.dechert.com/library/FS%20_1_01_09_Hong_Kong_Securities.pdf.

[2] Dechert LLP is preparing and will publish an OnPoint that provides detailed information with respect to these draft Codes.

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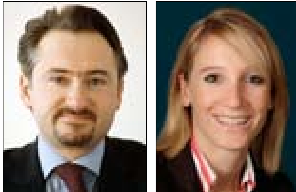
Extended Powers of the German Regulator Regarding Supervisory Board Members of a Bank or a Financial Services Provider



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

Any person who wishes to conduct banking business or render financial services in Germany as a commercial business must apply for a written licence from the Federal Financial Services Authority ("BaFin") under section 32 of the German Banking Act ("KWG"). In order to obtain such a licence, the applicant must name at least two directors and must provide information regarding such directors' *personal reliability* (extending the meaning of "reliable" set out by law) and *applicable expertise*. Up until now, these requirements have only been applicable to the applicant entity itself and its directors. There were no regulatory requirements that would have required members of the supervisory board to disclose any specified qualifications.

Recent Changes to the German Banking Act

As a result of the experiences gained during the recent financial crisis, the German legislator has decided to broaden the controlling powers of the BaFin and has introduced new provisions into the KWG regarding the approval and removal of members of a supervisory board of a bank or a financial services provider. These new provisions entered into force on 1 August 2009.

Key features of the new provisions

The main feature of the new provisions is the imposition of the duty to provide the BaFin with information regarding the personal reliability and applicable expert knowledge of members of an entity's supervisory board. This applies when an entity is applying for permission to conduct banking business or to render financial services, as well as when any such board member is replaced. Further to this, the BaFin has been granted the power to remove supervisory board members from their position or even to revoke the permission of the bank/financial services provider, if the supervisory board members prove not to be reliable or do not possess the applicable expert knowledge. The new provisions also limit to two persons the number of members of a supervisory board who were also former directors of the institution concerned.

Background to the legislation

The reasoning behind the creation of the new provisions was twofold. Firstly, the legislator wanted to ensure that supervisory board members are appropriately qualified, so as to enhance investor protection and the stability of the financial markets. Secondly, the legislator felt that by giving the BaFin the power to remove supervisory board members who do not meet

the standards set out by the KWG, it would help facilitate the restructuring of banks and financial services providers that is currently taking place in Germany.

The Criteria of "Personal Responsibility" and "Applicable Expertise"

Generally, one would assume that the criteria of "personal responsibility" and "applicable expertise" will be interpreted by the BaFin in this context in a similar way to its interpretation of such terms for the directors of a bank or a financial services provider, and that such criteria will apply equally to members of a supervisory board to the extent that such application is appropriate.

The requirements of personal reliability and applicable expertise are essential to the security and operational function of an institution and to banking supervision. These requirements apply not only in gaining authorisation, but also throughout a company's entire existence, (including the appointment of a director or a member of a supervisory board). The special emphasis placed upon personal reliability and applicable expertise also indicates that directors and members of a supervisory board are the intended subjects of the duties imposed by the KWG and regulatory measures, either directly or as the legal representative of an entity. The BaFin can reject an application if a director does not fulfil the criteria of personal reliability and applicable expertise.

Given this background, one needs to take a closer look at the criteria of personal reliability and applicable expertise as they apply to directors, in order to see how these criteria can be interpreted in relation to members of a supervisory board.

Personal reliability

There should be no facts that might cast doubt upon the personal reliability of a director. Facts that could raise such doubts include the perpetration of white collar crimes (such as, for example, fraud), the infringement of regulatory provisions, especially in the realms of business, trade, competition or tax laws, or personal or professional behaviour that indicates that solid business management cannot be expected of the individual. Such personal reliability does not have to be positively demonstrated but it is presumed if no facts are known that would suggest irresponsibility. Thus, the task of a potential director is simply to provide the BaFin with all requisite personal information, including such individual's personal experience. In addition to his résumé, the BaFin can obtain a certificate of good conduct from the police, information from the central trade bureau or information from the criminal records bureau. It is the responsibility of the regulatory authority to verify this personal information and, as the case may be, to determine a lack of reliability from the facts.

Applicable expertise

A director must have the requisite applicable expertise to direct a bank or a financial services provider. Generally, it is the responsibility of the regulatory authority to ascertain whether a director's qualifications are sufficient, based on legal, verifiable criteria, for the director to be appointed. Unlike the personal reliability criterion, applicable expertise is not presumed in the absence of any negative information. In fact, applicable expertise must be positively identified on one's résumé, particularly with respect to training, previous experience, current activities and examples of good stewardship. As a result, it is necessary to ensure that, in every case, the qualifications meet the requirements necessary to carry out the functions of a director. This depends heavily on the nature of the business and the size of the relevant institution.

The specific requirements to meet the standard of applicable expertise for directors are set out in § 33 para. 1 sen. 2 of the KWG, which provides that directors must possess a sufficient degree of theoretical and practical knowledge regarding their relevant business and management practice. For directors of a credit institution, the applicable expertise is regularly presumed where a director can demonstrate that he has served in a "leading position" at a credit institution of similar size and business type for a three-year period. Such a three-year leading position is considered by the regulatory authority, in its standard administrative practice, to be the equivalent of the management of units within a credit institution in a position directly beneath the board level. In order for candidates to provide evidence that they are qualified to lead a credit institution in full measure and with complete responsibility, their leading position may not have been of an essentially limited nature within the institution, must have involved a level of authority to outwardly represent the bank, and must have demonstrated success (and, particularly, a high level of responsibility). The applicable expertise criterion will depend upon the specific nature of the credit institution involved. For directors that have been employed predominantly outside the scope of the KWG (i.e. outside of Germany),

the regulatory authority will make a presumption of applicable expertise where a director has demonstrated that he held a three-year leading position at an institution (including an institution that operates in another country) of comparable size and business type, provided that such director has adequate command of the German language or another commonly used international language (i.e. English) that is required for such person's appointment as director, and can demonstrate having held at least a one-year long, practice-related position within the scope of the KWG (i.e. inside of Germany). In addition, at least one of the existing directors must have held a three-year leading position at an institution within Germany.

Application to members of the supervisory board

The criteria outlined above for directors form the basis for interpreting the criteria that apply to supervisory board members. However, in applying such criteria to supervisory board members, the "controlling" function of supervisory board members (rather than the "leading" function of directors) must be taken into account.

Personal reliability

In respect of the requirements of personal reliability, one can assume that such requirements should not differ for supervisory board members from the requirements applied to directors, as personal reliability is not tied to a "leading" function and is equally necessary for a "controlling" one.

Expert knowledge

The German legislator decided to express the necessary expertise for a supervisory board member as "expert knowledge" (*Sachkunde*) to emphasize that a supervisory board member can have more limited expertise than a director. Generally, the expert knowledge of the supervisory board members has to correspond to the kind of business being exercised by the relevant bank or financial services provider and it is considered appropriate if the applicant can demonstrate that he has held a leading position at an institution of comparable size and business type (or even another business type). In this respect, it can be assumed that the "leading position" requirement can be for a shorter period of time than the burdensome requirement of a three-year period for directors. In addition, it is considered sufficient if a supervisory board member has expert knowledge of a special area, so that the expertise of all board members taken together ensures a smooth functioning of the supervisory board.

Outlook

The changes brought about by the new provisions have been sought by market participants for some time. Although the additional controlling powers of the BaFin may impose higher regulatory burdens on banks and financial service providers, the improved investor protection and the added stability of the financial system potentially resulting from these changes should outweigh such burdens. Above all, the members of the supervisory boards that have been in place prior to the BaFin controls arguably should be able to meet the personal reliability and applicable expert knowledge requirements now imposed. Supervisory boards that do not currently fulfil these requirements will be forced to do so going forward, since the BaFin's power to remove supervisory board members if they do not meet the new criteria under the KWG will also apply to supervisory board members appointed before 1 August 2009.

To conclude, it should be noted that the legislator was not consistent when drafting the new provisions: the law does not provide the BaFin with the power to deny the grant of a licence to a bank or a financial services provider on the grounds that a supervisory board member lacks personal responsibility and/or applicable expertise; the BaFin may only remove a supervisory board member, and revoke a licence after it has been granted. Theoretically, such removal and/or revocation could take place immediately after the licence has been granted, if the required standards for supervisory board members were not fulfilled in the first instance. This should be borne in mind when selecting supervisory board members, and it is advisable to make a responsible choice even though the BaFin may not technically deny a permission on the grounds that supervisory board members lack the specified qualifications.

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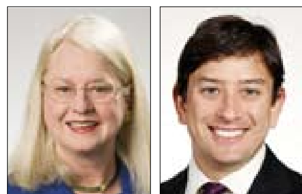
FAS 167: New Balance Sheet Consolidation Requirements for Private Equity Fund and Hedge Fund Managers



by **Cynthia J. Williams** and **Adam I. Gehrie**

Introduction

On June 12, 2009, the Financial Accounting Standards Board ("FASB") issued a new standard that will materially impact the extent to which the managers of private funds (including private equity funds and hedge funds) will be required to consolidate the assets of the private funds that they manage onto their own balance sheets. The new standard – *FASB Statement of Accounting Standards No. 167, Amendments to FASB Interpretation No. 46R* ("FAS 167") amends *FASB Interpretation No. 46R Consolidation of Variable Interest Entities* ("FIN 46R").

FAS 167 will be effective as of a private fund's (or any other reporting entity's) first annual reporting period that begins after November 15, 2009 (which will be January 1, 2010 for calendar year-end funds). It revises one of the tests to determine whether an enterprise is a "variable interest entity" (a "VIE") so as to treat almost all private funds as VIEs. FAS 167 also embraces a new control test for consolidation, such that most managers that receive customary private fund performance or incentive fees will be deemed to hold a variable interest in the fund, will be deemed the primary beneficiary of the fund and will be required to consolidate the fund into their own financial statements.

As elaborated below, FAS 167 will require many managers to consolidate onto their balance sheets the assets and liabilities of the private funds they manage even if the managers have no ownership interest in such private funds and have no obligation to pay the liabilities of such private funds. To increase transparency and reduce potential confusion related to such consolidation, FAS 167 modifies FIN 46R to require that a reporting enterprise which is required to consolidate a VIE separately present on its statement of financial position (a) assets of a consolidated VIE that can be used only to settle obligations of the consolidated VIE and (b) liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not generally have recourse to the assets of the reporting enterprise.

Notwithstanding such requirements for separate presentation of a VIE's assets and liabilities in the consolidated financial statements of the primary beneficiary, many in the financial community have expressed concern that such consolidation and related financial disclosure obligations will substantially increase the costs of preparing statements, is not necessary or helpful to investors or creditors of the manager from a policy standpoint, and may create problems for managers under existing financial covenants to which they may be subject.

Analysis of FAS 167 vs. FIN 46R

The principal differences between the current consolidation regime under FIN 46R and the new requirements pursuant to FAS 167 that are relevant to determining whether the assets of a private fund must be consolidated with those of its manager are as follows:

1. Which entities are VIEs?

Under FAS 167, a VIE is generally an entity in which either: (1) the equity investors are not deemed to have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, or (2) the equity investors lack any one of the following three characteristics: (i) the power, through voting rights or similar rights, to direct the activities that most significantly impact the entity's economic performance; (ii) the obligation to absorb the losses of the entity; and (iii) the right to receive the expected residual returns of the entity (i.e., the equity investors do not have a stipulated limit to their potential return on investment).

For many private funds, it is clear that investors possess the qualities enumerated in (1) and (2)(ii) and (2)(iii) above. It is not clear, however, that investors in private funds possess the power described in Section 2(i) above because such investors do not typically have any management rights with respect to the private funds in which they have invested. Therefore, under FAS 167, the analysis of whether the private fund may avoid VIE status centers around the "power to direct" criterion enumerated in 2(i) above.

Prior to FAS 167, many private funds were not subject to FIN 46R because there was sufficient equity in the fund to permit it to finance its activities without additional subordinated financial support, and the ability

of a majority of the equity investors unaffiliated with the manager to kick out and replace the manager without cause was deemed to meet the FIN 46R requirement that the equity investors have the ability to make decisions about the entity that have a significant effect on the success of the entity that most significantly impacts the entity's economic performance. Key to the FIN 46R analysis of the "power to direct" criterion was the concept that these kick-out rights constituted power to direct the private fund's activities as described in criterion 2(i).

However, FAS 167 makes clear that the presence of kick-out rights will not affect the determination of whether the holder of a variable interest has the power to direct the activities of a VIE unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights. This change means that unless a single equity investor unaffiliated with the manager (together with its related parties and de facto agents) possesses kick-out rights, the private fund will be a VIE and, as discussed in detail below, the manager will likely be the primary beneficiary required to consolidate the fund into its financial statements. If such a single equity investor does possess kick-out rights, then the fund will still be deemed to be a VIE but the holder of the kick-out rights will likely be deemed the primary beneficiary required to consolidate it.

2. When does a fee paid to a service provider (such as a manager or its affiliates) constitute a "variable interest" in a VIE?

A manager that is not an equity owner in a private fund and does not otherwise hold a variable interest in the private fund will not be the primary beneficiary, no matter how much control or power it may have and, hence, will not be required to consolidate it. However, fees received by the manager can constitute a variable interest. FAS 167 sets forth new, strict parameters for when fees paid to a fund's manager create a "variable interest" in the fund which, in turn, may subject the manager to "primary beneficiary" status. Under the new standard, fees paid to an entity's decision maker(s) or service provider(s) are *not* variable interests, provided that *all* of the following conditions are met:

(a) the fees are commensurate with the services provided and the level of effort required to provide those services;

(b) substantially all of the fees are at or above the same level of seniority as other operating liabilities in the normal course of the entity's activities;

(c) the decision maker or service provider and its related parties do not hold other interests in the VIE that individually, or in the aggregate, absorb or receive, as applicable, more than an insignificant amount of the entity's expected losses or expected residual returns, respectively;

(d) the service agreements contain only terms, conditions or amounts that are customarily present in arrangements for similar services negotiated at arm's length;

(e) the total amount of anticipated fees is insignificant relative to the total amount of the VIE's anticipated economic performance; and

(f) the anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

Any manager or manager affiliate that receives an incentive or performance fee or allocation from a private fund that is a VIE would be considered to have a "variable interest" in such private fund based on the criteria set forth in (b), (c), (e) and (f) above. A manager that takes only a senior fixed management fee based on assets under management likely will not be deemed a holder of a "variable interest," although this analysis is not entirely free from doubt. For example, it is not clear whether even a standard 2% senior management fee will be considered to be "commensurate with the services provided and the level of effort required to provide those services" by every finance department or external auditor, and FASB has provided no "bright lines" for the quantitative thresholds contained in these criteria. Pursuant to the criterion set forth in (b), a manager that takes a subordinate management fee or a subordinate incentive fee or performance allocation will be deemed to hold a variable interest in the related private fund.

3. Who is considered to be the "primary beneficiary" of a VIE?

Under FIN 46R, the determination of whether a holder of a variable interest in a VIE must consolidate the assets and liabilities of the VIE was based on a quantitative analysis that required an enterprise that held a variable interest that (i) absorbed a majority of the entity's expected losses, or (ii) received a majority of the entity's expected residual returns, or both, to consolidate the assets and liabilities of the VIE on its

financial statements. Assuming there was sufficient equity in the fund to permit it to finance its activities without additional subordinated financial support, under FIN 46R prior to FAS 167, the fund could avoid VIE status by building in the kick-out rights described above.

Now that most private funds will be considered VIEs pursuant to FAS 167, a manager that holds a variable interest in a fund must consider under FAS 167 whether it has a "controlling financial interest" in the fund and, thus is the fund's "primary beneficiary" required to consolidate the fund (assuming no single equity investor (together with its related parties and de facto agents) has kick-out rights). The criteria for "primary beneficiary" are both of the following:

(a) the power to direct the activities of a VIE that most significantly impact the entity's economic performance; and

(b) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE.

Consequently, any private fund manager or manager affiliate with investment discretion with respect to a private fund and the right to receive any significant performance or incentive fees (or possession of another variable interest such as an equity interest) would meet these criteria and be deemed to be a "primary beneficiary" of such private fund and will be required to consolidate the private fund, unless it either splits such controlling financial interest with another manager so that no one manager is the primary beneficiary or unless there is a single equity investor unaffiliated with the manager that, together with its related parties and de facto agents, has the unilateral right to kick out the manager without cause.

Enhanced Disclosure Requirements for Consolidating Entities

In addition to the existing burdens of consolidation, managers that hold variable interests in funds will also be required to make additional disclosures in their financial statements concerning such funds. Specifically, FAS 167 stipulates expanded disclosure with respect to:

(a) the significant judgments and assumptions considered by the manager in determining whether it must consolidate a fund which is a VIE or disclose information about its involvement therewith;

(b) the nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by the manager in its statement of financial position, including the carrying amounts of such assets and liabilities;

(c) the nature of, and changes in, the risks associated with the manager's involvement with a VIE; and

(d) how the manager's involvement with a VIE affects its financial position, financial performance and cash flows.

Such requirements will add significant burdens to the procedure for preparing financial statements for managers holding variable interests in the private funds they manage.

Conclusion

The changes in the consolidation analysis between FIN 46R and FAS 167 represent a very significant negative development for private funds because while previously managers could rather easily structure their relationships to the private funds they manage so as to avoid consolidation, the requirements of FAS 167 present no such simple fixes.

Many managers of private funds and their affiliates may now expect their finance departments or auditors to conclude that (i) the private funds so managed are VIEs; (ii) the managers hold a "variable interest" in the private funds they manage; and (iii) the powers held by the manager cause the manager to be considered the "primary beneficiary" of the private fund required to consolidate it. Managers may therefore expect that their balance sheets will be consolidated with those of the private funds they manage, absent taking steps to redesign the funds or contractual arrangements to prevent that result from occurring. Further, the additional disclosure requirements of FAS 167 will significantly increase the compliance and disclosure burdens of managers of private funds as well as the cost of preparing financial statements.

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Dechert Responds to Call for Evidence Regarding Draft EU Directive on AIFM

(continued from page 7)

The policy contained in the Directive does not appear to acknowledge that the real roots of the financial crisis lay in the ready availability of debt across the board. The use of leverage by certain AIFs was a small part of the overall picture. It would seem more logical for the focus of the regulatory attention to be the debt markets or banking institutions rather than investment structures that are primarily equity-driven.

Turning to micro rather than macro risks: in our view, those best placed to assess such risks are the investment professionals. At the underlying AIFM level, in most cases managers' personal fortunes are tied to their investment performance. Further, as noted earlier, AIF investors such as pension funds often have highly developed portfolio risk and due diligence functions that carefully scrutinise AIFs both pre-investment and on an ongoing basis. The AIF industry on both sides of the Atlantic has been developing best practice standards for quite some time, with close involvement from such investors. The Directive goes considerably further than such standards. This suggests that investors themselves do not see the net benefit in such additional restrictions and indeed this is borne out by much of the feedback on the Directive from investor representatives to date.

Is it appropriate to regulate Investment Fund Managers, rather than the Fund itself?

We believe that, in general, it is appropriate that the Directive should seek to regulate the manager rather than the funds. After all, as noted above, there is already an effective system of manager regulation in place.

In our view, those best placed to assess such risks are the investment professionals.

The Directive is, however, overly influenced by continental European fund structures, whereby the manager frequently has a greater degree of control over the fund than is the case with certain other structures common in the marketplace. With a corporate fund, for example, strategic management and control (including, for example, the appointment of key service providers) rests with the board of directors, not the management company. Likewise, a limited partnership fund acts through its general partner.

Accordingly, to make sense and to be workable in practice, regulation of AIFMs should be confined to matters that the AIFMs can actually control in the context of the fund structure.

Does the Directive contain appropriate provisions to distinguish between different types of alternative investment?

Although the Directive distinguishes between different sorts of funds to some degree, ultimately it applies concepts that appear to be motivated by systemic risk concerns indiscriminately to all kinds of AIFs.

For example:

- the concept of a depositary in the context of a private equity fund is a wholly unnecessary concept that will serve only to add an additional layer of fees, limit structuring opportunities and ultimately lead to competitive disadvantage for EU AIFs; and
- leverage limits may be aimed primarily at hedge funds, but could equally apply to other fund types, such as private equity funds, property funds or commodity funds.

It seems to us that better focused regulation that is more sensitive to the particular needs of managers of different types of investment strategies pursued by AIFs would better achieve the objectives.

Does the scope of the Directive create a danger of unintended consequences?

There has been wider commentary on potentially significant unintended consequences for the industry (which extends far beyond AIFMs themselves) and the consequential impact on the wider UK economy, which we will not rehearse here.

Here are some specific points:

- The Directive excludes non-EU managers who are nonetheless properly regulated in and by another jurisdiction (for example Australia, Hong Kong and the United States) from providing management services to AIFs. We do not believe that this restriction is in the interests of EU investors or the operation of an EU export market for the provision of fund vehicles.
- In particular, the Directive will most likely exclude EU investors from participating in anything except EU AIFs as the "equivalency" test for the approval of marketing of other regimes is not likely to be met in practice. It will hamper the ability of EU investors to access third country management talent, and will also effectively prevent EU AIFs from pursuing certain strategies that will not be compatible with the practical effect of the Directive, such as emerging market funds.
- AIFs provide valuable capital which can be deployed in all manner of situations: venture capital, private equity, real estate development, etc. The Directive will restrict the flow of this capital, in turn affecting jobs, local economies, etc. This consequence is exacerbated by the current dearth of capital available from other quarters.

Does the Directive contain appropriate rules on leverage?

We believe that the rules on leverage in the proposed Directive are commercially unworkable. If one fund in a group of funds managed by the same AIFM uses leverage up to a certain point, the terms of the Directive may prevent any other fund managed by that AIFM from using leverage. However, in general, funds managed by the same AIFM are not affiliated and so the use of a high level of leverage by one will not affect the others. AIFMs may have different objectives for different funds and the rules on leverage in the Directive could actually harm an AIFM's ability to manage separate funds.

This will create an uneven playing field for EU alternative investment funds against all other market participants.

Private equity funds are generally leveraged on an investment-by-investment basis so that, absent any bridging loan, the failure of one investment due to excessive levels of leverage will not even present a failure risk to the fund overall, let alone the market.

Is the requirement for independent valuation agents and depositaries for Alternative Investment Funds adequate?

See [above] for our comments on the inappropriateness of depositaries for private equity funds (which apply equally to certain types of real estate funds and others whose assets are not held in custody in the same way that securities are). The same might be said of valuation agents for closed-ended private funds that are not traded. The Directive also fails to

strike an appropriate balance between the advantages of independent valuation (where appropriate) and the fact that the manager may actually be best placed to value assets in many circumstances – meaning that the Directive could result in less accurate valuations than would otherwise be the case.

The Directive effectively states that no custodian (depositary) outside the European Union is suitable to act as custodian for funds. It is worth noting that the UCITS Directive does not impose similar geographic restrictions on the use of sub-custodians for UCITS funds, reflecting the needs of the market: and this is in a retail context. The Directive also creates a situation where the depositary could be subject to semi-strict liability for the potential frauds of other parties and other matters. It is also worth noting that a lot of valuable asset servicing expertise, in the form of fund administrators and other parties, does not reside in institutions who would be eligible to become "depositaries".

Why should EU investors be deprived of the chance to participate in such strategies?

These requirements, especially the high standard of liability and the requirement that depositaries be EU-authorised credit institutions, will in all likelihood reduce the number of institutions willing or able to carry out this service (potentially leading to concentration risk and increasing the impact of institutional failure) and will also lead to a significant increase in the costs that AIFs will have to bear. Moreover, the level of liability to which depositaries would be subject would no doubt force a change in the service level arrangements under which the depositary is willing to operate, thereby potentially limiting the ability of some AIFs to engage in transactions in some countries or engage in transactions with certain counterparties. Again, the end effects of these restrictions will be felt by those who ultimately invest in AIFs – primarily EU individual investors.

For example, limitations on sub-depositaries would make it difficult or even impossible for an EU-domiciled AIFM to manage an AIF with a global or emerging markets strategy and for any AIF with such an objective to be established in the EU, since sub-depositaries around the world are typically used by AIFs not investing solely in the EU and are often required in order to operate such a strategy. Why should EU investors be deprived of the chance to participate in such strategies?

Will the provisions strengthening disclosure requirements help to create a more transparent market or do they go too far?

As the Directive only applies to EU based AIFs, the disclosure requirements regarding controlling influence in companies will not ultimately achieve a more transparent market across the board, as non-EU based AIFMs and other industry players that are not categorised as AIFMs will not need to adhere to the same rules. This will create an uneven playing field for EU AIFs against all other market participants.

In addition, there are dangers in disclosing too much. For example, disclosure of information relating to strategy, development and any other 'forward-looking' information may be abused by third parties or serve to fetter management discretion in reacting to future developments. Given that some of the proposed disclosure requirements in relation to private companies go beyond that which is required in relation to listed companies, the case for requiring such disclosure needs to be better made.

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The Shape of U.S. Financial Regulatory Reform

(continued from page 4)

Title V, **the** "**Office of National Insurance Act of 2009**," would create an Office of National Insurance ("ONI") that, while not empowered to grant a federal insurance charter, would oversee the insurance system throughout the country. It is designed to deal with what many see as an inconsistent and patchwork system of state regulation. Others, however, have been critical of the proposed ONI, believing that it does not leave enough authority in the hands of state insurance regulators. Under the proposal, the ONI would be empowered to monitor the entire insurance industry, except the health insurance industry, and to look for issues or gaps in insurance regulation that could lead to systemic crisis in either the insurance system or the financial system as a whole. The ONI would also be able to recommend to the Federal Reserve that an insurer, including its affiliates, should be designated as a Tier 1 FHC.

Title VI, **the** "**Bank Holding Company and Depository Institution Regulatory Improvements Act of 2009**," would, consistent with one of the purposes of Title II, eliminate exceptions from the definition of "bank" under the BHCA for several types of entities, including: (1) thrift institutions; (2) trust companies that do not offer deposits or transaction accounts to the public; (3) credit card banks; and (4) industrial loan companies. In addition, the grandfathered status that applies to institutions that otherwise would be bank holding companies under the Competitive Equality Banking Act would be eliminated.

Currently, companies owning these types of non-bank banks, including a significant number of investment management firms that own limited purpose trust companies, are not considered BHCs. If this proposal is adopted, however, these companies would become BHCs by operation of law and would be required to register as such with the Federal Reserve within 90 days. Unless a company determines to eliminate or sell its "bank" subsidiary, it would become subject to the same limitations on activities that are in place for BHCs generally upon registration with the Federal Reserve. In recognition of the administrative difficulties many companies may encounter in adjusting to this new reality, the proposal would provide the Federal Reserve with the authority to grant various types of temporary relief.

Title VI also provides the Federal Reserve with broader authority to regulate and examine a BHC's functionally regulated subsidiaries, which are defined in Title VI to include broker-dealers, investment advisers and registered investment companies.

Title VII, **the** "**Over-the-Counter Derivatives Markets Act of 2009**," would provide for comprehensive regulation of over-the-counter ("OTC") derivatives in an effort to improve market transparency and discipline, and to close the regulatory gaps believed to have contributed to the financial crisis.

Among other things, Title VII would require all "standardized" swaps to be cleared by a registered derivatives clearing organization or, for certain market participants, on a registered swap execution facility. A swap would be considered standardized if it has the same terms and conditions as other swaps. It would be fungible with other swaps, thus permitting the con-

tracts to off-set each other. Cognizant of the fact that OTC market participants use OTC swaps specifically because of their customization (which prevents OTC swaps from naturally tending to be standardized) and that there might be incentives for market participants to keep their swaps off exchanges by differentiating them, Title VII calls on the CFTC and the SEC to define the term "standardized" as broadly as possible.

Title VII contemplates that clearing organizations will impose robust margin requirements on swaps trading. This is a departure from OTC swap practice where whether margin is required is a credit decision the counterparty makes on an end-user by end-user basis. Title VII also gives the CFTC and the SEC the power to prescribe rules to prevent evasions. If a swap is not accepted for clearing, both counterparties would be required to report the swap to either a swap repository or to the CFTC.

Under Title VII, all derivatives clearing organizations would have to register with either the CFTC or the SEC and dual-registration would be permitted. Title VII would require the CFTC to make available to the public aggregate swap data on trading volume and positions that it collects. This information was not previously available to the regulators and the public, meaning that the regulators could not see all the systemic risk in the markets. Attendant with requiring all swaps to be cleared on exchanges or reported, Title VII requires that swap dealers and major swap participants register and meet certain minimum criteria.

Until now, the CFTC has only set position limits on a small set of agricultural futures contracts, leaving the task of setting other position limits to the exchanges on which the contracts trade. Title VII permits the CFTC to set aggregate position limits across contracts listed on domestic and foreign exchanges and held in contracts that are considered to perform or affect a significant price discovery function with respect to regulated markets.

Title VII also provides for the regulation of security-based swap markets, adding the term "security-based" swap to the definition of security in the Securities Act of 1933 and Securities Exchange Act of 1934 and repealing provisions of the Commodity Futures Modernization Act of 2002 and the Gramm-Leach-Bliley Act that prohibit SEC regulation of the same.

Recognizing that the proper functioning of the financial markets is dependent upon safe and efficient arrangements for the clearing and settlement of payment, securities and other financial transactions, **Title VIII**, **the** "**Payment, Clearing, and Settlement Supervision Act of 2009**," would provide the Federal Reserve with enhanced authority over payment, clearing and settlement activities. Among other things, the Federal Reserve would have the authority to designate a financial market utility or payment, clearing, or settlement activity that it determines is, or is likely to become, systemically important, and to prescribe risk management standards governing those operations.

Title IX, **the** "**Investor Protection Act of 2009**," would substantially revise the regulatory landscape applicable to all types of investment activity. Title IX is comprised of 5 subtitles. Subtitle A deals primarily with disclosure issues; Subtitle B addresses enforcement and remedies; Subtitle C would seek to improve the regulation of the credit rating agencies; Subtitle D focuses on executive compensation issues; and Subtitle E would provide for improvements to the asset-backed securitization process. While each Subtitle is worthy of extended discussion, the following review focuses on certain of the disclosure issues covered by Subtitle A, more specifically proposed Sections 913 and 914.

Section 913 seeks to address the general question of harmonizing broker-dealer and investment adviser responsibilities towards investors. Specifically, Section 913 would provide the SEC with authority to establish a fiduciary duty for broker-dealers and investment advisers when providing investment advice about securities to retail customers or clients (and such other customers or clients as the SEC may establish by rule). Such a duty would require a broker-dealer or investment adviser to act solely in the interests of the customer or client without regard to such broker-dealer's or investment adviser's interests, financial or otherwise. Currently, only investment advisers owe their clients a fiduciary duty, whereas broker-dealers generally owe their clients a duty of fair dealing and a duty to recommend suitable investments.

Section 913 would also direct the SEC to (1) "take steps to facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with investment professionals;" and (2) examine and, if appropriate, adopt "rules prohibiting sales practices, conflicts of interest, and compensation schemes" for broker-dealers and investments advisers that are deemed contrary to the public interest and the interests of investors.

Section 914 would clarify the SEC's authority to require that certain disclosures, including a summary prospectus for mutual funds, be provided to investors at or before the point of sale rather than after the sale, if such disclosures would aid the investors in understanding the costs and risks associated with the specific financial product. At present, prospectuses are generally delivered to investors only following the sale of the applicable investment product. This proposal is intended to facilitate the implementation of "point of sale" disclosure to investors, which has been under consideration by the SEC and other regulators for the past several years.

Title X, the "Consumer Financial Protection Agency Act of 2009," is one of the more expansive, controversial and likely to be contested portions of the Obama administration's proposals.

While the concept is seemingly non-controversial, concern has been expressed by the fund industry that imposing point of sale disclosure requirements only on the sale of mutual fund shares could "incentivize intermediaries to recommend other investment products not subject to the same requirements at the point of sale, even when those products do not offer the same level of protection and other benefits to investors." To avoid this result, the industry has recommended that any point of sale disclosure requirement should be product-neutral and apply to all retail investment products.

Title X, **the** "**Consumer Financial Protection Agency Act of 2009**," is one of the more expansive, controversial and likely to be contested portions of the Obama administration's proposals. Most significantly, Title X would establish a new regulatory agency, the Consumer Financial Protection Agency ("CFPA"), with broad rulemaking, supervisory and enforcement authority over all retail financial products and services, most of which are already regulated to varying degrees by other regulatory agencies.

Some of the more controversial components of Title X include (i) the proposal that financial institutions be required to offer "plain vanilla" versions of their products and services and (ii) the proposal that the states be granted enforcement authority over federally chartered banks and thrifts. The high level of concern over these proposals is evidenced by the fact that, after just one week of hearings, Congressional leaders reportedly are already considering dropping the first and relaxing the second.

Fortunately, though, there is a silver lining for the investment management industry in that Title X expressly excepts from its coverage persons regulated by the SEC or the CFTC.

Title XI would amend the Federal Trade Commission Act to effectively transfer much of the Federal Trade Commission's authority over consumer financial products to the CFPA.

Title XII, **the** "**Resolution Authority for Large, Interconnected Financial Companies Act of 2009**," seeks to tackle the problem of institutions that are "too big to fail" by granting the federal government enhanced authority to "resolve" (i.e. serve as receiver or conservator for) large, interconnected financial firms in situations where the financial system's stability is threatened.

Title XIII would amend Section 13 of the Federal Reserve Act, which permits the Federal Reserve to authorize lending to individuals and companies that are otherwise not able to obtain adequate credit in "unusual and exigent circumstances," by requiring the written approval of the Secretary of the Treasury prior to invoking this authority in the future, effectively limiting the Federal Reserve's ability to act independently.

Conclusion

Despite much uncertainty over the final details, the one thing that is very clear is that financial reform legislation will be adopted and substantial changes to the financial service regulatory structure will be implemented. We will, of course, continue to monitor the reform proposals and advise you of significant developments as they occur.

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