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The German "Part II Fund": Maximum Flexibility for Mutual Funds and a New Opportunity for German Market Entry

by **Carsten Fischer**

The relatively recent so-called 'Other Fund' (also known as the German Part II Fund) was incorporated into the German Investment Act ("InvG") at the end of 2007. The creation of a new type of mutual fund for those funds pursuing innovative investment strategies, such as private equity, loan, commodity and precious metals strategies, with more flexible investment opportunities and limits, had become necessary due to the increased focus of German investors on other European fund domiciles, in particular Luxembourg.

German investment law now provides for a mutual non-UCITS fund, offering the same degree of flexibility as the market standard Luxembourg Part II fund[1]. The Other Fund allows, for instance, innovative investment strategies in shares and bonds in addition to investments in raw materials, complex derivatives and hedge fund "light" strategies.

Furthermore, the Other Fund is a very efficient wrapper for offshore investment fund products that are marketed in Germany. Many foreign fund initiators have, to date, chosen a Luxembourg Part I (UCITS) or Part II fund as a fund wrapper for their continental European (including German) offerings, and the Luxembourg Part II fund has become a popular wrapper and/or feeder structure in particular for complex offshore products.

Because certain types of German institutional investor, such as insurance companies and pension funds, may be subject to restrictions on investments in shares in a Luxembourg Part II fund, the Other Fund may be the better alternative for a German market entry solution.

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The Luxembourg Part II Fund as a Benchmark

Many international fund promoters have, in the past, chosen Luxembourg Part II funds as wrappers or feeders for their non-UCITS mutual funds. The principal reason driving this choice was the flexibility offered by the Luxembourg Part II fund with regard to eligible assets and investment restrictions. For example, when selecting underlying assets, the Luxembourg Part II fund is not limited to those classes of investment permitted by the UCITS Directive, but merely has to comply with a per issuer limit of 20% of the fund's net asset value to satisfy diversification requirements. One of the principal issues of the Luxembourg Part II fund centres on its ability to be admitted to public distribution in Germany and elsewhere in Europe. For the admission to public distribution in Germany, a notification letter has to be submitted to the German Federal Financial Supervisory Authority ("BaFin"). Public distribution can usually not begin sooner than three months after receipt of the complete fund documentation by the BaFin. This notification process can result in a substantial cost burden and time delay for the fund concerned, as significant changes may have to be made to the fund documentation (e.g., the sales prospectus), the fund structure and strategy as a consequence of the BaFin approval process. The admission to public distribution in Germany is frequently not granted immediately because the investment strategy of the Luxembourg Part II fund has not been set out with sufficient detail in the sales prospectus.

In addition, a significant number of German institutional investors are not allowed to invest into this structure because of mandatory (i.e., legal or regulatory) or voluntary restrictions. Against this background, fund promoters may wish to consider more closely the Other Fund if they intend to issue a non-UCITS mutual fund that is to be distributed first and foremost in Germany, both publicly and/or privately.

The German Other Fund – the Hidden Champion

With the introduction of the Other Fund, the InvG not only provides a match to the flexibility of the Luxembourg Part II fund, but in some respects offers a more suitable alternative. The legal framework allows a wide range of eligible assets and consequently makes the Other Fund attractive for a wide range of mutual fund strategies.

The Other Fund is a very efficient wrapper for offshore investment fund products that are marketed in Germany.

Other Funds may first of all invest in all assets that are permitted to be invested in by a UCITS fund. Consequently, the Other Fund can acquire securities, money market instruments, bank balances, investment shares and derivatives (as defined in the UCITS Directive). The starting point is that there are no investment restrictions for these assets, although the Other Funds are subject to the principle of risk diversification, which provides that at least four assets must be acquired and held at any one time. Other Funds are also able to pursue a more flexible investment approach because:

- The ability to invest in derivatives is significantly extended in comparison to UCITS funds – Other Funds can invest up to 30% of their assets in those derivatives that are not derived from securities, money market instruments, investment shares, approved financial indices, interest rates, exchange rates or currencies, and can acquire, for instance, derivatives using commodities, precious metals or raw materials as the underlying instrument.
- They can acquire shares in other domestic or foreign funds — in addition to shares in a UCITS fund, up to 30% of the Other Fund's net asset value may be invested in non-UCITS mutual funds and/or in hedge funds. The acquisition of shares in foreign (offshore and onshore) hedge funds is also permissible.

Moreover, an Other Fund may to a limited extent pursue a private equity strategy by acquiring classic company interests in a variety of different legal forms (with no restriction on the nature and purpose of the

target company), so that it is possible not only to invest in domestic and foreign partnerships and joint stock companies but also in companies having other legal forms, provided that the market value can be determined. The acquisition of company interests is limited to 20% of the net asset value at the time of acquisition, with a per target company limit of 5%.

In addition, Other Funds have the ability to acquire precious metals up to 30% of the fund's net asset value. While it is not possible to issue the Other Fund as a mutual fund that exclusively invests in physical precious metals, the Other Fund can be issued as a mutual fund that is practically a pure precious metal fund because alongside the 30% invested in physical precious metals and derivatives based on precious metals, the remaining 70% can be invested in securities issued by companies in the precious metals sector (e.g., mine operators), in precious metal index derivatives and certificates convertible into precious metals. The investment restriction for precious metals does not apply to Other Funds created as institutional buyer funds (i.e., German "*Spezialfonds*"), the shares of which may not be acquired by natural persons. As a result, it is possible to design institutional Other Funds as pure precious metal funds (100% investments in physical precious metals and/or precious metal derivatives) if the fund targets the right investor base.

Other Funds may also invest directly in non-securitized loan receivables (i.e., loans that are not in the legal form of a security), enabling them to participate in loans of all kinds (e.g., real estate loans, infrastructure loans, corporate financing loans, micro-financing and consumer loans), which includes participating in the financing of companies that do not issue securities themselves and can therefore not be acquired by means of shares or bonds. The Other Fund consequently enjoys wider-ranging investment opportunities than hedge funds do from a German regulatory perspective (which prohibits the direct acquisition of non-securitized loan receivables).

The ability of the Other Fund to acquire non-securitized loan receivables is limited because of a 30% investment restriction, similar to the restriction applying to the acquisition of precious metals and derivatives. However, the Other Fund can also be structured as a micro-finance fund. This type of fund typically acquires non-securitized loan receivables granted by micro-finance institutions in developing and threshold countries to small businesses in the form of small and micro loans. As a micro-finance fund, the Other Fund can invest up to 75% of its net asset value in non-securitized loan receivables of a micro-finance institution (a draft amendment currently being considered would increase this limit to 95%).

The legal framework allows a wide range of eligible assets and consequently makes the Other Fund attractive for a wide range of mutual fund strategies.

Other Funds are to a certain extent allowed to take out short-term loans to bridge liquidity squeezes, and for investments. While the limit for UCITS funds is 10% of the net asset value of the fund, Other Funds may take out short-term loans of up to 20% in aggregate of the net asset value ('short-term' in this context is presumed to mean a credit period of up to one year, although there is some uncertainty about the exact period).

A further benefit of the Other Fund worth highlighting relates to the issuance and redemption of fund units. It is possible to deviate from the obligation to redeem fund units at any time so that the fund structure of an Other Fund can be similar in effect to a closed-ended fund (although at least one redemption must be permitted each year). This would allow the investment management company or the investment stock corporation (essentially the German equivalent to the Luxembourg SICAV) to benefit from more efficient portfolio management, as the actual redemption can take place at a later point in time when fund units of a high aggregate value are surrendered. The amount that is required to be surrendered before a redemption right is triggered has to be set out in the fund documentation.

The Other Fund is finding particular favour in the form of loan, micro-finance and precious metal funds.

Conclusion

Other Funds bear the "made and regulated in Germany" quality seal and offer a flexible, cost-efficient, as well as internationally competitive, fund category for investment in innovative investment products. The Other Fund is finding particular favour in the form of loan, micro-finance and precious metal funds. For fund initiators intending to issue a mutual fund that does not (need to) comply with the UCITS Directive but that will be distributed first and foremost in Germany, the Other Fund may be a more suitable solution than the Luxembourg Part II fund.

[1] Investment funds not complying with the UCITS Directive and intended for public sale to private investors are regulated in Luxembourg under Part II of the Law of 17 December 2010 relating to undertakings for collective investment; therefore the term "Part II fund" is used in this article.

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New Disclosure Requirements for Dealings in Financial Instruments in Germany


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On 5 April 2011, the German Parliament passed a law designed to "strengthen investor protection and improve the functionality of the capital market". The law includes new rules regarding disclosure requirements for dealings related to the shares of German-domiciled issuers. These rules, which amend the German Securities Trading Act, came into force on 1 February 2012. To provide guidance with respect to the new rules, the German financial regulator ("BaFin") issued a list of frequently asked questions ("BaFin FAQs") on 9 January 2012.

The new rules expand the scope of the notification requirements to include financial instruments or other instruments whose performance is linked to voting shares (regardless of whether such instruments grant a right to acquire voting shares).

Before the amendments, purchasers of financial instruments were required to disclose certain interests in the voting shares of German-domiciled issuers listed on a regulated stock exchange within the European Economic Area. In particular, purchasers were required to notify both BaFin and the issuer when the purchaser's holdings reached, exceeded or fell below designated thresholds. The former rules covered (and threshold calculation was based upon) both the voting shares of such issuers as well as any financial instruments granting a unilateral and legally binding right to acquire such voting shares.

The new rules expand the scope of the notification requirements to include financial instruments or other instruments whose performance is linked to voting shares (regardless of whether such instruments grant

a right to acquire voting shares).The new rules may have been prompted by the actions of some market participants who (i) used such instruments to cause other market participants, acting as counterparties, to acquire a large number of voting shares in order to hedge their exposure to such financial instruments, and (ii) subsequently acquired the respective positions from these counterparties *en block* without being obliged to disclose the crossing of any relevant threshold (and consequently of any major holding of voting rights on the way to reaching a targeted overall holding). This was possible because, under the former rules, the disclosure requirement applied only to the crossing of thresholds in relation to shares conferring voting rights, which were already held by a party. Holding through options and certain other derivatives on shares was subject to disclosure if delivery of the underlying shares was required, but not where such transactions were cash settled.

It remains to be seen whether the new rules provide the intended transparency or rather lead market participants to make erroneous assumptions about hedging transactions of other market participants.

The new rules introduce an additional notification obligation with respect to: (i) derivative contracts with *cash settlement*; (ii) claims for the return of securities that are part of a securities lending transaction; and (iii) the repurchase obligation in connection with a repo transaction. According to the BaFin FAQs, such instruments include, but are not limited to:

- physically settled options and other derivatives that were not covered by the former rules;
- contracts for difference;
- cash settled swaps and options;
- certain baskets of securities and instruments linked to indices (provided that the weighting of the respective voting shares exceeds 20 %); and
- rights of first refusal.

The mere offer to buy a financial instrument is not taken into account when determining when the notice obligation applies. Convertible bonds and option bonds are not covered by the new rules if they are linked to new voting shares to be issued. In contrast, market participants must take into account instruments held by subsidiaries or trustees, as well as instruments that grant an indirect right to purchase voting shares (e.g., an instrument that grants the right to purchase a call option on voting shares).

The holder of such instruments (or a third person benefiting from such instruments) must disclose its *economic* position each time it reaches, exceeds or falls below 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75% of an issuer's voting rights. The holder of the instrument must notify the BaFin and the issuer regarding the total number of all voting shares and related instruments held, as well as the number of the holder's: (i) voting shares; (ii) instruments that were already covered by the former rules; and (iii) financial instruments covered by the new rules. The holder of such positions must make the notification promptly after purchasing the position, and no later than four business days after such purchase. This may lead to multiple notifications being required because the holder of the position must also make a separate notification regarding its holdings of any voting shares and financial instruments that were covered by the former rules.

Conclusion

It remains to be seen whether the new rules provide the intended transparency or rather lead market participants to make erroneous assumptions about hedging transactions of other market participants. In any event, investors in such financial instruments now need to assess carefully whether any disclosure requirements may arise.

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U.S. Money Market Funds and the European Sovereign Debt Crisis


by **Jack W. Murphy** and **Stephen T. Cohen**

The financial press recently reported that the U.S. Securities and Exchange Commission ("SEC") is considering and may propose in the coming weeks new restrictions on U.S. money market funds ("money funds"), including capital requirements and a "liquidity fee" that would hold back a portion of a client's account for 30 days in the event of a redemption. These possible proposals would be in addition to the extensive reform of U.S. money fund regulation that occurred in early 2010.

Notwithstanding these potential proposals for reform, the ability of money funds to have operated successfully through the volatile European markets in 2011 calls into question the need for additional regulatory measures. In June 2011, when news intensified regarding a potential Greek sovereign default, regulators and policymakers immediately identified money funds as being prone to risks due to their exposure to European banks that could be impacted by the events in Greece.[1] However, to date, money funds have successfully weathered the market fluctuations in Europe.

Investment advisers and directors of money funds have responded by intensifying their fund oversight, adjusting their funds' exposure to European banks and making public information regarding fund holdings of securities issued by European banks, in order to quell any concerns.

This article, based upon a *DechertOnPoint*, examines how the rules governing money funds, as amended in 2010, operated to protect funds throughout the challenging market environment in Europe in 2011. It also offers suggestions as to areas on which boards and management may wish to focus in the future.

For further information regarding financial developments related to the eurozone crisis, please refer to the *DechertOnPoints* listed below (and future client alerts on our website):

- U.S. Money Market Funds and the European Sovereign Debt Crisis, available at http://www.dechert.com/US_Money_Market_Funds_and_the_European_Sovereign_Debt_Crisis_02-14-2012/.
- The Eurozone Crisis: Risk Planning for Asset Managers, available at http://www.dechert.com/The_Eurozone_Crisis_Risk_Planning_for_Asset_Managers_03-19-2012/.
- Risk Management by U.S. Mutual Funds Facing European Sovereign Debt Risk, available at http://www.dechert.com/Risk_Management_by_US_Mutual_Funds_Facing_European_Sovereign_Debt_Risk_03-19-2012/.

Overview of Money Funds and Regulatory Structure

Unlike other funds registered under the Investment Company Act of 1940, as amended (the "1940 Act"), a money fund seeks to maintain a stable net asset value ("NAV") of $1.00 per share, by complying with Rule 2a-7 under the 1940 Act.[2] Rule 2a-7 and related rules governing money funds impose strict requirements on money funds that seek to maintain a stable NAV, including robust requirements relating to:

- the oversight of a money fund by its board;
- the portfolio quality, diversification, maturity and liquidity of the money fund (the "Risk-Limiting Provisions"); and
- the disclosure of money fund portfolio holdings.

Board Oversight

Initial Board Findings and Adoption of Procedures

Before a money fund may use the amortized cost method to offer fund shares at a stable $1.00 NAV per share, the fund's board must initially determine in good faith that it is in the best interests of the fund and its shareholders to maintain a stable NAV per share and that the fund will only continue to do so as long as the board believes that the stable NAV per share fairly reflects the fund's market-based NAV.

Boards overseeing money funds also must adopt procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to stabilize the fund's NAV per share, as computed for the purpose of distribution, redemption and repurchase, at a single value (i.e., $1.00) ("Procedures"). These Procedures must include "shadow pricing" provisions that monitor any deviation between the current NAV per share calculated using available market quotations and the fund's $1.00 amortized cost price per share.

As the issues in Europe continue to unfold, money fund boards and management should remain vigilant to possible risks. In the case of fund management, steps that might be taken include continuing or further enhancing the review and monitoring of banks and other issuers whose debt is held in the money fund's portfolio. This would assist management to anticipate and, where necessary, mitigate, the impact that the developing situation in Europe might have on the creditworthiness of those issuers and the market for their securities. In the case of boards, directors should carefully review the reports and other information they receive regarding those money funds of which they are directors, asking questions as necessary in order to satisfy themselves that fund management is taking reasonable steps to protect the funds and their shareholders.

Stress Testing

The SEC added stress testing requirements to Rule 2a-7 as part of the February 2010 amendments to the Rule (the "2010 Amendments").[3] These stress testing provisions require the board of a money fund to provide for periodic testing of the fund's ability to maintain a stable NAV per share upon the occurrence of certain hypothetical events, including, among others: changes in short-term interest rates; an increase in shareholder redemptions; and a downgrade of or default on portfolio securities. The 2010 Adopting Release also stated that money funds should incorporate into their stress testing procedures "know your customer" evaluations ("KYC Evaluations"), pursuant to which a fund should evaluate the liquidity needs of its shareholder base.

The results of a money fund's stress tests must be reported to the board. As part of the report, the fund's investment adviser must provide the board with its assessment of the fund's ability to withstand those events (including simultaneous occurrences of those events) that are reasonably likely to occur within the following year.

Stress testing and the reporting of the results to a money fund's board has focused the attention of both management and fund directors on potential risks to the fund coming from possible market events, including the market volatility in Europe. Fund management should monitor a money fund's exposure to European banks and other issuers that may be adversely affected by the fear of European sovereign defaults on an ongoing basis and consider stress testing the impact of a possible default or widening of credit spreads on the fund's ability to maintain a stable price per share. Management may also wish to consider whether any modifications to a money fund's stress testing procedures are advisable under the circumstances. Boards should review the stress testing reports they receive and discuss with management the steps that are being taken to monitor the impact that European events could have on the fund.

With respect to the KYC Evaluations requirement, fund management and boards should consider the nature

and concentration of a fund's shareholder base to determine whether an event in Europe could trigger significant redemptions of money fund shares. If fund management concludes that redemptions are likely to be significantly heavier than usual, the money fund's liquidity position, as well as any existing line of credit, should be reviewed to make sure that the fund would be able to meet such redemption requests. A board should discuss these possibilities with fund management and satisfy itself that appropriate steps are being taken to protect the fund.

Finally, in light of the requirement that a money fund's investment adviser must provide the board with an assessment of the fund's ability to withstand events that are reasonably likely to occur within the following year, a board should discuss with fund management the scenarios the investment adviser has considered and the types of events that fund management believes are reasonably likely to occur within the upcoming year.

Oversight of Money Fund Registration Statements

As with boards of other funds, money fund boards are responsible for statements made in the fund's registration statement. Given the heightened scrutiny of money funds, their boards may wish to have management confirm that the fund's principal investment strategies and risks have been accurately disclosed to investors.

Risk-Limiting Provisions

Denomination of Portfolio Investments

Rule 2a-7 limits the portfolio holdings of money funds to securities that are denominated in U.S. dollars. For a security to qualify as U.S. dollar-denominated under Rule 2a-7, all principal and interest payments must be payable to the holder in U.S. dollars under all circumstances. Recognizing this restriction, non-U.S. issuers, such as European banks, seeking capital from U.S. money funds, issue U.S. dollar-denominated securities that qualify under Rule 2a-7. Therefore, while a money fund may be directly exposed to the credit risk of a European bank, the fund is not directly exposed to the currency risk of the euro depreciating against the dollar.

Minimal Credit Risks

Rule 2a-7 further restricts money funds to investments in portfolio securities that present minimal credit risks, as determined by the fund's board. Under Rule 2a-7, fund boards can delegate this responsibility to the fund's investment adviser and, as a matter of practice, virtually all boards do so. The adviser's assessment must be made initially for every security held by the fund, and should be monitored and updated in response to market events. These requirements reduce the possibility that money funds will be exposed to the undue credit risks of European banks or other issuers.

Credit Quality

Money funds may only acquire "Eligible Securities," which are securities with a maturity of 397 calendar days or less and are rated in the two highest short-term ratings categories (or deemed to be of comparable quality) by Nationally Recognized Statistical Rating Organizations ("NRSROs").[4] While "Second Tier Securities" (i.e., those that are not rated in the highest short-term ratings categories by NRSROs) are Eligible Securities, money funds may not acquire any Second Tier Securities that have remaining maturities of greater than 45 days. Furthermore, a money fund is prohibited from investing more than 3% of its total assets in Second Tier Securities, or more than 0.5% of its assets in Second Tier Securities of any one issuer. As a result, a money fund's maximum exposure to lower quality securities issued by European banks is quite limited.

Diversification

Money funds are subject to strict portfolio diversification requirements. Generally, prime money funds (i.e., money funds that invest in corporate issuers) may not invest more than 5% of their total assets in the securities of a single issuer. As with the Second Tier Security concentration limits described above, the diversification restrictions under Rule 2a-7 further reduce a money fund's exposure to the credit risk of any one issuer.

Maturity

Rule 2a-7 requires a money fund to maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable NAV. As noted above, money funds are restricted from acquiring any security that has a remaining maturity of greater than 397 calendar days. In addition to the limitations on individual securities, a money fund must also maintain a dollar-weighted average portfolio maturity ("WAM") of 60 days or less across its entire portfolio, as well as a dollar-weighted average life to maturity ("WAL") of 120 days or less across its entire portfolio.[5]

Liquidity

Pursuant to the 2010 Amendments, money funds must hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of the fund's obligation to pay redemption proceeds within seven days of receiving a redemption request, as well as any other commitments the fund has made to its shareholders (the "General Liquidity Requirement"). Rule 2a-7 prohibits money funds from investing more than 5% of their total assets in illiquid securities, which are defined as securities that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to them by the fund. Furthermore, prime money funds are required to invest at least: (i) 10% of their total assets in "daily liquid assets" (cash, U.S. Treasury securities, and securities convertible into cash within one business day); and (ii) 30% of their total assets in "weekly liquid assets" (cash, U.S. Treasury securities, certain U.S. government securities with remaining maturities of 60 days or less, and securities convertible into cash within five business days). These liquidity requirements have enabled money funds to withstand increases in redemption requests received as a result of the ongoing European sovereign debt crisis.

Portfolio Holdings Disclosure Provisions

Public Website Posting Requirement

Rule 2a-7 requires a money fund, on a monthly basis, to disclose the fund's schedule of investments and to disclose certain information with respect to each security held. In addition, Rule 2a-7 requires a money fund to disclose the overall WAM and WAL of its portfolio securities. Under Rule 2a-7, a money fund must post portfolio information, current as of the last business day of the previous month, no later than the fifth business day of each month and maintain the information on its website for no less than six months after posting.

The monthly public website posting requirement has been helpful in providing investors and the marketplace with timely information regarding a money fund's holdings during the volatile European markets in 2011. In fact, some money funds have gone further and have voluntarily disclosed details regarding portfolio holdings, including information as to the fund's holdings of European bank securities and/or holdings of issuers from particular countries.

Monthly Reporting to the SEC

Rule 30b1-7 under the 1940 Act requires a money fund to report on new Form N-MFP, with respect to each portfolio security held on the last business day of the prior month, detailed information beyond what is required to be posted on the fund's website. Form N-MFP also requires money funds to report to the SEC information about the fund, including information about the fund's risk characteristics, as well as the market-based values of each portfolio security and the fund's market-based net asset value per share. The information contained on Form N-MFP is made available to the public by the SEC 60 days after the end of the month to which the information pertains. The SEC has used the information required by Form N-MFP to create a central database of money fund portfolio holdings to enhance its oversight of money funds and its ability to respond to market events, such as those occurring in Europe.

Analysis of Data on Portfolio Holdings

Based on industry data compiled by trade associations and other organizations, during 2011, money funds significantly reduced their holdings of debt securities issued by banks and other businesses headquartered in the 17 countries that use the euro as their currency. As a result of these portfolio adjustments, U.S. money funds hold virtually no securities of issuers domiciled in Greece, Italy, Spain or the other eurozone "periphery" countries.

Securities of all eurozone issuers accounted for 14.0% of total assets of U.S. prime money funds at the end of January 2012, down from 17.4% in October 2011 and 31.1% in May 2011.[7] However, U.S. prime money funds held a greater percentage of eurozone issuers in January 2012 than in December 2011, marking the first increase in the preceding eight months.[7] In addition, bankers have reported that money funds have begun moving back into European bank short-term paper.[8] These purchases could signal an improvement in the perceived creditworthiness of certain eurozone issuers, as the European Central Bank attempts to backstop key institutions.

Conclusion

The robust regulatory structure governing money funds and diligent oversight by money fund boards and management have contributed to the resilience shown by U.S. money funds during the market volatility in Europe. Although the SEC continues to focus on

proposing additional reforms to money fund regulation, the success of money funds during the challenging market conditions in Europe should lend support to the notion that the 2010 Amendments have adequately strengthened money funds and that further structural changes to money funds, such as a floating NAV, are not necessary for the protection of investors.

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[1] See, e.g., Graham Bowley, In a Greek Default, Higher Risk for Money Market Funds, N.Y. Times, June 28, 2011.

[2] Virtually all U.S. money market funds use the amortized cost method of valuation to maintain a stable NAV per share. Rule 2a-7(a)(2) defines the amortized cost method as the "method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors."

[3] Money Market Fund Reform, Investment Company Act Release No. 29, 132, 75 Fed. Reg. 10,060 (Feb. 23, 2010) (the "2010 Adopting Release").

[4] In addition, there are certain other provisions that permit a security to be deemed an Eligible Security when it is subject to a demand feature or guarantee.

[5] Generally, the WAM is calculated by determining the period remaining until the date on which the principal amount of a security must be paid, or, in the case of a security that is called for redemption, the date on which the redemption must be made. However, Rule 2a-7 contains several specific exceptions that permit a money fund to shorten the maturity of a security by taking into account the effect of demand features and other maturity shortening devices, such as interest rate reset dates for adjustable-rate securities. Unlike WAM, WAL is measured without reference to these maturity shortening provisions.

[6] Emily Gallagher & Chris Plantier, Prime Money Market Funds' Eurozone Holdings Remain Low, Investment Company Inst., Feb. 28, 2012, available at http://www.ici.org/viewpoints/view_12_mmfs_europe_data_feb.

[7] Id.

[8] Gallagher & Plantier, supra note 7; Richard Leong, Money Funds Add Euro Zone Debt Again, Reuters, Mar. 12, 2012, available at http://www.reuters.com/article/2012/03/09/us-moneyfunds-eurozone-idUSBRE82810G20120309.

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UK Serious Fraud Office Increases the Burden on Institutional Investors


by **Jonathan Pickworth** and **Karen Coppens***

SFO Recovers Dividends from Innocent Shareholder

On 13 January 2012, the UK Serious Fraud Office ("SFO"), using its civil recovery powers under Part V of the Proceeds of Crime Act 2002 ("POCA"), recovered funds from the innocent shareholder of a UK company, which company was convicted in 2009 of various corruption-related offences. The SFO has stated that this case is a signal that it expects shareholders to drive anti-corruption compliance. Where institutional shareholders do not do so, the SFO can seek to recover the proceeds of unlawful conduct already paid out to third parties, even if those shareholders are completely innocent of the wrongdoing that has occurred, and even if they do not hold a controlling interest.

As set out below, fund managers and other institutional investors should sit up and take note of this development. The SFO is sending a clear message to shareholders that they should be pro-active in seeking to ensure compliance within the companies in which they invest. The potential application of POCA is broad and could apply to all types of unlawful activity, not just corruption.

Background

Following a self-report to the SFO, Mabey & Johnson Limited — a privately owned engineering company — pleaded guilty to corruption and sanctions offences in 2009. In doing so, it became the first company in the UK to receive a conviction for corruption under the then existing legislation. More recently, two former directors of Mabey & Johnson and a senior manager were convicted in February 2011 of sanctions offences in connection with the Iraq Oil for Food programme. The sanctions offence proved the basis for the SFO exercising its civil recovery powers.

The Use of the Civil Recovery Regime

This is not the first time that the SFO has used its civil recovery powers against a shareholder company. It recovered £7 million from MW Kellogg Limited in February 2011, but that related to funds that had been identified as recoverable property due to the shareholder.

The SFO's action in the *Mabey* case is the first time that powers have been used to claw back dividends that had already been paid up. The SFO's action against the shareholder may have been seen as having a second bite of the apple because the company had successfully negotiated a plea in relation to the criminal charges in 2009. But the legal basis was quite straightforward as POCA enables the SFO to recover property (such as dividends) obtained by the unlawful conduct of others, from those who had no knowledge of, or involvement in, the unlawful acts. The SFO's rationale is outlined in the statement (below) of its Director, and is clear: it is not to punish further a company or its owners, but rather to send a message to others. If institutional shareholders fail to ensure that compliance within the companies in which they invest is adequate, then they risk past dividends received being recovered through this process.

Potential Implications for Institutional Investors

Although the *Mabey* case involved a privately-owned company, the principles from *Mabey* could, in theory, apply to shareholders of publicly traded companies. There have been criticisms levelled in the press that the exercise of such powers is unfair to investors who do not have access to internal compliance procedures of the companies in which they invest. However, the SFO has indicated its intention to use its powers of civil recovery more widely. The Director of the SFO, Richard Alderman, stated:

> *There are two key messages I would like to highlight. First, shareholders who receive the proceeds of crime can expect civil action against them to recover the money. The SFO will pursue this approach vigorously. In this particular case...the shareholder was totally unaware of any inappropriate behaviour....*
>
> *The second broader point is that shareholders and investors in companies are obliged to satisfy themselves with the business practices of the companies they invest in. This is very important and we cannot emphasise it enough. It is particularly so for institutional investors who have the knowledge and expertise to do it. The SFO intends to use the civil recovery process to pursue investors who have benefitted from illegal activity. Where issues arise we will be much less sympathetic to institutional investors whose due diligence has clearly been lax in this respect.*[1]

There is little doubt that the SFO could potentially target investors in publicly listed companies, considering the broad scope of powers granted to the SFO under POCA. There are questions, however, as to

what shareholders realistically can do, given that such investors, in contrast to private investors, have far less opportunity to conduct detailed due diligence outside what is publicly available.

It is also worth noting that Part V of POCA contains certain important protections for investors. The court has discretion to refuse to order civil recovery against:

- A third party who obtained the property in question in good faith;
- Where that third party also took subsequent steps in relation to the property that the third party would not otherwise have taken; and
- Where recovery against a third party would be detrimental to that third party and would not be just and equitable.

How to Guard Against an Action for Civil Recovery

This recent development brings into focus the steps that investors might consider taking in relation to current and potential investments, including some form of enhanced risk-based due diligence of higher risk companies. It may no longer be enough simply to ask for a copy of anti-corruption policies.

Shareholders can take the following steps to reduce risks:

- Assess the nature of the company's business and whether it is high risk, including consideration of the jurisdictions in which the company operates and how those jurisdictions rank in the Corruption Perceptions Index[2];
- Ask the company for information about its policies and procedures;
- Enquire how the company trains its employees and agents;
- Determine how the company assesses the understanding of employees as to correct behaviour so as to measure the effectiveness of training given; and
- Assess how the company tests and monitors its processes and controls.

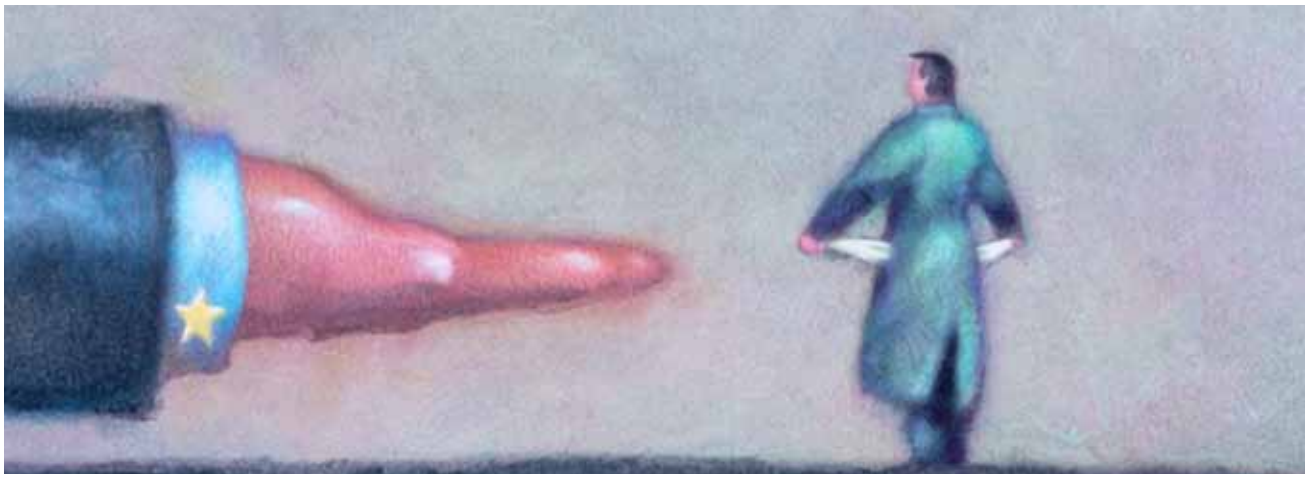
Next Steps

The recent use by the SFO of its civil recovery powers to recover funds from an innocent shareholder is a landmark development in anti-corruption enforcement. However, there are a number of outstanding questions as to the broader applicability of the SFO's power to recover funds from innocent shareholders:

- How will the SFO be able to trace the proceeds of unlawful conduct?
- Is it possible to reliably establish that particular dividends are the proceeds of unlawful conduct?
- What will happen in cases where the shareholder no longer holds the dividend?
- What will happen where a dividend is paid to numerous shareholders?

A number of points should be borne in mind when considering the concerns identified above:

- The SFO is sensitive to the criticism voiced in the press. It is our understanding that the SFO has



written to a number of the leading trade associations, including the Association of British Insurers, the Investment Management Association and the British Bankers' Association to receive their feedback. This highlights the importance of this development.

- POCA is an established piece of legislation that came into force in February 2003 but it is the first time that POCA has been used to recover the proceeds of unlawful conduct already paid out to third parties. POCA has extensive application and can be used to recover all property wherever situated acquired further to fraud, tax evasion and money laundering, and which represents the proceeds of crime. Those who have interpreted the scope of POCA narrowly should reconsider whether their actions and property could potentially fall within the scope of POCA in light of *Mabey*.

Institutional investors, private equity houses and fund managers, amongst others, who choose to do nothing, sit back and hope to rely on the technical difficulties that the SFO faces in tracing the proceeds of unlawful conduct should ready themselves for a legal challenge. Alternatively, a better option would be to elect to be pro-active and ask questions of the companies in which current and potential investments are made, as well as maintaining an accurate record of all the steps taken to ensure that enhanced risk-based due diligence has been carried out and that satisfaction has been obtained that appropriate processes and controls are in place in companies invested in.[3]

It is abundantly clear that the burden falling on institutional investors, private equity houses and fund managers to be pro-active and ask questions of the companies in which current and potential investments are made, is increasing.

Conclusion

The SFO's recent use of its civil recovery powers to recover funds from an innocent shareholder is a landmark development in anti-corruption enforcement. Some people have suggested that senior members of the SFO may not be keen to follow the initiative of the current Director of the SFO. But David Green QC, the incoming SFO Director, is the former head of the Revenue and Customs prosecution office and may be even more prosecution-oriented than his predecessor.

In addition, recent developments stem from the SFO and UK coalition government's desire to encourage sweeping changes in corporate behaviour, which is a commendable aim. Even if institutional investors are not caught under the strict technicalities of the law, a broader corporate governance point applies. Prudent institutional investors, private equity houses and fund managers should want to know as much as possible about the companies into which they are currently investing or will potentially invest in. A failure to do so may have wide-ranging consequences for both investors and the companies into which they choose to invest. These may include: costly reputational issues, unlimited fines, the imprisonment and disqualification of directors, the imposition of a corporate monitor, debarment from tendering for public contracts, confiscation of turnover, and significant legal expense, amongst others. It is abundantly clear that the burden falling on institutional investors, private equity houses and fund managers to be pro-active and ask questions of the companies in which current and potential investments are made, is increasing.

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* The authors would like to thank Lloyd Firth for his research for this article.

1 http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2012/shareholder-agrees-civil-recovery-by-sfo-in-mabey--johnson.aspx

2 http://cpi.transparency.org/cpi2011/results/

3 In the recent Cayman Islands Grand Court decision in *Weavering Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom*, the two defendants, both "independent" directors of the fund in question, were each ordered to pay damages in the amount of US $111 million for wilful neglect or default in carrying out their duties as directors, based in large part upon the fact that the defendants "did nothing and carried on doing nothing for almost six years". For further information regarding the *Weavering* case, please refer to "Private Fund Directors: Don't Just Sit There – Do Something!", available at http://www.dechert.com/Financial_Services_Quarterly_Report_09-27-2011/.

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Outsourcing for U.S. Financial Institutions After Dodd-Frank: Regulation, Risk and Governance

by **Vivian Maese**

The global economic crisis has powerfully re-taught a lesson that we have understood for some time — the whole world is economically connected. In response, the Dodd-Frank Act ("DFA") has created new regulatory structures such as the Financial Stability Oversight Council ("FSOC"), and put more regulations in place to improve market transparency and to consolidate reporting in the hope that more information and more monitoring and more diligence will prevent the next economic crisis, or at least provide a longer lead time to try to avoid a crash or perhaps achieve a softer landing. The legislation was drafted in an intensely emotional climate and, as a result, the DFA is imperfect. In some places, it is too complicated. However, in other places, for instance in its focus on transparency, financial stability and mitigation of systemic risk, it is praiseworthy.

The outsourcing transaction itself involves something of a leap of faith. . . . Even more faith, diligence and documentation are required when the outsourcing transaction contemplates that the work is accomplished in another country.

Per Ben Bernanke, "Systemic risk can be broadly defined as the risk of the possibility that the failure of a large inter-connected firm could lead to a breakdown in the wider financial system." The DFA uses the word "interconnectedness" many times in the statute when addressing financial stability. The DFA creates an analytical regulatory environment with a very strong focus on risk. In this context, risk means the possibility of an unexpectedly bad outcome from an event or events, which may or may not have been foreseen. "Interconnectedness" throughout the financial system means that risk cannot simply be evaluated as to the impact on a single company. Because all risk evaluation is contextual, financial services companies will need to create a number of methodologies for risk assessment.

So, how does outsourcing in financial services companies play a role in financial stability? A typical outsourcing transaction takes a function or operation that a company would have controlled and operated for itself, and puts that function or operation in the care and control of a third party. Risks arise because an outsourcing transaction connects a third party to the financial system through the contracting company. Under the Bank Service Corporation Act, third parties providing outsourced services to FDIC-insured banks are subject to examination and oversight by the Federal bank regulators. Third-party servicers also may be deemed to be "institution-affiliated parties" under the Federal Deposit Insurance Act, making them subject to the enforcement jurisdiction of the federal bank regulators. In other settings, the third party may not be regulated at all. In all cases, the third party has the potential to introduce risk to a financial institution and also to the financial system as a whole.

The outsourcing transaction itself involves something of a leap of faith. How much faith depends upon: how critical the outsourced function or operation is to the primary business; how much diligence the company has performed prior to entering into the transaction; and, critically, how rigorously the company's needs and expectations have been set out in the contract. In advance of every outsourcing transaction, a company needs to ask and answer the threshold question, "What happens to my company if the supplier or service provider fails?" Even more faith, diligence and documentation are required when the outsourcing transaction contemplates that the work is accomplished in another country. (This is commonly known as an "offshoring" transaction.) Each country has its own infrastructure, its own form of government, its own legal and political system and its own customary "way of doing things." Consequently, there is more uncertainty when operating businesses in different locations, and that variable — call it "country risk" — is a further and very important consideration.

Generally, companies in the financial services industry broadly depend on their relationships with third parties. Because a single failure can have a profound impact on the enterprise, and present risk to the financial system, bank and securities regulators have had outsourcing guidance in place for many years.

However, the frightening and extensive domino experience of the global economic crisis has caused new emphasis on strengthening existing rules. For example, the Financial Industry Regulatory Authority ("FINRA") has proposed FINRA Rule 3190, Use of Third-Party Service Providers, which emphasizes initial and continuing third-party due diligence, on-point contract terms, compliance with existing and specific function-related regulations and oversight control.

The Dodd-Frank Act uses the word "interconnectedness" many times in the statute when addressing financial stability.

When the DFA addresses threats to financial stability in Section 113(a)(1), it provides factors to consider when evaluating risk. They include nature, scope, size, scale, concentration, interconnectedness and the mix of activities of the company.

Additionally, if the company is a bank holding company with total consolidated assets of $50 billion or more, or a nonbank holding company supervised by the Board of Governors of the Federal Reserve System (or any subsidiary of such company), it will need to be prepared to submit certified reports to the FSOC regarding, among other things, "systems for monitoring and controlling financial, operating and other risks," and "the extent to which the activities and operations of the company, and any subsidiary thereof could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall stability of the United States."

The frightening and extensive domino experience of the global economic crisis has caused new emphasis on strengthening existing rules.

Financial services companies may need to take action to create or enhance their supplier governance programs in order to comply with the DFA, and to provide correct data for the necessary reporting. In addition, financial services companies must review existing agreements and relationships to assure that risks have been evaluated in context, and appropriately addressed in the outsourcing contract terms. New outsourcing contracts will require more specific compliance language for a successful result in a regulatory examination, investigation or litigation.

Years ago, the bank regulators, under the banner of the Federal Financial Institutions Examination Council ("FFIEC"), issued extensive guidance concerning outsourced relationships. Financial institutions were advised to conduct multi-factor diligence on their suppliers at the outset of the relationship. Often diligence was performed, a contract signed, or perhaps the company refreshed the analysis on an annual basis and then put the contract in storage. That level of governance will no longer suffice. In addition, in December 2011, the Federal Reserve Board ("FRB") issued its proposed enhanced prudential requirements, which include new risk committee and enterprise-wide management requirements for covered companies. These requirements would apply to non-bank companies supervised by the FRB, bank holding companies with greater than $50 billion in assets and publicly traded bank holding companies with greater than $10 billion in assets.

In order to meet a company's obligations under the existing and proposed bank and broker-dealer regulations, DFA or prudential risk management requirements, active monitoring and management of third-party relationships is required, and well-drafted contracts are essential.

The question arises, "How do you take account of outsourcing controls in the new regulatory environment?" In addition to the DFA, FINRA, existing bank regulations and post-DFA guidance above, in June of 2011, the Basel Committee on Banking Supervision provided guidance when it published, "Principles for the Sound Management of Operational Risk." In the context of outsourcing, the Basel Committee suggests:

> "Outsourcing policies and risk management activities should encompass:
>
> (a) procedures for determining whether and how activities can be outsourced;
>
> (b) processes for conducting due diligence in the selection of potential service providers:
>
> (c) sound structuring of the outsourcing arrangement, including ownership and confidentiality of data, as well as termination rights;
>
> (d) programmes for managing and monitoring the risks associated with the outsourcing arrangement, including the financial condition of the service provider;
>
> (e) establishment of an effective control environment at the bank and the service provider;
>
> (f) development of viable contingency plans; and
>
> (g) execution of comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank."

For examination and reporting purposes, the financial service company needs to demonstrate that:

- It has an inventory of all of its third-party relationships (since contracts are signed or may expire on a daily basis, the procedures supporting the inventory will need to be frequently refreshed);
- Risks in each transaction have been identified, evaluated and documented; procedures are in place to monitor each transaction and its risks regularly, to ensure that levels of risk tolerance have not deteriorated;
- Actions taken toward risk mitigation or risk transfer are clearly articulated in writing (e.g., contract terms, insurance, contingency plans);
- A process or processes are in place to actively monitor third-party performance to support the company's various reporting obligations; and
- Risks in transactions have been evaluated at the individual level and have also been examined in the aggregate (e.g., are there too many eggs in one basket?).

At the end of the day, the financial services company will need to demonstrate that it has command of its third-party support. There is no doubt that such a governance program is a significant undertaking. However, if done correctly, the required diligence efforts will prevent or mitigate the impact of an unexpectedly bad outcome to the franchise. In addition, the work can be repurposed internally so that the same information from governance programs, contract review and creation feeds DFA financial stability reporting, proposed FINRA requirements, SEC CF Disclosure Guidance: Topic No. 2, Cybersecurity as it relates to outsourcing, and resolution planning and reporting (a.k.a. living wills).

Beyond bank and broker-dealer regulation, outsourcing strategy must also consider other variables such as the Patriot Act, regulations of the U.S. Treasury Office of Foreign Asset Controls ("OFAC"), the Foreign Corrupt Practices Act, U.S. export control regulations and privacy regulations (see, for example, the Gramm-Leach-Bliley Act and SEC Reg. S-P), each of which has its own requirements. These are all "gears" in the outsourcing strategy machine that must be properly meshed in order to preserve transaction validity and transaction economics. All of these regulations represent a simple recognition that the world has become more complicated as it has become more "interconnected."

Governance programs and outsourcing contracts need to be carefully structured so that they are not so burdensome that business stalls or stops. There is a delicate balance between being nimble enough to stay competitive in your business and smart enough to know, understand and account for risk.

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Hong Kong's New Anti-Money Laundering Law

by **Angelyn Lim** and **Kylee Zhu**

Background

Following an evaluation of Hong Kong in 2008, the Financial Action Task Force ("FATF")[1] identified the following deficiencies in the Hong Kong anti-money laundering ("AML") and counter-terrorist financing ("CTF") regime:

- The customer due diligence ("CDD") and record-keeping requirements for financial institutions ("FI") did not have statutory backing (i.e., the guidelines were not sufficient for FATF purposes);
- The financial regulatory authorities lacked supervisory and enforcement powers;
- There were no criminal sanctions or supervisory sanctions to deal with cases of non-compliance; and
- Remittance agents and money changers were not subject to a regulatory regime.

The Securities and Futures Commission ("SFC") has now taken concrete steps to enhance the Hong Kong AML/CTF regime so as to conform to international standards.[2] At the end of January 2012, following industry feedback, the SFC announced a new set of guidelines as part of Hong Kong's AML/CTF regime (the "Guidelines"), which comprise:

- Guideline on Anti-Money Laundering and Counter-Terrorist Financing; and
- Prevention of Money Laundering and Terrorist Financing Guideline issued by the SFC for Associated Entities.

The Guidelines will come into effect on 1 April 2012, replacing the existing Prevention of Money Laundering and Terrorist Financing Guidance Note previously published by the SFC. The Guidelines are intended to assist licensed corporations and associated entities in designing and implementing appropriate and effective policies, procedures and controls in compliance with the requirements of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (the "AMLO"), and/or other applicable AML/CTF legislation and regulatory requirements.

The AMLO will be Hong Kong's first AML-specific legislation. AML requirements and obligations will no longer be ancillary obligations entrenched in another piece of legislation, as they currently are in the Organized and Serious Crimes Ordinance[3] and the Drug Trafficking (Recovery of Proceeds) Ordinance[4]. The AMLO, which was gazetted on 8 July 2011, will come into effect on 1 April 2012.

The Issues

The new AML/CTF regime addresses the following issues.

Customer Due Diligence

The Guidelines list the steps that should be taken when carrying out CDD and provide examples of relevant information that should be obtained, including identifying and verifying the identity of customers, beneficial owners in relation to customers, and persons acting on behalf of customers (e.g., authorized account signatories and attorneys). As part of the verification process, the performance of a company search for companies incorporated in Hong Kong will become mandatory. For companies incorporated overseas, FIs must:

- perform a similar company search enquiry in the place of incorporation and obtain a company report;
- obtain a certificate of incumbency or equivalent; or
- obtain a similar or comparable document to a company search report or a certificate of

incumbency, certified by a professional third party in the relevant jurisdiction.

Although "customer" is not a defined term under the AMLO, the term "customer" refers to a person who is a client of the licensed corporations under the Guidelines. CDD measures are expected to be conducted:

- at the outset of any business relationship, before performing any occasional transaction that is valued at HK$120,000 or more, or that is a wire transfer of HK$8,000 or more (in either case, whether in single or several apparently linked operations);
- when the customer or its account is suspected of being involved in money laundering or terrorist financing; or
- when the veracity or adequacy of any information previously obtained for the purposes of identifying the customer is doubted.

A customer that falls within specified requirements (e.g., if the customer is an FI itself) may be subject only to simplified due diligence ("SDD") pursuant to the Guidelines. Nevertheless, other aspects of CDD still need to be undertaken and ongoing monitoring of the business relationship must be conducted. Further, SDD must not be applied when the FI suspects that the customer, its account or the transaction is involved in money laundering or terrorist financing or when the FI doubts the veracity or adequacy of any information previously obtained for the purpose of identifying the customer.

Continuous Monitoring

The Guidelines require effective ongoing monitoring by FIs. This entails: reviewing customer information; monitoring customers' activities to ensure consistency with the nature of their business, risk profile and source of funds; and identifying transactions that are complex, large or unusual, or patterns of transactions that have no apparent economic or lawful purpose and that may indicate money laundering or terrorist financing. The Guidelines set out the different aspects of the business relationship that may be considered, and FIs are expected to adopt a risk-based approach to such monitoring, depending on the risk profile of the customer.

Suspicious Transaction Reports

Existing AML legislation in Hong Kong will continue to apply, in particular, the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crime Ordinance, and the United Nations (anti-terrorism measures) Ordinance,[5] all of which require FIs to report any property where an FI knows or suspects that such property represents the proceeds of crime or terrorist property. The Guidelines provide comprehensive guidance in relation to the identification and reporting of suspicious transactions, setting out the general principles that apply once knowledge or suspicion has been formed, as well as a non-exhaustive list of examples of various circumstances that may give rise to the suspicion of money laundering or terrorist financing.

Pre-existing Customers

FIs must consider if any action needs to be taken in relation to their existing customers with whom the business relationship had been established before the AMLO came into effect. FIs are required to perform CDD on customers where a transaction takes place that, by virtue of the amount or nature of the transaction, is unusual, suspicious or inconsistent with what the FI knows about the customer, its business or risk profile, or the source of its funds. CDD must also be conducted when a material change has occurred in the way the customer's account is operated or where the customer or its account is suspected to be involved in money laundering or terrorist financing. Where the FI doubts the veracity or adequacy of any information previously obtained for the purpose of identifying the customer, CDD should also be carried out.

Staff Training

A clear and well articulated AML/CTF training policy should be implemented and FIs are expected to monitor the effectiveness of staff training. This should be specific to what the staff needs to carry out their particular roles within the FI with respect to AML/CTF, with a focus on training new staff prior to their commencing work. The Guidelines set out the areas of training that may be appropriate for different groups of staff members, and FIs are encourage to incorporate a mixture of training techniques and tools in the training system as appropriate. The Guidelines require that staff training records be maintained for a minimum of three years. This requirement is in line with the SFC's Guidelines on Continuous Professional Training.

Criminal Charges and Civil Sanctions

The AMLO gives bite to the AML/CTF regulatory regime by introducing criminal charges or civil sanctions for non-compliance with requirements imposed under the AMLO. Furthermore, the SFC, the Hong Kong Monetary Authority and the Office of the Commissioner of Insurance will be able to impose supervisory sanctions for non-compliance. Disciplinary actions by these authorities can include public reprimand, remedial action and fines of up to HK$10 million (equivalent to approximately US$1.3 million) or three times the amount of profit gained or costs avoided as a result of the contravention. The penalties that may be meted out are, arguably, harsher than necessary in seeking to put in place the appropriate levels of CDD in Hong Kong in the context of non-compliance.

Conclusion

The AMLO and the Guidelines will function alongside existing AML legislation and are intended to fortify the current AML/CTF regulatory regime. FIs in the banking, securities, insurance, and remittance and money changing sectors will be affected by the AMLO and Guidelines and may be forced to tighten their internal controls. Management and compliance personnel of such entities should ensure that they are familiar with the changes and commence preparations so as to comply with the specific requirements by the effective date.

Money laundering and terrorist financing are clearly issues of importance to both regional and international regulators. For example, Singapore has also recently expressed an intention to take a firmer stance against money laundering and terrorist financing. In particular, it is considering a tougher penalty regime for violations of AML/CTF regulations and laws, making the laundering of proceeds from tax offences a criminal offence and stepping up its enforcement resources to deal with suspicious transactions reported by financial institutions. In light of the general increased focus on AML/CTF regulations and laws and the substantial criminal and civil penalties for non-compliance with the AMLO requirements, FIs would do well to ensure compliance with all applicable requirements of the SFC's Guidelines and the AMLO.

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[1] FATF is an inter-governmental body whose purpose is to develop and promote national and international policies to combat (i) money laundering and (ii) the financing of terrorism.

[2] For further information regarding the initial AML proposals, please refer to "Anti-Money Laundering Proposals in Hong Kong", available at http://www.dechert.com/Financial_Services_Quarterly_Report_03-31-2010/.

[3] Cap 455, Laws of Hong Kong.

[4] Cap 405, Laws of Hong Kong.

[5] Cap 575, Laws of Hong Kong.

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New Channel of Mutual Fund Distribution in Mainland China


by **Angelyn Lim** and **Jessica Shao**

Background

On 23 February 2012, the China Securities Regulatory Commission (the "CSRC") issued mutual fund distribution licences to four independent financial advisors in Mainland China. These are the first independent third-party mutual fund distributors ("MFDs") to be so licenced since the implementation of the revised "Measures for the Administration of the Sale of Securities Investment Funds"[1] (证券投资基金销售管理办法) (the "Revised Fund Sale Measures") on 1 October 2011. The Revised Fund Sale Measures stipulated the detailed qualifications required of MFDs, the first official indication of a sanctioned deviation from the current monopoly by banks of the fund distribution business in Mainland China.

Eligibility Requirements of a Third-Party Mutual Fund Distributor

In order to carry out mutual fund distribution activities, MFDs, as all other financial institutions (including, without limitation, commercial banks, securities firms and securities investment consulting firms), must comply with certain general requirements as set out in the Revised Fund Sale Measures. The MFD must:

- have an appropriate name, organizational structure and business scope, in compliance with relevant regulations;
- have registered capital of at least RMB 20 million (approximately US $3.2 million) that is fully paid up;
- not have experienced any major change, legal proceeding, arbitration or other significant event that has, or may have, a serious impact on the ordinary business operations of the MFD;
- have senior managers who have obtained the requisite fund practice qualification certificates,

and have at least two years' experience working in the fund industry or at least five years' experience working in other financial institutions;

- have at least 10 staff members who have obtained the requisite fund practice qualification certificates;
- have a corporate governance structure and a complete internal control, anti-money laundering and risk management programme;
- maintain sound financials and stable business operations;
- maintain a system for assessing investors' risk tolerance level and classifying the risk level of each mutual fund, as well as a complete set of internal operational policies and procedures;
- have a place of business and the necessary security, technology and other resources suitable for an MFD; and
- establish a settlement process that is in compliance with the relevant requirements set out by the CSRC.

An MFD can take the form of a limited liability company, a partnership or other form as permitted under the relevant regulations promulgated by the CSRC.

These are the first independent third-party mutual fund distributors to be so licenced since the implementation of the revised "Measures for the Administration of the Sale of Securities Investment Funds".

The shareholders of an MFD may be corporations or individuals. When determining whether or not to issue an MFD licence, the CSRC will assess whether the shareholders:

- have sound financials or prior working experience in the fund business;
- have had any criminal or administrative penalties imposed on them in the preceding three years;
- have any adverse financial records or credibility records at commercial banks or other self-regulating institutions; or
- are under any investigation by any regulatory authority.

Going Forward: Foreign Participation?

The Revised Fund Sale Measures are silent as to whether third-party foreign fund distributors may apply for MFD licences. It is also unclear at this stage whether the CSRC will approve foreign financial institutions to form MFD joint ventures with domestic partners or to be shareholders of MFDs. The first four approved MFDs are all either subsidiaries of domestic securities firms or listed companies or are owned by a local national engaged in the domestic fund business.

Currently, foreign participants can engage in fund distribution in Mainland China either: (i) by forming a joint venture fund management company with a domestic fund manager; or (ii) in the case of a foreign bank, by applying for a commercial bank licence.

The Explanatory Notes on the Revised Fund Sale Measures (《证券投资基金销售管理办法》修订说明) issued by the CSRC on 22 June 2011 indicate the CSRC's desire to increase the professionalism of MFDs in Mainland China and to broaden distribution channels. There is speculation that the Mainland Chinese authorities may in time allow foreign participants to enter into the independent MFD business to help achieve these goals.

Increasing the number and type of entities approved as MFDs (whether local or foreign) will enhance competition and diversity in the fund distribution market; however, it will be difficult for these new entrants to challenge the current dominant position of commercial banks in the mutual fund distribution business.

[1] The concept of "securities investment fund" under Mainland Chinese laws has the equivalent meaning to "mutual fund" in Hong Kong.

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Self-Managed Alternative Investment Funds: A New AIFMD-Compliant Structure?*


by **Declan O'Sullivan** and **Aaron Mulcahy**

As part of the European Commission's efforts to reform the European financial regulatory environment in the wake of the financial crisis, on 11 November 2011, the European Parliament voted to adopt the Alternative Investment Fund Managers Directive ("AIFMD"). The AIFMD is due to be implemented across the EU by July 2013 and will have a significant effect on a large cross-section of alternative investment fund managers ("AIFMs") that manage and/or market alternative investment funds ("AIFs") within the EU, including managers of hedge and private equity, venture capital, commodity, infrastructure and real estate funds.[1]

In November 2011, the European Securities and Markets Authority ("ESMA") published its technical advice to the European Commission on possible implementing measures of the AIFMD ("Level II"). This marked a significant milestone in the four-stage legislative framework and added significant substance to the Level I measures represented by the AIFMD itself.[2]

Following adoption of the AIFMD, there has been significant discussion among industry participants as to whether it might be possible to comply with the provisions of the AIFMD by structuring the AIF as a self-managed investment company, in the same way that UCITS[3] self-managed investment companies ("SMICs") are managed.[4]

Prior to the publishing of Level II, there was not much direction given about how a self-managed AIF (referred to in this article as a "SMAIF") might look in terms of AIFMD implementing measures. There were also concerns that, notwithstanding the very important UCITS precedent, the delegation that would be inherent in a SMAIF might be such that it would become a "letter-box" entity in contravention of AIFMD.

Level II provides helpful guidance on the complexion of a SMAIF and goes into detail in respect of the general operating conditions for AIFMs, including SMAIFs.

Why Are SMAIFs Important?

Quite simply, structuring an AIF as a SMAIF means that the fund is both an EU AIF and an EU AIFM, which, from July 2013, subject to compliance with the provisions of the AIFMD, will be able to take advantage of the passporting provisions of the AIFMD in a similar manner to a UCITS.

Earlier drafts of the AIFMD provided that AIFMs could delegate only to other AIFMs. This position was changed in subsequent drafts so that, as a general rule, delegation of portfolio management or risk management is permitted where: (i) the delegate is authorised or registered for the purpose of asset management and subject to regulatory supervision; and (ii) cooperation is ensured (see discussion below) between the competent authority of the home Member State ("EU Competent Authority") of the AIFM/SMAIF and the supervisory authority of the undertaking.

Accordingly, SMAIFs should be able to delegate to U.S. and other non-EU investment managers without the investment manager having to be an AIFM or having to comply with either the private placement or third-country provisions of the AIFMD.

In its Level II advice, ESMA removed an earlier suggestion that the regulatory regime applicable to a delegated entity should be equivalent to that which applies to an EU AIFM, on the basis that this position was not supported by the Level I text. However, in discussing how cooperation can be assured between the EU Competent Authority and the supervisory authority of the delegate, Level II has set out detailed requirements for the form of the cooperation agreements, which should be in the form of written arrangements. It will be necessary to ensure that these arrangements are entered into by ESMA or, failing that, by the national regulatory authorities, as soon as possible.

The Problem with Private Placement

For U.S. and other non-EU investment managers, the opportunity to sell funds in the EU using the AIFMD passport will not be available for at least two years after the implementation of the AIFMD and, accordingly, in the absence of the option of a SMAIF, such managers will be required to rely on the continuance of the private placement regime. The continuance of private placement under the AIFMD is subject to a number of fundamental uncertainties.

Following adoption of the AIFMD, there has been significant discussion among industry participants as to whether it might be possible to comply with the provisions of the AIFMD by structuring the AIF as a self-managed investment company.

First, it is not compulsory for EU Member States to allow private placement or "marketing without a passport", which means that certain Member States may choose not to implement these provisions, or may remove or limit existing provisions. In addition, those Member States that do permit marketing without a passport may provide for stricter rules than those contained in the AIFMD. However, the concept of reverse solicitation or passive marketing[5] has been retained. For example, the UK Treasury has provisionally indicated its intention to continue to permit the marketing of non-EU AIFs managed by EU AIFMs, and EU and non-EU AIFs managed by non-EU AIFMs, to UK professional investors, subject to compliance with the minimum requirements specified in the AIFMD. It will be interesting to see what actions other Member States take in this regard.

Second, Member States may only allow private placement where there is a cooperation agreement in place between the Member State of the AIFM or where the AIF is marketed, and the supervisory authority of the non-EU AIF or AIFM. There has been little to date in establishing cooperation agreements, and ESMA has also cautioned that when these arrangements are entered into, there will be a need to "ensure a regular flow of information for supervisory purposes, including for systemic risk oversight [and to ensure]...that enforcement can be performed if necessary". It is worth noting ESMA's comment that "in this context, it is crucial to avoid creating an unlevel playing field which unduly favours entities established in third countries".

Given the added burden that the AIFMD will undoubtedly place on EU AIFMs, there may be a lively debate as to what constitutes a level playing field. It is likely that the form of agreement will be a multilateral memorandum of understanding ("MMoU") centrally negotiated by ESMA. However, ESMA will be challenged in meeting its goal "to finalise such a MMoU in good time ahead of the deadline of July 2013 and in a manner that ensures fair treatment of all third country authorities".

Third, the AIFMD requires the competent authority in the third country to meet the standards of data protection required by the Data Protection Directive[6]. This too will be a difficult hurdle.

What Can Be Learned from UCITS?

The template for SMAIFs comes from the UCITS world where the UCITS Management Company Directive made provision for the concept of self-managed investment companies.

The UCITS Directive and Central Bank of Ireland's ("Central Bank") Guidance Note 4/07 on the Organisation of Management Companies set out a series of operating conditions for SMICs, which are designed to ensure that the SMIC has, and maintains, sufficient substance and does not delegate the totality of its functions to one or more third parties, so as to become a letter-box entity. These requirements will form the template for the establishment of a SMAIF regime in Ireland.

Level II considers that an AIFM would become a letter-box entity when: (i) the AIFM is no longer able to effectively supervise the delegated tasks and manage the risks associated with the delegation; and (ii) the AIFM no longer has the power to take decisions in key areas that fall under the responsibility of the senior management or to perform senior management functions.

The substance requirement is achieved by putting in place management structures meeting common EU standards. For UCITS, the Central Bank has set out the key management functions that it considers to be the responsibility of the board of directors of the SMIC. The Central Bank regards the management functions as significant roles and requires a business plan to be

prepared setting out, *inter alia*, the identities of the persons appointed to perform those functions and how they will be performed in practice (e.g., reports to be provided by delegates and escalation procedures). With the exception of requirements in relation to liquidity management, the management functions that are imposed on SMICs are broadly similar (and in some instances virtually identical) to the operating conditions under the AIFMD.

Alignment of Level II with the approach adopted in respect of UCITS highlights the likelihood that AIFMs and SMAIFs will be required to adopt a business plan or procedures manual to document their operating, administrative and accounting policies and procedures. While UCITS will provide a template, it will be important from an Irish perspective to ensure that the approval process for SMAIFs can be aligned as closely as possible with the existing fast track approval process for qualifying investor funds.

Capital Requirements

The initial capital requirements for SMAIFs are the same as those for SMICs – €300,000 (approximately US $400,000). In addition to the initial capital requirement, AIFMs are subject to an "own funds" requirement of 0.02% of the amount by which the value of the SMAIF's portfolio exceeds €250,000,000 ("Own Funds Requirement"). The Own Funds Requirement has been criticised as inappropriate in the context of SMAIFs, and it was hoped that Level II would clarify that the Own Funds Requirement did not apply. Unfortunately, the Level II advice did not provide this certainty and focused on the Own Funds Requirements in the context of cover for potential liability risks. Notwithstanding that ESMA did not address this issue, the UK Financial Services Authority, in its discussion paper on the implementation of the AIFMD, suggests that the Own Funds Requirement applies only to externally managed AIFMs. If SMAIFs are subject to the Own Funds Requirement, this would mark a significant divergence from the UCITS Directive.

Next Steps

The European Commission is now in the process of preparing implementing measures in light of the Level II advice. The alternative investment funds industry will be watching closely the implementing measures adopted by the Commission and further developments by EMSA relating to the form of cooperation agreements.

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* This article is based on an article that appeared in the March 2012 issue of *HFMWeek*.

[1] The AIFMD will require AIFMs to be authorised pursuant to a harmonised regime and will impact on capital requirements, remuneration, valuation of assets, safekeeping of assets, delegation, leverage and marketing of EU AIFs and non-EU AIFs, managed by an EU AIFM or a non-EU AIFM.

[2] The AIFMD is a Lamfalussy directive. This means that the primary legislative act (Level I – the AIFMD itself) is only the first – framework – part of the four-stage process. Level II, which is presently underway, is the stage when the implementing measures are prepared by the European Commission to supplement Level I. The European Commission has mandated ESMA to advise it on the content of these measures. The European Commission will enter into public consultation before adopting Level II, which must be endorsed by a "qualified majority" of EU Member States (51%, and a minimum of 255 votes out of 345). Once Level II has been adopted, each Member State will then implement the Level I text and Level II regulations into the Member State's domestic legal system. Level III will comprise advice to the European Commission from ESMA on the development of Level I and II measures. Level IV will consist of the measures EU Member States enact to bring Levels I and II into force in their respective national laws.

[3] Undertakings for collective investment in transferable securities (UCITS) are a retail fund structure established by Directive 85/611/EC, as replaced by Directive 2009/65/EC (the "UCITS Directive"). UCITS may take advantage of a marketing passport throughout the EU.

[4] SMICs are managed by the board of directors of the investment company pursuant to a delegation model, whereby the board of directors delegates the investment management and administration of the UCITS to third parties.

[5] These terms refer to instances where an investor, on its own initiative, contacts an AIFM and subsequently invests in the AIF managed by the AIFM.

[6] The Data Protection Directive (the "DPA") regulates the processing of personal data and the free movement of such data. Subject to certain limited exemptions, the DPA only permits the transfer of personal data outside the European Economic Area to countries that have "adequate levels of data protection". The European Commission has prepared a list of countries that are deemed to provide an adequate level of data protection, which includes the United States, Canada and Australia.

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Upcoming and Recent Events

SECOND TUESDAY OF EACH MONTH
U.S. Regulation for UK Legal and Compliance Professionals
London

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

Program schedule:

April 11	Antitrust and Competition Issues for Advisers
March 13	The Latest FATCA Guidance
February 14	Status of CFTC Rulemakings Affecting Investment Managers and Funds
January 10	U.S. Compliance Calendar for 2012

MARCH 27, 2012
U.S. Derivatives Regulation in Hong Kong: The CFTC's New Direction
Hong Kong

On 9 February 2012, the CFTC removed the Rule 4.13(a)(4) exemption used by nearly all Hong Kong managers with U.S. investors. Other exemptions still exist, but each has its own drawbacks and may not be available for some managers. All managers will need to consider their status under the CFTC's registration regime — and some may find themselves subject to oversight by both the CFTC and the SEC. During this seminar, we will discuss: what fund managers need to do in response; the pros and cons of the remaining exemptions from CFTC registration; and prospects for future regulatory relief.

MARCH 14, 2012
Private Fund Tax Considerations
Boston

This CLE program examined the tax considerations in structuring private investment funds, including domestic, offshore and master-feeder fund structures. The program addressed fund-level taxation issues, taxation of investors, reporting obligations and manager compensation considerations.

MARCH 8, 2012

The New U.S. Government Program to Convert Foreclosed Single Family Properties Into Rental Units: Investor Opportunities
Webinar

The Obama Administration is seeking to address the continuing U.S. foreclosed property and troubled single family loans inventory by encouraging sales of such assets and converting them into rental units. The Federal Reserve Board has reported that major dislocations in the housing markets and increases in rental rates for single family units suggest attractive bulk purchase opportunities for private investors. This webinar addressed issues related to these developing transactions, including: key federal policy developments; key considerations and exit strategies for purchasers; and private equity and REIT considerations.

FEBRUARY 9, 2012
You're SEC Registered, Now What?
New York

Dechert hosted this event for the New York Chapter of the Private Equity CFO Association, a group intended for individuals who manage the financial and operational aspects and oversee the reporting, accounting and fund administration of private equity funds, venture capital funds, funds of funds, and secondary funds. Speakers included Dechert partners and representatives from ACA Compliance Group.

FEBRUARY 1, 2012
MiFID II for Asset Managers
London

This seminar provided a review of the MiFID II proposals and related developments in the financial services markets from an investment management perspective. Topics discussed included: the relationship between MiFID II and other EU initiatives; structural reform of the markets; organised trading venues, market transparency and high frequency trading; powers of intervention and position limit; commodity regulation; reform of investor protection; new rules on advice and payment of commission; requirements for "appropriateness" assessments; and harmonised requirements for firms from third countries doing business in Europe.

JANUARY 18 AND 19, 2012
The Eurozone Sovereign Debt Crisis and the Regulatory Response: European Bank Actions and Investment and Acquisition Opportunities
Greenwich, CT and New York

The ongoing Eurozone Sovereign Debt Crisis and changing regulatory environment have compelled many European banks to consider a variety of asset disposition transactions and capital raising structures. Having advised on a variety of precedential bank recapitalizations, acquisitions and asset dispositions, Dechert lawyers shared our perspective on what future deals may look like in light of government-sponsored solutions yet to be determined.

For more information, or to receive materials from the seminars and webinars listed above, please contact Beth Goulston at +1 202 261 3457 or beth.goulston@dechert.com.

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