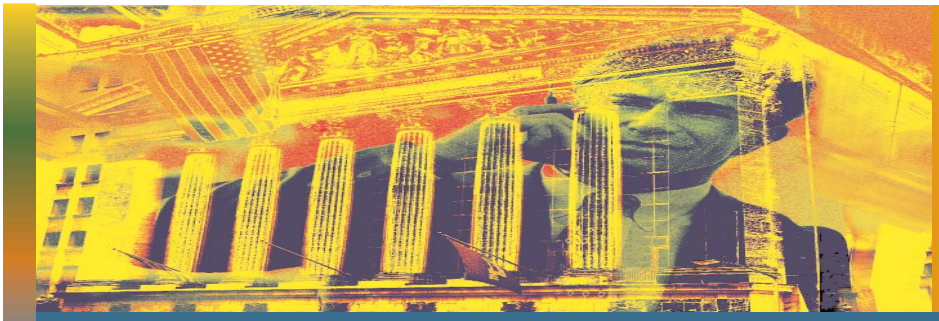

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Summer 2006

Kirkpatrick & Lockhart Nicholson Graham LLP's

Investment Management Update

SEC Adopts New Fund-of-Funds Rules

By Helen C. Kuo, Mark D. Perlow and George J. Zornada

On June 20, 2006, the Securities and Exchange Commission adopted three new rules under the Investment Company Act of 1940 that expand the ability of all funds to invest in money market funds and generally enlarge the investment scope of funds of funds. The SEC thereby gives further momentum to the growth of funds of affiliated funds, the vehicle for many "life-cycle" funds, which use combinations of investments in affiliated funds to structure portfolios that gradually lower their risk profiles as they approach a target retirement date. The rules largely codify a number of existing exemptive orders permitting cash sweep and fund of funds arrangements. In adopting them, the SEC appears to have cleared the crowded docket of the exemptive applications office of many of its most routine orders, in the hope that it will expedite consideration of other applications.

In addition, the SEC amended fund registration forms to require each fund that invests in other funds to disclose the cumulative amount of expenses charged by the acquiring fund and any fund in which it invests. These detailed requirements will present calculation challenges for many funds and especially for closed-end funds of hedge funds.

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Liability Insurance— A Few Thoughts on Renewals

By Alan C. Porter and Gregory S. Wright

Liability insurance coverage is an important consideration for all fund complexes, especially in the current environment where the responsibilities of fund directors are expanding and fund boards are subject to intense scrutiny. Here are a few considerations to focus on when reviewing and renewing liability coverage.

WHAT LIABILITY COVERAGE IS AVAILABLE?

There are two primary types of insurance protecting funds and their boards from losses incurred as a result of alleged improper activities. The first type of coverage—Errors and Omissions liability insurance ("E&O")—generally affords coverage for losses

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Welcome to the Summer 2006 Edition of K&LNG's Investment Management newsletter keeping you abreast of news and developments in today's regulatory and operating environments.

Diane E. Ambler
Editor

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Compliance Corner

Mutual Fund Redemption Fee Rule 22c-2: Still on Track

By Francine J. Rosenberger

As of press time, this discussion represents the current status of new Rule 22c-2. It is expected that the SEC staff will take some action on the Rule's implementation and we are on a day-to-day watch for a staff decision.

With the October 16, 2006 mandatory compliance date approaching for new Rule 22c-2 under the Investment Company Act of 1940, mutual funds are facing several challenges in implementing the new requirements to consider imposing redemption fees and to enter into agreements with financial intermediaries. These challenges primarily stem from the provisions under Rule 22c-2 requiring funds to enter into "information-sharing agreements" with financial intermediaries governing fund access to underlying shareholder information and the ability to restrict share transactions by beneficial owners.

Further complicating implementation for funds is the uncertainty of the final provisions of Rule 22c-2. When the SEC adopted Rule 22c-2 last year in response to short-term trading abuses in mutual funds, it also requested comments on various provisions and implementation of the rule. In response to more than 100 comment letters, the SEC proposed amendments to Rule 22c-2 in February 2006. The amendments are designed to reduce the costs of complying with the rule, including limiting the rule's application when there are chains of intermediaries. Although the SEC has stated that the October 16, 2006 compliance date is still in effect, the SEC staff noted that the compliance date may be revised or extended. To date, the SEC has not finalized the proposed amendments nor addressed whether the compliance date will be extended. On August 9, 2006, the Investment Company Institute reported that it expects the SEC staff to delay the compliance date relating to information-sharing agreements for six months until April 16, 2007 but that the compliance date relating to the imposition of redemption fees will remain at October 16, 2006.

WHAT DOES NEW RULE 22C-2 REQUIRE?

New Rule 22c-2 requires two kinds of actions by a mutual fund and its board. First, a fund board must consider implementing a redemption fee. Second, the fund or its principal underwriter must enter into written agreements with each fund financial intermediary governing underlying shareholder information and account activity.

Board Consideration of Redemption Fee—Rule 22c-2 requires the board of any fund that redeems shares within seven days after they are purchased to either:

- adopt a redemption fee of no more than 2% of the amount of the shares redeemed within a time period of no less than seven calendar days from the date of purchase; or
- determine that a redemption fee is not necessary or appropriate for the fund.

The fund itself retains the proceeds from the redemption fees in order to recoup for the fund the costs it may incur as a result of those redemptions or to otherwise eliminate or reduce, so far as practicable, any dilution of the value of the outstanding securities issued by the fund.

Agreements with Financial Intermediaries—Rule 22c-2 requires a fund to enter into written information-sharing agreements with its financial intermediaries (such as broker-dealers and banks) obligating those intermediaries to:

- provide the fund with shareholder trading information upon the fund's request; and
- respond to instructions from the fund to restrict or prohibit further purchases or exchanges in fund shares by a shareholder who has been identified by the fund as having violated the fund's policies on market timing/short-term trading.

Exceptions to the Rule—Money Market funds, exchange traded funds, and funds that encourage active trading and disclose to investors in the prospectus that such trading will likely impose costs on the fund, and do not elect to impose a redemption fee under the rule, will not be subject to the provisions of Rule 22c-2.

WHAT ARE THE PROPOSED AMENDMENTS TO RULE 22C-2

To address concerns about the Rule's cost and its application in certain circumstances, the SEC proposed amendments to Rule 22c-2 that would serve three purposes: (1) limit the types of financial intermediaries with which a fund must negotiate information-sharing agreements; (2) address the rule's application when there are chains of intermediaries; and (3) clarify the effect of a fund's failure to obtain an information-sharing agreement with any of its financial intermediaries.

Limiting the Definition of a Financial Intermediary—The proposed amendments narrow the definition of a "financial intermediary" under Rule 22c-2 to exclude any person that a fund treats as an individual investor for purposes of the fund's short-term trading policies. For example, many funds apply a redemption fee or exchange limits to transactions by a retirement plan at the omnibus account, rather than the individual shareholder, level. In such cases, the fund would not be required to enter into an information-sharing agreement with that plan because the fund is not attempting to apply its short-term trading policies at the underlying shareholder level.

Chains of Financial Intermediaries—The proposed amendments to Rule 22c-2 limit the required information-sharing agreements to only first-tier financial intermediaries, meaning those intermediaries that submit orders to purchase or redeem shares directly to the fund, its principal underwriter, transfer agent or a registered clearing agent. However, the proposed amendments expand the required terms of an information-sharing agreement to obligate a first-tier intermediary that maintains a shareholder account for another financial intermediary to:

- use its best efforts to determine, promptly upon the request of the fund, whether any other person that holds fund shares through the financial intermediary is itself a financial intermediary (indirect intermediary);

- upon further request by the fund, provide (or arrange to have provided) the shareholder identification and transaction information noted above regarding shareholders who hold an account with an indirect intermediary; and
- upon further request by the fund, restrict or prohibit the indirect intermediary from purchasing, on behalf of itself or other persons, securities issued by the fund.

The SEC stated that these proposed amendments rely upon the initiative of a fund to determine whether to request that first-tier intermediaries identify and collect information from a specific indirect intermediary and to request that an indirect intermediary be restricted from further trading in fund shares. The SEC anticipates that intermediaries may use a variety of arrangements with indirect intermediaries to ensure that the requested information is provided to a fund, ranging from formalized contracts to informal communications in response to a specific fund inquiry.

Effect of No Agreement—The proposed amendments clarify that, if a fund does not have an information-sharing agreement with a particular financial intermediary, the fund must prohibit the intermediary from purchasing, on behalf of itself or other persons, shares of the fund. This change would alleviate a significant burden of the original rule, which implies that a fund that fails to enter into a shareholder information agreement with even a single intermediary would be prohibited from redeeming its shares in less than seven days after purchase.

WHAT ARE SOME ISSUES THAT HAVE ARISEN WHEN IMPLEMENTING THE PROVISIONS OF RULE 22C-2?

As funds begin to implement the provisions of Rule 22c-2, the following issues have arisen:

Form of Agreement—Although the Investment Company Institute prepared a standard agreement package for funds and their financial intermediaries, not all intermediaries are willing to accept this standard agreement. Indeed, certain retirement plan intermediaries have prepared alternative agreement packages. As a result, the industry may have varying arrangements, with no one overall best practice or standard.

Standard Policies—According to the SEC's adopting release, the written agreement between a fund and its intermediary should obligate the intermediary to respond to directions from the fund to enforce the fund's market timing policies, including restricting or prohibiting further purchases or exchanges. However, in negotiating information-sharing agreements, funds and intermediaries may have different market timing and exchange policies which both parties believe shareholders should follow. Several intermediaries have requested that funds permit the intermediaries to impose their policies. As a result, it may be difficult for a fund to maintain a single set of policies that would apply to all fund shareholders.

Collecting and Reviewing Shareholder Information—Rule 22c-2 provides a means for a fund to obtain information from financial intermediaries on underlying beneficial owners. However, the rule leaves it within a fund's discretion to determine how frequently, or under what specific circumstances, it will request shareholder information from its financial intermediaries. Thus, each fund will have to make such determination.

Safekeeping and Privacy Concerns—During the comment period, several organizations expressed concern to the SEC over the safekeeping of personal shareholder information required in the originally proposed Rule 22c-2 and the proposed amendments to the rule. Although not raised during the comment process, Rule 22c-2 also may present concerns of potential violations of privacy laws or regulations outside of the United States. Funds and their intermediaries should be sensitive to the safekeeping of shareholder information, and should consider any implications non-U.S. law may have on information-sharing arrangements.

TIN Information—Rule 22c-2 requires financial intermediaries to provide, upon request by a fund, the taxpayer identification numbers of all shareholders with accounts through that financial intermediary. The rule does not require equivalent information for shareholders in jurisdictions that do not have TINs and, thus, will present certain challenges if not addressed by the SEC.

Chairman Cox's Recent Statement on the Future of Hedge Fund Regulation

By Jarrod Melson

On August 7, 2006, SEC Chairman Christopher Cox issued a statement confirming that the Commission would not seek en banc review of the D.C. Circuit Court's June 23, 2006 decision in *Goldstein v. Securities and Exchange Commission*, which struck down the rule that required most hedge fund managers to register under the Investment Advisers Act of 1940 ("IAA"). The Chairman stated that the Commission was "moving aggressively" on rulemaking and on providing guidance to address the legal consequences of the decision, some of which may be issued in the next week.

He emphasized the SEC's continuing authority to bring enforcement cases against hedge funds and their managers for fraud and other violations under existing laws, and reiterated many of the provisions and changes he identified in recent testimony before the Senate Committee on Banking, Housing, and Urban Affairs on July 25, 2006, such as:

- A new anti-fraud rule under the IAA expressly extending the fiduciary duties of a hedge fund manager to the investors in the fund.
- An amendment to augment the asset and income requirements for "accredited investor" status for persons investing in hedge funds to further limit the marketing and availability of hedge funds to general retail investors.
- Other amendments to restore many of the transitional and exemptive provisions of the pre-*Goldstein* rule. In his testimony before the Senate, Chairman Cox expressly cited the need to restore provisions of the vacated rule (i) permitting advisers to use pre-registration performance information with substantially less back-up material than would otherwise be required, (ii) extending from 120 to

180 days the time period during which fund of funds may provide audited financial statements to investors, and (iii) removing disincentives to remain registered for certain offshore advisers. In his statement, Chairman Cox said that these provisions would help to "eliminate disincentives for voluntary registration, and enable hedge fund advisers who are already registered under the rule to remain registered."

Chairman Cox asserted that further appeals of the *Goldstein* decision, given the multiple grounds on which it was based and the fact that it was unanimous, would be "futile," but that "[h]edge funds are not, should not be, and will not be unregulated."

AML Applied—An Illustration of Potential Pitfalls Under U.S./U.K. Law

By John Magnin, Andras P. Teleki and Martin King

Much has been written about U.S. and U.K. anti-money laundering regulations and what they require, yet little has been said regarding the practical impact of these regulations. The following is a hypothetical scenario illustrating some of the potential pitfalls for U.S. and U.K. financial institutions in navigating their respective anti-money laundering regimes.

PART I—THE U.K. BANK

Joe Banker, a customer account manager, is employed by Lazybank Plc, a U.K. bank affiliated with Lazybrokerdealer LLC, a U.S. federally registered broker-dealer. Sue Slipshod is Lazybank's finance director ("CFO") and is responsible for Lazybank's financial reporting. She is also Lazybank's Money Laundering Reporting Officer ("MLRO"), nominated to receive internal disclosures regarding suspicions of money laundering, and with responsibility for implementing AML procedures, training staff and monitoring compliance.

Lazybank's AML procedures are insufficient and out-of-date but year-end is approaching and Sue is inundated with financial reporting deadlines. She creates a basic "check-the-box" form for Lazybank's employees to confirm that they have verified their customer's identity. Sue gave Lazybank's staff a training session on recognizing suspicious transactions a few years ago and, to refresh memories, she sends a brief memo to department managers. When she has some spare time, Sue conducts a random review of a day's transactions.

A friend of Joe Banker puts him in touch with a wealthy individual, Rob Rogue. Rob has numerous international business interests and Joe would love to have him as a customer. Rob lives in Monaco and, unbeknownst to Joe, has a sophisticated web of shell and offshore companies designed to evade significant tax liabilities in the U.K. Joe speaks to Rob by telephone and requests a copy of Rob's passport and a utility bill as proof of identity to open an account. Rob faxes an illegible copy of his passport and a utility bill dated January 2005 for a property in Spain. Joe checks the boxes on Sue's form, sends the form to her and discards the fax.

Rob's new account soon accumulates multiple international transactions. One transfer, which catches Joe's eye, involves an arms manufacturer in Chechnya. Joe is concerned but sees it as Sue's responsibility to consider its ramifications and believes she is bound to pick it up on her daily transaction review. Rob is an important customer and the volume of his business through Lazybank is edging Joe closer towards his bonus target. Joe processes Rob's transactions without consulting with Sue.

Sue does spot the Chechen transfer in a rare transaction review. Sue and Joe are old friends and know each other well. Joe checked all the appropriate boxes on Sue's customer ID form and she knows Joe would say something if he was concerned. Lazybank's accounts are due for submission to the board, and Sue decides Joe must have things covered so she does not make a suspicious activity report to the Serious Organised Crime Agency ("SOCA").

Rob calls Joe as he wants to concentrate his investments in the U.S. and Joe subsequently arranges for a transfer of Rob's account to Lazybrokerdealer, Lazybank's affiliated U.S. broker-dealer.

Implications under U.K. Law

Joe and Sue's actions (or inactions) may constitute offenses under the Proceeds of Crime Act 2002 ("POCA 2002"), the Money Laundering Regulations 2003 ("MLR 2003") and the Terrorism Act 2000 ("Terrorism Act"). POCA 2002 sets out substantive U.K. money laundering offenses; MLR 2003 provides for preventative measures and controls in the regulated sector (banks, financial institutions, real estate agents, insolvency practitioners, accountancy, tax and legal services etc); and the Terrorism Act sets out specific offenses relating to terrorist financing.

Taking the above events in order:

1. Lazybank's AML procedures are insufficient. Lazybank and Sue (as MLRO) must take measures to ensure that employees are aware of the provisions of U.K. AML legislation and are trained to recognize and deal with transactions that may involve money laundering. Under MLR 2003 regulations, they must establish internal controls and lines of communication as may be appropriate to forestall and prevent money laundering.

   Better practice:

   - Sue should implement comprehensive AML procedures documenting employees' required action in the event of suspicion of money laundering, including rigid rules for internal communication to her as the MLRO.
   - Sue should arrange (at least) annual training for all relevant staff (including account managers, general accounting staff, secretarial, clerical and administrative staff who may encounter evidence of money laundering) regarding money laundering offenses, internal procedures and the recognition of suspicious activity.

2. Lazybank and Joe must maintain identification procedures requiring Rob to provide evidence of identity. An illegible copy of his passport and an old bill are unsatisfactory.

Better practice:

- Joe should meet Rob personally to get evidence of identity and address (for example: a legible copy of Rob's passport or driving license and a recent utility bill identifying his current address).
- If a face-to-face meeting is not possible, Joe should ask Rob to visit his local solicitor to copy and certify his passport and utility bill and provide those copies to Joe.

3. If Rob is improperly evading tax in the U.K., his gains from doing so represent criminal property. He is also receiving funds from questionable sources. By acquiring, possessing, using, transferring or facilitating Rob's transactions, Joe could be committing serious offenses under POCA 2002.

Better practice:

- It is crucial for Joe to "know the customer"—not only identity and address but also business interests, the purpose of transactions and the source of funds. Numerous transactions on and off-shore without apparent purpose should trigger alarm bells.
- Suspicion should be reported either internally to Sue (the MLRO), or directly to SOCA.
- Joe should be careful not to "tip off" Rob of any such report to SOCA that might prejudice an investigation.

4. Joe notices a suspicious transaction but fails to report it to Sue (the MLRO) or SOCA. Joe may be committing offenses under §§15-18 of the Terrorism Act, which prohibit terrorist funding, use or possession of property for the purposes of terrorism and money laundering to facilitate control of terrorist property.

Better practice:

- Joe should disclose any suspicion to Sue or SOCA.
- If Joe has any suspicion that terrorist activity is involved, he should report it to SOCA immediately.

5. Sue (as MLRO) learns of the suspicious transaction but fails to report it to SOCA. Sue is also under a duty to report any suspicion relating to terrorist property.

Better practice:

- Sue should follow up her suspicion regardless of her relationship with Joe. She should, at the least, raise the transaction with Joe for his explanation.
- Sue should carefully consider all disclosures received to assess whether there is sufficient information and/or suspicion to make a suspicious activity report to SOCA.

PART II—THE U.S. BROKER-DEALER

John Broker, a registered representative, is employed by Lazybrokerdealer, Lazybank's U.S. broker-dealer, and serves as the broker-dealer's anti-money laundering compliance officer ("AML Officer"). Joe calls John one morning and informs him of Rob's desire to open a U.S. brokerage account. John is thrilled at the thought of having his first international client and begins carrying out Lazybrokerdealer's Customer Identification Program ("CIP") as part of the account opening process. John receives from Joe an address and a date of birth for Rob, both of which he carefully notes on the account opening form. John asks Joe for Rob's passport number and country of issue, which Joe cannot provide, so John leaves the item blank on the account opening form. Lacking any means for doing a documentary verification of Rob's identity, he attempts to carry out a non-documentary verification by querying the major credit service databases but learns nothing, given that Rob has no credit history in the U.S. John, figuring that Lazybank, an affiliate, must know who Rob is, decides to check the box on the account opening form indicating that he has verified Rob's identity. No one at Lazybrokerdealer ever checks to see if the account opening form is properly completed.

Once the account is opened, Rob engages in minimal trading activity and, when he does trade, he is not interested in the trading losses he is racking up. In fact, the only regular activity in the account that Rob is interested in is a monthly withdrawal, which John is directed to send to a bank in the Republic of Nauru, a small island in the South Pacific identified by the Financial Action Task Force on Money Laundering as non-cooperative in the fight against money laundering. Although Lazybrokerdealer has a suspicious activity reporting policy, John does not file a Suspicious Activity Report ("SAR") with the Financial Crimes Enforcement Network ("FinCEN") or conduct an investigation as to whether a SAR must be filed.

Two months after the account is opened, an overnight envelope from Bank Notell, a bank domiciled and located in Nauru, appears in John's office containing $20,000 in cash with instructions that it is to be deposited in Rob's brokerage account. Although Lazybrokerdealer has a firm "no-cash" policy, John decides to deposit the cash in the account thinking that while the receipt of cash is a bit unusual it did come from a "bank" so all must be well.

Six months after Rob's account was opened, John is informed by Joe that Rob would like to open a second brokerage account, except this time the account would be opened through Bank Notell, which is to be the account holder of record. With minimal further inquiry, John opens the second brokerage account.

Over the remainder of the year, John opens 10 more accounts for Joe's customers. At the end of the year, John conducts the requisite annual review of Lazybrokerdealer's anti-money laundering program and drafts a report of his findings stating that everything is "fine."

Implications under U.S. Law

John's actions (or inactions) are likely to raise a number of issues under the Bank Secrecy Act, as amended by the USA PATRIOT Act, and the regulations thereunder (collectively, the "BSA") and NASD regulations.

Taking the above events in order:

1. For each non-U.S. person, Lazybrokerdealer must obtain either a taxpayer identification number, a passport number and country of issuance, an alien identification card number, or the number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard (31 CFR 103.122). John does not collect any of the foregoing required customer identification information. Further, Lazybrokerdealer's CIP must enable it to form a reasonable belief that it knows the true identity of each

customer (31 CFR 103.122). In this case, John is unable to verify the identity of the customer under the usual policy and instead relies on an unverified assumption that the affiliated bank had done so. Whereas the regulations would permit Lazybrokerdealer's reliance on another entity for CIP purposes, Lazybrokerdealer may not do so in this situation because, among other reasons, Lazybank is not required to maintain an anti-money laundering program under the USA PATRIOT Act (31 CFR 103.122), a prerequisite for reliance under the regulations.

Better practice:

- John should find an alternative method of verifying Rob's identity when the primary method under Lazybrokerdealer's policy does not work. Such methods may include requiring Rob to provide a copy of his passport or some other government-issued identification or use of a third party database to gather information about Rob.
- John, as the AML Officer, should also consider whether any changes need to be made to the Lazybrokerdealer's CIP procedures if accounts for non-U.S. persons will be opened on a regular basis.

2. Lazybrokerdealer is required to file a SAR with FinCEN for certain suspicious transactions relevant to a possible violation of law or regulation (31 CFR 103.19). John fails to determine whether a SAR is required, even though Rob's transactions have the classic earmarks of money laundering (i.e., an investor opens a brokerage account yet does minimal investing of any sort, the account owner is not interested in the losses the account is incurring, withdrawals are sent to a location identified as presenting a high money laundering risk, and cash deposits are being made into the account).

Better practice:

- Lazybrokerdealer should maintain a thorough set of procedures for identifying activity that requires a SAR filing and should conduct random reviews to verify that the procedures are being followed.
- Lazybrokerdealer should identify brokerage accounts as a high risk if little is known about the account holder or the source of funds and should monitor account activity accordingly.
- Lazybrokerdealer should consider an exception reporting system whereby unusual account-related activity, such as disinterest in trading related losses or the transfer of funds to or from high-money-laundering risk jurisdictions, is promptly reviewed for SAR filing purposes.

3. Lazybrokerdealer is required to file a Cash Transaction Report ("CTR") with respect to the receipt of more than $10,000 in cash (31 CFR 103.22). John fails to file the CTR even though $20,000 in cash is received for deposit into Rob's brokerage account. For purposes of filing the CTR, it is not relevant whether the source of the cash was a bank.

Better practice:

- Lazybrokerdealer should maintain procedures to address the receipt of cash to ensure that CTR filings are made as required even though the firm has a "no cash policy." Further, in an environment where cash is rarely received, such as a broker-dealer, receipt of cash may be an indication of suspicious activity that may also require a SAR filing in addition to the CTR.

4. Lazybrokerdealer is required to maintain a due diligence program for correspondent accounts opened for foreign financial institutions (31 CFR 103.176). John fails to identify Bank Notell as a foreign financial institution and, as a result, fails to subject the account to the required additional anti-money laundering due diligence.

Better practice:

- Lazybrokerdealer should maintain procedures for identifying foreign financial institutions. Any account opened by a foreign financial institution with the broker-dealer must be treated as a correspondent account and subject to an assessment of the money laundering risk presented by the account. Risk-based procedures should be applied to these accounts to detect and report known or suspected money laundering.

5. Lazybrokerdealer is required to develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the firm's compliance with the requirements of the BSA and to provide for independent testing for compliance with the anti-money laundering program (NASD Rule 3011). The independent testing cannot be done by the AML Officer, thus John's review of the program does not satisfy the requirement. In addition, John's review failed to address the expansion of Lazybrokerdealer's customer base to non-U.S. persons and thus did not address the need to make necessary changes to the firm's AML program to address the new types of customers and their associated money laundering risks.

Better practice:

- Lazybrokerdealer should have a robust independent testing program conducted by a designated person or entity with a working knowledge of applicable requirements under the BSA. This person or entity should not be the AML compliance officer or have responsibility for performing the functions being tested.
- The testing program should identify exceptions to usual procedures, incomplete paperwork, and out-of-the-ordinary money laundering risks, as well as evolving regulatory requirements and business practices.
- Lazybrokerdealer's testing program should identify anti-money laundering risks that may not be covered under the current program, such as accounts opened for non-U.S. persons; the AML compliance officer should adopt new or expanded procedures to address such new risk areas.

IN CONCLUSION

As may be seen from the foregoing hypothetical, even seemingly routine banking and brokerage related transactions can produce novel anti-money laundering issues. Financial institutions subject to anti-money laundering regulations must be ever vigilant to identify the next money laundering threat.

UPDATE—Independent Chair Rule—Commission Solicits Additional Comment

By Kurt J. Decko

The continuing saga concerning the controversial independent chair and 75% independent director requirements began a new chapter as the Commission issued a request for additional comments addressing not only the costs of compliance but also, more broadly, "any issue related to the underlying purpose of the [requirements], which is the protection of funds and fund shareholders." The request for comments (which are due August 21, 2006) responds to the April 7, 2006 decision of the U.S. Court of Appeals for the D.C. Circuit in which the Court concluded that the Commission had violated the Administrative Procedure Act by failing to seek comment on the data it used to estimate the compliance costs of the new requirements—which the Commission had previously stated should be "minimal." The Court had vacated the controversial requirements, although it delayed issuance of its mandate for 90 days to allow the Commission to reopen the record for additional comment on the anticipated costs.

Accordingly, the Commission now seeks comment on the costs associated with the two requirements—as well as "suggestions for additional provisions designed to achieve the underlying purpose of the amendments"—and particularly has requested reliable cost data (monetary or non-monetary) to support commenters' assertions. The Commission is also specifically seeking comment on the adequacy of the data it relied upon previously, which the Court had criticized as not being part of the public record, as well as other appropriate measures of costs. As the Court strongly suggested, the Commission is requesting implementation data for funds (particularly for small fund groups) that have already voluntarily complied with one or both of the requirements, including types of costs not identified by the Commission.

The Commission's inquiry, however, extends beyond these straightforward requests: it is soliciting comment on any issue related to the underlying purpose of the requirements, as well as any issue related to the Commission's legal mandate to determine whether the requirements promote efficiency, competition and capital formation. The breadth of this inquiry, which extends beyond that required by the Court, provides proponents and opponents alike the opportunity to strengthen their arguments on substance as well as cost. By articulating such a broad inquiry, the Commission has similarly provided itself an opportunity to reconsider whether its stated goal of providing for the "protection of funds and fund shareholders" can best be achieved through implementation of these requirements, which have been highly divisive, or perhaps through other means; it also suggests a possibility that any further requirements in this area may not sufficiently "promote efficiency, competition, and capital formation," in which case additional rulemaking might not be proposed.

The Commission offered few clues concerning an ultimate resolution of this matter. The cost data requested by the Commission, in all likelihood, can be expected to support the arguments of both proponents and opponents. Thus, much will depend on intangibles that affect decisionmaking within the Commission. Given the same Court's recent vacating of the hedge fund registration rule, the arrival of a new Commissioner, and Chairman Cox's desire to reach consensus on significant issues, it is difficult to predict the Commission's next move.

In a related action, Chairman Cox announced that he has asked the Commission's General Counsel to conduct a "top-to-bottom" review of the Commission's process for complying with the laws that require it to conduct an economic analysis of rule proposals. Chairman Cox stated that the review would ensure that the Commission takes full advantage of its professional staff—including those in the Office of Economic Analysis—when conducting its economic impact analysis. Although there is no timetable for completion of this review, when viewed together with the broad comment requests in the fund governance release discussed above, it could suggest that the Commission may consider significantly restructuring its process for proposing rulemaking, reviewing comments, and ultimately adopting new regulatory requirements. All too often, cost-benefit analyses appear to involve unrealistic assumptions, and changes in the Commission's methodology to reflect economic data could have far-reaching implications for future rulemaking initiatives.

The SEC's New Interpretive Guidance on "Soft Dollars"

By Sandra L. Geiger and Richard M. Phillips

On July 18, 2006, the SEC issued a final interpretive release ("Final Interpretation") on soft dollar commission practices under Section 28(e) of the Securities Exchange Act of 1934. The SEC considered the final client soft dollar rules recently adopted by the United Kingdom Financial Services Authority ("FSA") but emphasized in its open meeting that the FSA's rules as adopted are more restrictive than Section 28(e). The Final Interpretation does not deviate substantially from the Commission's proposed interpretation ("Proposed Interpretation") that was published for comment in October 2005, but clarifies and/or modifies prior interpretations of the safe harbor in the following material respects:

- **Commission Sharing Arrangements**. The Final Interpretation takes a broader approach to commission-sharing arrangements than the Proposed Interpretation: it states that a broker-dealer is deemed to be "effecting securities transactions" under the safe harbor if the broker-dealer either (i) executes, clears or settles the trade, or (ii) provides one of four specified functions while allocating the remaining responsibilities to a clearing broker. These four functions are: (1) being financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment or securities; (2) making and/or maintaining records relating to its customer trades as required by the Commission or SRO rules; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements. In addition, the Final Interpretation broadens the Commission's interpretation of when research services are "provided by" a broker-dealer that effects transactions because it includes a broker-dealer who is not directly obligated to pay for such research and brokerage, but pays the research preparer directly and takes certain steps to ensure that the client commissions paid are used only for eligible brokerage and research.

- **Mass-Marketed Publications**. The Final Interpretation makes clear that "mass-marketed publications" are not eligible research under Section 28(e).

- **Proxy Voting**. The Final Interpretation explicitly states that research or advice on how to vote proxy ballots falls outside of Section 28(e) because it does not provide the adviser with "lawful and appropriate assistance" in making investment decisions. Other products and services offered by proxy servers or providers are eligible for inclusion as research under Section 28(e) to the extent that they satisfy the "lawful and appropriate assistance" standard. Certain proxy services may be treated as mixed-used items if appropriate (*e.g.*, used for investment decision-making and in connection with voting).

- **Order Management Systems**. The Final Interpretation relaxed the Commission's position in the Proposed Interpretation in which it proposed a blanket exclusion of order management systems ("OMS") as eligible brokerage. It makes clear that certain functionalities provided through OMS may be eligible brokerage or research and that market research (which includes pre- and post-trade analytics, including trade analytics transmitted through OMS) may be eligible research under the safe harbor. Examples of potentially eligible brokerage include: dedicated lines between the broker-dealer and the manager; lines between the broker-dealer and the OMS operated by third-party vendors; and trading software used to route orders, provide algorithmic trading strategies or transmit orders to direct market access systems or provide connectivity to this software.

The Final Interpretation, among other things, excludes most forms of hardware and commercially available publications from the definition of "research." For example, it eliminates the use of brokerage commissions to pay for Bloomberg terminals.

The Final Interpretation is not retroactive and will be effective upon publication in the Federal Register. Money managers may rely on either the SEC's 1986 Release or the Final Interpretation for a period of six months after publication. The SEC is expected later this year to propose requirements for disclosure and recordkeeping of client commission arrangements.

The SEC announced that it welcomes additional comments on client commission arrangements and may supplement the Final Interpretation if it determines that additional guidance is appropriate. For more detailed information on the Final Interpretation, please see our July 2006 Investment Management Alert entitled *Securities and Exchange Commission Issues Guidance on Client Commission Practices* at the Newsstand at http://www.klng.com.

SEC Interactive Data Roundtable: A Path to Better Disclosure

By Diane E. Ambler

On June 12, 2006, the SEC held the first of a proposed series of roundtables intended to facilitate the implementation of Internet tools designed to improve financial information provided to investors and analysts. This first roundtable focused on improving the quality of mutual fund disclosures and employing interactive data and technology to provide mutual fund investors with better information. The roundtable also addressed how analysts and investors can use interactive data and what the SEC can do to help companies take advantage of the potential power of interactive data.

Buddy Donahue, the new Director of the SEC's Division of Investment Management, set the stage for discussion with a visual presentation of a tall stack of disclosure documents required to be prepared by the typical mutual fund, including in the first instance the fund prospectus—referred to by Chairman Cox as "a dense blob of legalese, difficult to search, time consuming to read, impossible to navigate quickly." From that, participants discussed ways in which this information might be structured to highlight critical information and facilitate opportunities to digest it and compare it to that of comparable funds.

All seemed to agree that a short summary of the most essential information was key. Not surprisingly, the long-dormant Profile Prospectus and the newer industry-proposed Profile Plus were raised as a good place to start, with further emphasis on layering details, such as different services for different investor classes, and improved, user-friendly formatting. The Commissioners discussed with participants the current legal impediments to using the Profile as well as delivery issues for investors who do not use the Internet.

Participants discussed interactive data as a promising tool for providing this layering and for making all the required data usable for a fund investor or intermediary. Examples provided included: helping investors quickly pull up and compare after-tax return information for multiple funds; helping retirement plan fiduciaries track changes in portfolio holdings of a fund to better assess how closely the stated objectives and strategies are followed; and helping financial journalists move from a portfolio manager's name and background in a prospectus to the detailed information about that manager's potential conflicts in the SAI to the most recent Code of Ethics provisions governing these conflicts filed with the SEC.

The goal underlying participants' remarks focused on giving investors more control over how they access data and how much data they choose to review, with the recognition that investors are influenced in their decision-making by third-party intermediaries, journalists and other professionals. Of particular interest to the Commissioners was how those in the business of analyzing fund investments, such as Morningstar, and other intermediaries, might benefit from tagging information in mutual fund prospectuses and what further information that might bring to investors. Participants also addressed disclosure needs in the context of 401(k) plans. A subtext of the discussion included allusions to more effective disclosure creating more balanced incentives. For example, there was discussion of disclosure of fund managers' compensation structure creating incentives to compensate based on long-term performance rather than short-term performance or asset growth.

Overall, the principal theme revolved around the virtue of the Internet as a means to more effectively access information, as distinguished from data, by providing an architecture or hierarchy of data based on that which is most relevant to an investor. Participants discussed potential uses of XBRL (eXtensible Business Reporting Language), also known as interactive data tagging, in the context of current mutual fund disclosure requirements and the different emphasis on mutual fund financial statements compared to public companies. Participants agreed that the first step is to develop a taxonomy or catalogue prioritizing the most relevant data points for tagging, and the discussion included ideas for the role of the SEC in that context. The ICI referenced its project to develop, by the first quarter of 2007, tags for the Risk/Return Summary in fund prospectuses.

Advantages of interactive data identified by participants included greater transparency of financial information, reduced costs for investors and analysts, deeper coverage of companies by analysts (since they can spend less time preparing data for analysis and more time actually analyzing the information) and ultimately more efficient markets. Some participants urged caution in developing taxonomies in order to avoid complex and expensive tagging of more detailed data and remarked that, once the taxonomy is put together, there must be an organization that will maintain it over time.

The critical relationship between disclosure, liability and information that investors are seeking was discussed at length. Participants encouraged the SEC to take a broad view of requirements for delivery of prospectus information and advertising to enable greater flexibility in this area and to relax some of the liability concerns.

Future roundtables will address how to encourage the development of software for companies, institutions, and retail investors that takes full advantage of the potential of interactive data and how to redesign the SEC's disclosure requirements to maximize the advantages of using interactive data.

SEC Adopts

(continued from page 1)

RULE 12D1-1: INVESTMENTS IN MONEY MARKET FUNDS

New Rule 12d1-1 permits all funds to invest unlimited amounts of cash in registered and unregistered money market funds (whether or not affiliated) under specified conditions. The rule applies to money market fund investments by mutual funds, closed-end funds (including business development companies) and unregistered funds exempt under Section 3(c)(1) or 3(c)(7) of the 1940 Act. This rule eliminates the need for individual "cash sweep" exemptive orders.

The exemption is conditioned on the acquiring fund either not paying any sales charge or service fee on the acquired fund's shares, or waiving advisory fees to offset any sales or service fees. However, unlike prior exemptive orders, Rule 12d1-1 does not place restrictions on advisory fees or require special board findings that investors are not paying duplicative fees. In addition, the rule permits acquiring funds to pay commissions, fees, and other remuneration to second-tier affiliated broker-dealers in connection with transactions in portfolio securities without meeting the quarterly board review and record keeping requirements of Rule 17e-1, where the affiliation solely results from the acquiring fund's investment in a money market fund whose adviser is affiliated with the broker-dealer. The rule also permits investments in unregistered money market funds, provided that they "operate like" registered money market funds by meeting specified criteria, particularly complying with Rule 2a-7. This new possibility allows fund complexes to operate internal money market pools without the administrative expense and burden of registering them.

RULE 12D1-2: INVESTMENTS OF FUNDS OF AFFILIATED FUNDS IN OTHER TYPES OF SECURITIES

Section 12(d)(1)(G) of the 1940 Act permits mutual funds and unit investment trusts ("UITs") to acquire unlimited shares in other mutual funds or UITs in the same fund complex, as well as government securities and short-term paper. However, such an affiliated fund of funds is restricted in the other types of securities it can hold. In addition, the acquired funds may not themselves

be funds of funds and thus may not rely upon Section 12(d)(1)(F) or Section 12(d)(1)(G) to invest in shares of other funds.

New Rule 12d1-2 permits funds that rely on Section 12(d)(1)(G) to invest also in unaffiliated funds, subject to the limits of Section 12(d)(1)(A) and (F). A fund complex with a weakness in one investment strategy (*e.g.*, international stocks) can now use unaffiliated funds to round out a fund of funds offering that otherwise relies upon affiliated funds. The new rule also permits such funds to invest in affiliated or unaffiliated "money market funds" under Rule 12d1-1, as well as investments in securities offered by issuers other than funds, such as stocks, bonds and other types of "securities" (as that term is defined under the 1940 Act), provided that the investments are consistent with the funds' investment objectives and policies. This exemption presents funds of affiliated funds with opportunities to adopt new strategies crafted from derivatives that qualify as "securities." One caveat—it does not appear to permit investment in derivatives or other instruments that do not constitute "securities."

RULE 12D1-3: SALES CHARGE FLEXIBILITY FOR FUNDS OF UNAFFILIATED FUNDS

Section 12(d)(1)(F), although not widely used, permits a registered fund to invest in unaffiliated registered funds if, among other conditions, the acquiring fund and its affiliates would not own more than 3% of the total outstanding stock of any such acquired fund, and the sales charge on the acquiring fund's shares is not greater than 1½ %. New Rule 12d1-3 permits a registered fund that relies on Section 12(d)(1)(F) to levy sales charges and service fees up to the applicable limits set forth in NASD Conduct Rule 2830. While loosening the sales charge restrictions of 12(d)(1)(F), the new rule does not alter the other limitations that have resulted in relatively few funds relying on this section.

NEW DISCLOSURE REQUIREMENTS

In addition, the SEC significantly amended fund registration forms to require all funds that invest in other funds to disclose as a separate line item in the fee table the acquiring fund's *pro rata* portion of the cumulative net expenses charged by funds in which the acquiring fund invests, even if the acquiring fund does not rely on the new rules. The SEC also adopted highly detailed instructions for calculating the amount of acquired funds' fees and expenses. Generally, the acquiring fund must aggregate the total annual operating expenses of acquired funds and related transaction fees. The expense calculations must include expenses of private funds excepted from registration by Sections 3(c)(1) or 3(c)(7) of the 1940 Act, if any. The new requirements provide an exception if acquired fund expenses are less than 0.01% (one basis point) of the acquiring fund's assets, in which case the expenses should be reflected in general fund expenses.

Form N-1A was amended to add a new line item called "Acquired Fund Fees and Expenses" in the total fund operating expenses section of the prospectus fee table, in which the acquired funds' expenses will be expressed as a percentage of average net assets. These expenses must also be included in the "Example" portion of the fee table, which discloses the cumulative amount of fund expenses for 1, 3, 5, and

10 years based on a hypothetical investment of $10,000 and an annual 5% return.

Similarly, Form N-2 was amended to require registered closed-end funds to include, as a line item in the fee table, their "*pro rata* portion of the cumulative expenses charged by the acquired funds, including management fees and expenses, transaction fees and performance fees (including incentive allocations)."

Funds of hedge funds may face challenges in preparing the line item because of the variable nature of hedge fund performance fees. The SEC required funds of hedge funds to add a disclaimer about the variable nature of hedge fund fees and to add a footnote to the new item that discloses the "typical performance fee charged by acquired hedge funds" in which they invest. In addition, the SEC permitted funds to exclude from the expense ratio in the fee table specified performance fees that may be unrelated to the costs of investing in a fund of funds, such as fees that are calculated solely on the realization or distribution of gains, which are typically paid upon liquidation of the fund.

The SEC similarly amended Forms N-3, N-4, and N-6, which apply to insurance company separate accounts. The new rules went into effect on July 31, 2006. New registration statements on Forms N-1A, N-2, N-3, N-4, and N-6, as well as post-effective amendments thereto that are annual updates, filed on or after January 2, 2007, must comply with the amended disclosure requirements. We advise funds to consult with their accountants and legal counsel well in advance of a fund's deadline regarding compliance with the instructions and calculation of the newly required expense amounts.

Liability Insurance

(continued from page 1)

arising from the "wrongful acts" (often defined as an act, error, or omission in the rendering of professional services) of directors, officers, employees, or other service providers (e.g., investment advisers, transfer agents, distributors, and administrators).

This article focuses primarily on the second type of coverage—Directors' and Officers' liability insurance ("D&O")—which generally protects the officers and directors of a fund for claims brought against them for "wrongful acts" (which, as discussed below, is defined differently than in E&O policies). At the outset, it should be noted that the terms of D&O policies vary widely. This variation among policy terms arises not only from the fact that there is wide variation among the policy forms offered by large commercial insurers, but also because policyholders are often able to negotiate favorable changes to policy forms during renewal periods.

D&O policies generally provide two types of coverage. So-called "Side A" coverage typically covers "loss" to directors and officers arising from "claims" alleging "wrongful acts" where the fund has not indemnified the insured. So-called "Side B" coverage typically covers the fund itself when the fund indemnifies a covered individual for a covered claim. Some, but not all, D&O policies include a so-called "Side C" coverage part, which expands coverage to claims against the fund itself.

Most D&O policies are "claims-made" policies. Coverage is potentially triggered under this type of policy when a "claim" (another term defined in the policy) is brought against the insureds within the policy period. Some D&O policies contain an "extended reporting period," which affords coverage for claims filed within a specified time period after the policy period, provided such claims relate to wrongful acts that occurred prior to the end of the policy period. In addition, coverage may be available for claims filed after the policy period that is based on "circumstances" or "potential claims" that the policyholder reported to the insurer during the policy period.

Many D&O policies also include other provisions that limit the insurer's exposure to wrongful acts that occurred during a specified time period. For example, certain D&O policies do not cover claims related to wrongful acts that occurred prior to a specified "prior acts" date or that relate to lawsuits that were pending as of a specified "continuity" date or "prior or pending litigation" date. Given that D&O policies generally require that the "claim" itself be filed during the policy period (or extended reporting period), it necessarily follows that the alleged wrongful act generally also must take place prior to the end of the policy period. In certain circumstances, though, a D&O policy might respond to a wrongful act that takes place after the end of the policy period that "relates back" to a claim that was first filed during the policy period.

When analyzing the scope of coverage afforded under existing policies or when negotiating new policies, funds and their directors should focus on several key provisions, including but not limited to the terms discussed below.

WHAT "CLAIMS" ARE COVERED?

It is important to review the policy definition of "claim." The definition varies from policy to policy and can significantly affect the scope of coverage provided. Some definitions include not only formal *lawsuits or proceedings* brought against an insured, but also *investigations* into possible violations initiated by a governmental body or self-regulatory organization. Other definitions of claim may be more restrictive, triggering coverage only if a lawsuit or other formal proceeding is brought. Some policies may cover criminal investigations or proceedings; others do not.

Funds and other insured parties may be compelled to respond to regulatory investigations and, in some cases, to defend themselves against alleged violations before any formal proceedings have been initiated. This may require insureds to retain outside counsel and to undertake the costly process of organizing and producing large amounts of documents and other information. An insured's expenses in responding to and defending against alleged violations in these circumstances may be covered under a broader definition of claim.

WHAT "LOSS" IS COVERED?

There are several other key policy terms that should be reviewed. First is the policy's definition of "loss." Loss is typically

defined to include costs of defense, judgments, settlements, and damages. Some policies do not cover punitive damages; others cover punitive damages in states that do not prohibit such coverage as a matter of public policy. Some policies afford coverage for multiplied damages; others do not. Some policies arguably cover what might be characterized as "disgorgement" or "restitution"; others do not. Additionally, many D&O policies define loss to exclude coverage for penalties, taxes, and "matters which may be deemed uninsurable under the law pursuant to which [the] policy shall be construed." Thus, the policy definition of loss can significantly affect the scope of the available coverage, as well as shape the manner in which insureds may choose to defend against or settle a proceeding.

WHAT "WRONGFUL ACTS" ARE COVERED?

A policy's definition of "wrongful acts" should also be scrutinized. D&O policies generally provide coverage for claims made against insureds arising out of wrongful acts, but may differ on the conduct that constitutes a wrongful act. While many D&O policies broadly define the term wrongful act, insureds should not erroneously assume that the term includes *all* improper conduct. In fact, policies may restrict coverage either via the definition of "wrongful act" itself or via several common exclusions that potentially bar coverage for intentional conduct such as fraud (discussed below). For example, certain D&O insurers define "wrongful act" as "any breach of duty, neglect, error, misstatement, misleading statement, omission, or other act" committed in the scope of the individual director's or officer's duties. In contrast, other D&O policies limit the definition of "wrongful act" to "any *negligent* act, error, or omission." Under either definition, disputes often arise between policyholders and insurers whether the policy covers intentional acts or reckless conduct. Ultimately, the resolution of this issue will turn on the specific policy language at issue and controlling state law. In any event, policyholders should seek the broadest definition possible when renewing their coverage.

WHEN DO THE SO-CALLED BAD CONDUCT EXCLUSIONS APPLY?

As noted above, many D&O policies restrict the scope of coverage for "wrongful acts" through exclusions, including so-called bad conduct exclusions, which bar coverage for certain claims relating to criminal or fraudulent activity or for claims alleging that the insured received a profit to which he or she was not legally entitled. The terms of these exclusions vary widely. Certain exclusions bar coverage merely when the excluded conduct is alleged. This version of the exclusion is obviously pro-insurer, as the insurer may rely on this language to refuse to reimburse any defense costs for contested claims. A second common version of the exclusion bars coverage when the excluded conduct "in fact" occurred. Disputes often arise between the policyholder and insurer relating to whether the excluded conduct did "in fact" occur, particularly when the policyholder settles the underlying case without an admission of guilt. Another common (and the most favorable) version bars coverage only when the excluded conduct is established via a "final adjudication" or "non-appealable judgment." Policyholders should seek some version of this "final adjudication" test, as this language may enable them to preserve coverage for cases that settle prior to a final adjudication.

A policy's severability provisions also should be considered in this context. Some, but not all, D&O policies include severability provisions that preclude the insurer from imputing the knowledge or actions of so-called bad actors to other, "innocent" directors and officers as a bar to coverage. Some severability provisions apply only with respect to the application of some or all exclusions, while other policies may include severability provisions that also relate to rescission defenses (see discussion below). In order to preserve coverage for innocent directors and officers, insureds should seek the broadest possible severability provisions.

CAN THE INSURER RESCIND THE POLICY?

In recent years, many policyholders have been shocked when their insurer responded to a claim by filing a lawsuit seeking to rescind the policy based on alleged misrepresentations in the policy application. In so doing, insurers often point to allegations in underlying securities class-action lawsuits or enforcement proceedings alleging that the insured's financial statements or public filings (which are often incorporated into the policy application) contained false or misleading statements.

Policyholders should carefully review their policies to determine the insurer's right to rescind. While D&O policies often contain a general statement that the insurer relied on the "application" in issuing the policy, the definition of "application" may vary widely. For example, some policies define "application" to include all public filings ever made by the insured. In contrast, other D&O policies limit the definition of "application" to include only those recent filings that the policyholder directly submitted to the insurer.

Certain D&O policies contain a "prior knowledge" exclusion or some other provision in the policy that requires the insured to disclose any known or potential claims before entering into the policy. In many cases, the application for the policy contains a question seeking information on all potential claims. If insureds have knowledge of a potential claim, but fail to notify the insurer before entering into the policy, this provision could allow the insurer to seek rescission. While the insurer's burden on this draconian defense is high, it should be noted

that if the insurer is successful in rescinding the policy, all or some of the insureds could lose all coverage under the policy, not just coverage for the particular claim. As a result, careful thought should be given when entering into a policy to whether there are potential claims to be disclosed.

Again, careful attention should be paid to whether the D&O policy contains a severability provision that applies to the insurer's potential rescission defense. Some D&O policies are silent, while others arguably permit the insurer to rescind the policy with respect to all insureds in certain circumstances or when certain specified senior officers had knowledge of the misrepresentations. While terms offered by insurers vary widely, policyholders should seek broad form severability clauses that eliminate or restrict the insurer's right to rescind the policy. For example, certain policies contain provisions expressly stating that a policy can be rescinded only with respect to an individual that had actual knowledge of the misrepresented facts. Again, a well-drafted severability provision may preserve coverage for innocent directors and the fund itself, even if no coverage is available for so-called bad actors.

WHAT ABOUT OTHER COVERAGE EXCLUSIONS?

D&O policies generally contain a long list of exclusions. Two exclusions that frequently are of concern to funds are the "insured-versus-insured" exclusion and the mutual fund practices exclusion. First, D&O policies often exclude coverage for claims brought against an insured party by a co-insured. The general purpose of this insured-versus-insured exclusion is to prevent collusive claims filed by one insured against another insured for purposes of obtaining coverage for internal governance disputes. This exclusion should be reviewed for consistency with SEC regulations. In the case of a policy covering both funds and their investment adviser or other affiliated persons, SEC regulations preclude application of an insured-versus-insured exclusion to *bona fide* claims made by interested directors or investment advisers against a fund's independent directors. This carve-out recognizes the statutory or fiduciary duties of independent directors to challenge the actions of interested directors or investment advisers in certain circumstances. In essence, it encourages independent directors to fulfill such duties by providing comfort that they will be covered in the event that interested directors or investment advisers respond by filing a lawsuit against them.

In recent years, most D&O insurers have added exclusions for market timing, late trading, fair valuation, revenue sharing, selective disclosure, and other matters. Careful attention should be paid to the scope of these or any other new exclusions. First, it is important to understand the way in which each type of excluded conduct is defined. Second, the text of the definition should be analyzed to determine whether it encompasses any conduct beyond what is intended by its title. Third, the nature and extent of the funds' and other insured parties' involvement in the excluded conduct should be evaluated to determine the extent to which the exclusion may in fact apply.

HAS THE FUND PURCHASED SUFFICIENT LIMITS?

Some funds may have joint liability coverage with other funds having different boards or investment advisers. Because D&O policies usually contain aggregate limits, each payment by the insurer generally reduces the aggregate coverage available for pending or future claims. Although funds usually obtain higher limits through joint policies than they might obtain through separate policies, joint coverage could present a considerable problem in that claims made against another fund may exhaust even the higher aggregate coverage.

WHEN DOES THE INSURER HAVE TO REIMBURSE DEFENSE COSTS?

Certain D&O policies contain a provision that requires the insurer to reimburse the insured's defense costs on a rolling basis while the underlying case is ongoing (although the insurer generally reserves the right to recoup the defense costs if it ultimately determines that the claim is not covered). This provision may prove to be extremely valuable with respect to claims that take many years and substantial defense costs to resolve. If the policy does not require such advancement, insureds may have to finance the cost of defending a matter out-of-pocket until the claim is finally resolved.

Also, many policies require insureds to obtain the insurer's written consent before incurring defense costs or entering into any settlement. In return, insurers often agree that their consent will not be unreasonably withheld. Nevertheless, insureds should determine whether consent is required so that they do not begin to incur expenses without it, thereby potentially raising a barrier to coverage.

WHAT ABOUT STAND-ALONE SIDE A COVERAGE?

As noted above, Side A coverage generally affords coverage for claims against directors and officers that are not indemnified by the fund. While insurers historically have offered Side A coverage in conjunction with Side B coverage (company reimbursement coverage), in recent years, certain insurers have started to offer so-called Side A-only coverage (or stand-alone Side A coverage). In the wake of recent corporate scandals, it has been common for directors and officers to demand that the insured company purchase so-called stand-alone Side A coverage. While this coverage is commonly misunderstood and some funds may be buying this coverage for the wrong reasons, it may offer benefits in certain circumstances.

Again, the terms of Side A policies vary widely, but they generally apply when the insured fund does not indemnify the director or officer. As a general matter, Side A policies offer additional protection to officers and directors when there is some question regarding the fund's obligation or ability to indemnify claims. They also offer limits dedicated to the insured officers and directors, which provides some protection when the fund's D&O policy includes Side C claims against the fund that could erode the aggregate limit. Some Side A policies are non-rescindable.

Nevertheless, Side A policies do not afford protection in all circumstances. While some Side A policies eliminate certain common exclusions in D&O policies, they generally still contain common exclusions for fraud and other improper conduct. In addition, to the extent that underlying plaintiffs demand that directors and officers make contributions to settlements from their personal assets and forego the right to seek coverage (as has happened in recent, high-profile cases), Side A policies would offer no protection.

WHAT ABOUT CHANGING INSURERS?

If a fund group considers changing insurers, it should consider several issues to minimize the chance of creating gaps in coverage. First, the funds obviously should ensure that the new policy takes effect at the same time that the old policy expires. Second, the funds should negotiate for the earliest possible retroactive or continuity date in the new policy. As noted above, certain D&O policies do not cover claims alleging wrongful acts that occurred prior to or relate to a lawsuit pending on a specified date. While the retroactivity date often does not change when a policyholder renews its policy with its existing insurer, a new insurer may seek to include a more recent retroactive date in order to minimize its risk. This could create problems if the insured later faces claims related to activity that occurred prior to the new retroactive date (for example, many operating companies are now facing claims related to the backdating of stock options in the 1990s). Third, the policyholder should consider whether to purchase an extended reporting period under the expiring policy. As discussed above, most policies allow insureds to pay an additional premium to purchase an extended reporting period, which would expand the notice period to afford coverage for claims made during the extended reporting period that relate to wrongful acts that occurred prior to the end of the old policy period.

One final point to keep in mind arises with respect to whether to provide notice of potential claims to the old insurer, the new insurer, or both. Many D&O policies contain provisions stating that if the policyholder becomes aware of "circumstances which could give rise to a claim," it may elect to give notice to its existing carrier. If it does, any claims that are filed after the policy period will be considered to have been made during the policy period. With respect to the new insurer, as discussed above, many D&O insurers include a "prior knowledge" exclusion or require the disclosure of potential claims in the application.

Unfortunately, D&O policies typically do not define the term "circumstances," and courts have struggled with the issue of when notice of potential claims is required. Disputes frequently arise when the new insurer denies a claim alleging that the policyholder should have disclosed certain "circumstances" during the application process. During any renewal period, but especially when switching insurers, policyholders should carefully analyze, with the assistance of coverage counsel, whether they need to provide notice based on the facts and circumstances of the potential claim, the likelihood of it ripening into an actual claim, the specific terms in the relevant policies, and a myriad of other factors, including whether the limits of the expiring policy have been exhausted or impaired and/or whether the new carrier intends to add an exclusion that may bar coverage for the potential claim.

* * *

The preceding discussion highlights some of the key considerations for fund directors and other insureds in reviewing and renewing their D&O liability coverage. Policy forms differ widely and, as illustrated above, some provide substantially broader coverage than others. These differences underscore the importance of having knowledgeable insurance coverage counsel closely scrutinize policy terms so that coverage issues can be addressed at the outset and future problems avoided.

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Industry Events

Please visit our website at www.klng.com, for more information on the following investment management events in which K&LNG attorneys will be participating:

Nicholas Hodge and Derek Meisner: *SEC Enforcement and Examination Issues Impacting Hedge Funds*, Strategic Research Institute 2006 Blue Ribbon Hedge Fund Symposium, July 11-13, 2006, New York, NY

Michael S. Caccese: *Mastering the Investment Advisers Act of 1940: Parts 1 and 2*, National Regulatory Services, July 11, 2006, New York, NY

Diane E. Ambler and Richard D. Marshall: *Learn How to Prepare and Thrive Through an SEC Audit, REG NMS and Soft Dollar Compliance Forum*, Financial Research Associates Conference, July 17-18, 2006, Bethesda, MD

Michael S. Caccese and Richard D. Marshall: *Second Annual IA Compliance and SEC Audit Survival Guide*, Financial Research Associates, July 19, 2006, New York, NY

Michael S. Caccese and Rebecca O'Brien Radford: *Understanding Separately Managed Accounts*, K&LNG Investment Management Breakfast Seminar Series, July 20, 2006, K&LNG, Boston, MA

Alan J. Berkeley: *Postgraduate Course in Federal Securities Law*, ALI-ABA, July 20-22, 2006, Boston, MA

Michael S. Caccese: *Preparing for an SEC Exam*, Hedge Fund Accounting and Administration Forum, Financial Research Associates, July 24, 2006, New York, NY

Michael J. Missal and Richard L. Thornburgh: *Internal Investigations*, American Corporate Counsel Association, July 26, 2006, Webcast

Michael S. Caccese: *Preparing for an SEC Hedge Fund Examination*, Financial Research Associates, LLC, July 31, 2006, Webinar

Richard D. Marshall: *Nuts & Bolts of SEC's Risk-Based Exam Program*, Financial Research Associates, LLC, August 2, 2006, Webinar

Michael S. Caccese: *Mastering the Investment Advisers Act of 1940: Parts 1 and 2*, National Regulatory Services, August 8-9, 2006, San Francisco, CA

Richard D. Marshall: *Annual Compliance Review Preparation*, Financial Research Associates, LLC, August 24, 2006, Webinar

Nicholas S. Hodge: *Business Best Practices*, Lipper HedgeWorld's Third Fund Services Expo 2006, September 12, 2006, New York, NY

Rebecca O'Brien Radford and Richard D. Marshall: *Marketing and Advertising Compliance Forum for Investment Advisers*, Financial Research Associates, LLC, September 13-14, 2006, New York, NY

Cary J. Meer: *GAIM USA Funds of Funds 2006*, Institute for International Research, September 18-20, 2006, New York, NY

Nicholas S. Hodge *Current Issues Affecting Hedge Funds*, K&LNG Investment Management Breakfast Seminar Series, September 19, 2006, K&LNG, Boston, MA

Michael S. Caccese: *Mastering the Investment Advisers Act of 1940: Parts 1 and 2*, National Regulatory Services, September 20, 2006, Chicago, IL

Mark P. Goshko, Mark D. Perlow and Richard M. Phillips: *Investment Adviser Compliance Forum West*, Financial Research Associates, LLC, September 20-21, 2006, San Francisco, CA

Derek M. Meisner: *UBS's Inaugural COO/CFO Hedge Fund Conference*, September 27-29, 2006, Scottsdale, AZ

Clifford J. Alexander, Mark P. Goshko and Richard D. Marshall: *National Society of Compliance Professionals National Meeting*, October 18-20, 2006, Washington, D.C.

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