K&L|GATES

Investment Management Update

Lawyers to the investment management industry

Fall 2010

In this issue:

The SEC's Eyes and Ears

By Stephen J. Crimmins

If the reinvigorated SEC Enforcement Division is a "new sheriff in town," its new deputies may be your own employees. Section 922 of the new Dodd-Frank Act provides powerful monetary incentives for employees to contact the SEC directly at the first sign of a possible securities violation, while at the same time creating significant new protections for those whistleblowers. As discussed below, now is the time to focus proactively on ways to enhance early internal detection and resolution of possible problems.

Rich Bounties for Whistleblowers

Dodd-Frank mandates that, where information provided by a whistleblower leads to an SEC enforcement action with monetary sanctions over $1 million, the SEC must pay that individual (and any other whistleblowers, in the aggregate) a bounty of between 10 and 30 percent of the amount collected. To qualify for a bounty,

continued on page 17

The Changing Face of Regulation: Significant Changes Impacting Investment Advisers

By Beth R. Kramer and David Dickstein

During the past twelve months, there have been a number of regulatory developments that impact investment advisers. Both new, and amended, laws and rules were approved that will significantly affect the way investment advisers do business. In light of the dramatic changes outlined below, investment advisers will be required to reevaluate their SEC registration status as well as update their policies and procedures to remain in compliance with the new and impending regulatory reform.

Amended Custody Rule.

On December 30, 2009, the SEC released amendments to the Custody Rule (*i.e.*, Rule 206(4)-2 of the Investment Advisers Act of 1940). The amended Custody Rule (with significant exceptions) provides that a registered investment adviser with custody of client funds or securities (*i.e.*, generally holding directly or indirectly client funds or securities or having any authority to obtain possession of them) is required, among other things: (i) to undergo an annual surprise examination by an independent public accountant to verify client assets; (ii) to maintain client funds and securities with a qualified custodian; (iii) to have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients (eliminating the option for the adviser to send them itself); and (iv) if the adviser opens the custodial account on behalf of the client, to have the adviser notify the client of the qualified custodian's name, address and the manner in which the funds or securities are maintained promptly upon opening the account and following changes to the information. In addition, if client assets are maintained at a qualified custodian that is not independent of the adviser, the adviser must obtain a report of the custodian's internal controls relating to the custody of those assets (typically a SAS-70 Report) from an independent public accountant registered with the Public Company Accounting Oversight Board. There are a number of exceptions to some of these requirements for advisers to pooled investment vehicles that undergo annual audits and advisers that have custody because their client invested in "private securities" as defined by the Custody Rule. The amendments to the Custody Rule became effective on March 12, 2010. For further information, please see our K&L Gates Alerts, "SEC Releases Amended Custody Rule" (January 2010) and "SEC Offers Guidance on Looming Custody Rule Amendments" (March 2010).

continued on page 16

Compliance Corner

New Interactive Data "XBRL" Filing Requirements For Mutual Funds

By Kathy Kresch Ingber and Mirela Izmirlic

The SEC rule amendments requiring mutual funds to file and post on their websites their risk/return summary information in an interactive data format, using "eXtensible Business Reporting Language," commonly referred to as "XBRL," require compliance by the beginning of 2011. The SEC adopted the XBRL rules in late 2008 shortly after adopting summary prospectus requirements for mutual funds. Recognizing the burden associated with requiring mutual funds to comply with new XBRL rules while revising their prospectuses, the SEC delayed the compliance date for the XBRL rules until January 1, 2011, a year after compliance with new summary prospectus requirements was required.

K&L Gates is working with clients and the SEC to prepare for the new filing requirements, which are intended to improve the usefulness of risk/return summary information for investors. XBRL files will allow investors to download mutual fund cost and performance information directly into spreadsheets, and analyze the data using easily accessible software or investment models. Interactive data also will facilitate the comparison of mutual fund cost and performance information across different funds and classes of the same fund.

We have summarized below, in a Q&A format, certain highlights of the new rules.

New Registration Statement Filing Requirements

What are the new filing requirements?

Mutual funds are required to file the new exhibit with the SEC, on the EDGAR system, in conjunction with initial registration statements and annual registration statement updates that become effective after January 1, 2011.

What is risk/return summary information?

A mutual fund's risk/return summary information includes the fund's Investment Objective, Fee Table, Expense Example, Portfolio Turnover, Principal Investment Strategies, Principal Investment Risks and Performance information. The disclosure of this information is required by Items 2, 3 and 4 of Form N-1A.

Is the new exhibit included in a mutual fund's registration statement filing?

No. The interactive data exhibit will be filed with the SEC as a separate post-effective amendment to a mutual fund's registration statement pursuant to Rule 485(b) under the Securities Act of 1933 as amended ("Securities Act").

What is included in the interactive data exhibit post-effective amendment filing?

The post-effective amendment will contain the new exhibit, a facing page, a signature page, a cover letter explaining the nature of the amendment and a revised exhibit index.

When is a mutual fund required to file a post-effective amendment containing the interactive data exhibit?

A mutual fund must file a post-effective amendment that includes the interactive data exhibit no later than 15 business days after the effectiveness of the related registration statement filing.

Does the information included in the new exhibit differ at all from the risk/return summary information in a fund's registration statement?

No. The risk/return summary information included in the interactive data exhibit is the same information that is filed with a fund's registration statement. The new rules do not change existing substantive disclosure or formatting requirements for mutual fund prospectuses.

Is a mutual fund required to file an interactive data exhibit in connection with the filing of a summary prospectus pursuant to Rule 497(k) under the Securities Act?

No. A fund is not required to file an interactive data exhibit in connection with the filing of a summary prospectus because the fund's summary prospectus includes the same information as the fund's statutory prospectus, which is filed as a part of the fund's registration statement.

Is a mutual fund required to file an interactive data exhibit for a class that is registered but not offered for sale?

Yes. A fund is required to file an interactive data exhibit for all effective series and classes of the fund.

Can a mutual fund include a legend in the exhibit cautioning investors to read and consider the full prospectus or other filing to which the exhibit relates before making an investment decision?

No. The information included in the interactive data file may not differ from the information included in the related registration statement filing. The SEC intends to include on its interactive data viewer a default legend recommending that investors review a fund's full prospectus before investing.

Do the new requirements apply to closed-end funds?

No. The new requirements apply only to open-end management investment companies.

Does the filing containing the interactive data exhibit require auditor consent?

No. A mutual fund's auditor will not be required to consent to the interactive data exhibit filing.

Prospectus Supplements

Is a mutual fund required to file a new interactive data exhibit in connection with a prospectus supplement?

A mutual fund is required to file a new interactive data exhibit in connection with a prospectus supplement only to the extent that the prospectus supplement changes the fund's risk/return summary information.

Is the updated interactive data exhibit that is submitted with a prospectus supplement filed as a post-effective amendment?

No. An interactive data exhibit submitted in connection with a prospectus supplement must be filed pursuant to Rule 497(c) or (e) under the Securities Act either (1) with a prospectus supplement, or (2) in a separate Rule 497 filing within 15 business days thereafter.

Website Posting Requirements

When is a mutual fund required to post an interactive data file on its website?

A mutual fund is required to post an interactive data exhibit on its website by the earlier of (1) the end of the calendar day that the interactive data exhibit was filed with the SEC, or (2) the date that the fund was required to file the interactive data exhibit with the SEC.

How long is an interactive data exhibit required to remain on a mutual fund's website?

An interactive data exhibit must remain on a mutual fund's website for as long as the registration statement or prospectus supplement to which it relates remains current.

Can a mutual fund post a link to the SEC website to access the interactive data exhibit?

No. A mutual fund may not comply with the website posting requirements by including a hyperlink to the SEC website on the fund's website.

Consequences of Non-Compliance

What are the consequences of failing to file or post an interactive data exhibit in connection with a mutual fund registration statement or prospectus supplement?

If a mutual fund does not file an interactive data exhibit with the SEC or post the interactive data exhibit on its website, the fund's ability to file a post-effective amendment to its registration statement pursuant to Rule 485(b) under the Securities Act will be suspended until the fund complies with the requisite filing and posting requirements. The suspension becomes effective at the time that the filer fails to meet the requirement to submit or post interactive data and terminates as soon as the filer has submitted and posted that data.

Does the suspension apply to post-effective amendments filed for the purpose of submitting an interactive data exhibit?

No. A mutual fund will be permitted to cure a failure to file an interactive data exhibit by filing the exhibit in a post-effective amendment to its registration statement or a prospectus supplement, and posting the information on its website.

Does the failure to file an interactive data exhibit for one series suspend the ability to file Rule 485(b) filings for all series of a mutual fund?

Yes. If a mutual fund is not current in its obligation to file an interactive data exhibit for one series, the fund's ability to file a post-effective amendment pursuant to Rule 485(b) for all series will be suspended.

Will the failure to file an interactive data exhibit affect a mutual fund's ability to incorporate by reference the fund's prospectus into another document?

No. The failure to file an interactive data exhibit will not affect a mutual fund's ability to incorporate by reference the fund's prospectus into its summary prospectus or another document.

Liability

Is a mutual fund subject to liability under the anti-fraud provisions of the federal securities laws in connection with an inaccurate or incomplete interactive data file?

Yes. A mutual fund will be subject to liability under Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 there under and Section 206(1) of the Investment Advisers Act of 1940 to the extent that an inaccurate or incomplete interactive data file is deemed to defraud an investor.

Is a mutual fund subject to prospectus liability under the federal securities laws in connection with an inaccurate or incomplete interactive data file?

Until October 31, 2014, an interactive data file will be deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act, Section 18 of the 1934 Act or Section 34(b) of the Investment Company Act of 1940. As a result, a mutual fund will not be subject to liability under these provisions in connection with an inaccurate or incomplete interactive data exhibit. After October 31, 2014, an interactive data exhibit will be subject to the same liability provisions as the related registration statement or prospectus supplement.

What is a mutual fund's liability for transmission errors?

A mutual fund will not be subject to liability or the anti-fraud provisions of the federal securities laws in connection with an error or omission resulting solely from an electronic transmission error beyond the fund's control. However, the fund must file an amendment to correct the error or omission as soon as reasonably practicable after becoming aware of such error or omission.

What is a mutual fund's liability for formatting errors?

Until October 31, 2014, a mutual fund will be deemed to have complied with the content, formatting, submission and posting requirements of Regulation S-T, Rule 405 and will not be subject to liability under the anti-fraud or other provisions of the federal securities laws if the fund: (1) makes a good faith effort to comply with the content, formatting, submission and posting requirements; and (2) promptly amends the interactive data file to comply with applicable requirements after the fund becomes aware that the interactive data file does not comply with Rule 405.

What does "promptly" mean?

Regulation S-T, Rule 11 defines "promptly" to mean "[a]s soon as reasonably practicable under the facts and circumstances at the time." The definition is followed by a non-exclusive safe harbor, which provides that an amendment to an interactive data file that is made by the later of 24 hours or 9:30 a.m. on the next business day after a fund becomes aware of the need for a correction is deemed to be promptly made. In the adopting release for the new XBRL rules, the SEC explained that "[i]f a fund fails to comply with the safe harbor, the fund still may have corrected promptly depending on the applicable facts and circumstances."

Hardship Exemption

Is a hardship exemption available?

Yes. The new XBRL rules provide a continuing hardship exemption that is available to funds that are unable to submit interactive data without undue burden or expense.

How can a mutual fund avail itself of the continuing hardship exemption?

A mutual fund must apply in writing for the continuing hardship exemption. If the SEC grants the request, the fund must file the information in paper by the applicable due date and file a confirming electronic copy if and when specified in the grant of the request.

Does the continuing hardship exemption apply to the posting of an interactive data exhibit on a fund's website?

Yes. A fund also can apply in writing for an exemption from the requirement that the fund post an interactive data exhibit on its website if the information cannot be posted without undue burden or expense.

Filing Matters

How is an interactive data exhibit filed?

A mutual fund's interactive data exhibit will be filed with the SEC on the EDGAR system. Funds will submit risk/return summary information in an interactive data file using tags prescribed by Regulation S-T and the EDGAR Filer Manual. Document and entity identifier tags will be used to indicate a form type and a fund's name. Funds will format their risk/return summary information using data tags, which contain descriptive labels, references to SEC regulations and other "elements" that enable interactive data to be recognized and processed by software.

How will a fund file disclosure that is not covered by the standard list of tags?

To the extent that a mutual fund uses non-standard disclosure that is not included in the standard list of tags, the fund will create a fund-specific element called an "extension" and a customized tag.

Will risk/return summary information for multiple classes of a fund that are included in one statutory prospectus be filed in the same interactive data exhibit?

Yes. The interactive data exhibit will be formatted in a manner that will permit the information for each class of a fund included in a statutory prospectus to be separately identified. Information that is not class-specific, such as investment objectives, will not be identified by class.

Will risk/return summary information for different series that are included in one statutory prospectus be filed in the same interactive data exhibit?

Yes. An interactive data exhibit will be submitted in a manner that will permit the information for each fund included in a statutory prospectus to be separately identified.

Can I read an interactive data exhibit?

Risk/return summary information in an interactive data format is designed to be read by software. Hence, it is not readable by humans. The SEC's website provides links to interactive data viewers that convert or "render" the interactive data exhibit to a human readable format.

The Voluntary Program

What is the Voluntary Program?

The SEC has established an Interactive Data Voluntary Program, which allows public companies and mutual funds to voluntarily submit XBRL-formatted files to the SEC. The Voluntary Program makes available to mutual funds the opportunity to make a test submission of risk/return summary information in interactive data format until January 1, 2011. The Voluntary Program also offers mutual funds the opportunity to submit exhibits containing a tagged schedule of portfolio holdings in XBRL.

Can K&L Gates prepare a filing for my fund to participate in the Voluntary Program?

We encourage funds to begin the process of having their risk/return summary information prepared in XBRL format and submit test filings under the Voluntary Program to help prepare for the January 1, 2011 compliance date. Our K&L Gates EDGAR filing team can assist you in all aspects of preparing and submitting EDGAR-acceptable electronic filings with attached documents in XBRL format and is available to discuss the current SEC XBRL initiatives.

New XBRL Rule Requirements

Where are the new XBRL rules?

Form N-1A, General Instruction C.3.(g) of Form N-1A directs mutual funds to submit to the SEC and post on their websites an interactive data file in the manner provided by Rule 405 of Regulation S-T. Regulation S-T, Rule 405 governs the content, format and posting of the interactive data exhibit. Regulation S-T, Rules 103 and 406T address liability associated with an interactive data file. Regulation S-T, Rule 202 addresses the continuing hardship exemption. The preparation, submission and validation of the interactive data exhibit are governed by Chapter 6 of Volume II of the EDGAR Filer Manual. ■

Reporting Obligations and Investment Abroad

By Rebecca O'Brien Radford and Douglas Y. Charton

Investing abroad is commonplace in the U.S. investment industry and is integral for those managers that utilize global equity, emerging market and other international investment strategies. The ability to spot undervalued companies and those companies with great growth potential largely drives the success of such strategies. Investment managers should be cognizant of the reporting rules and regulations applicable to "significant shareholders." Because of the wide variance in international reporting rules and regulations, investment managers should become comfortable with the reporting obligations before acquiring foreign securities on behalf of their clients.

There oftentimes can be unusual or unexpected laws or restrictions that may be relevant to the investment manager or the issuer in which the manager plans to invest. Some of the key issues to be aware of are:

- Fundamentals: What holdings thresholds trigger a filing requirement? When must the filing be made? What are the potential penalties?
- Aggregation: When must holdings of affiliates of the investment manager be aggregated?
- Investment Limits: What transactions/ acquisitions are prohibited by local law?
- Other Issues and Considerations: What other issues may arise in connection with global investment strategies?

Significant Shareholding Fundamentals

What are the initial thresholds?

This question will yield widely varying responses depending on the country. In the U.S., we are used to 5% reporting (Rule 13d-1), but reporting may be required at lower levels elsewhere. For example, the following countries impose their first threshold at 3% or lower:

- 1% - Bulgaria (insurance companies) and U.K. Takeover Panel.
- 2% - Portugal and Italy.
- 3% - Germany.

On the other hand, other countries have thresholds more similar to the Exchange Act's Section 13 requirements in the United States. Canada, Mexico and Serbia each impose an initial 10% threshold.

Are there subsequent thresholds?

"Yes" will almost always be the answer to this question. After the initial threshold, there will usually be subsequent thresholds, the crossing of which also will trigger notification filings. Additionally, filings may be required when falling below a threshold. To illustrate how much variance there is across country regimes, here is a sample of some of the thresholds in selected countries:

- Canada's initial threshold is 10%, and subsequent increases of 2.5% and decreases of 2% will also trigger filings;
- Germany imposes a mandatory public offering of an issuer's shares (including those acquired) when one person has acquired 30% or more.
- India has thresholds (among others) at 14%, 54% and 74%.

Investment managers should become comfortable with reporting obligations before acquiring foreign securities on behalf of their clients

- Malaysia has an initial threshold of 5% and subsequently requires a notification of all changes in ownership.

When must the filing be made?

It should be no surprise at this point that the answer to this question depends on the jurisdiction. Obviously, the deadlines of the most concern and those most often violated are those that allow for the least amount of time between the transaction and the deadline. Below are selected deadlines:

- 3:30 p.m. the date after the transaction (UK Takeover).
- 9 a.m. on the day following the transaction (Mexico).
- "Immediately" (Brazil, Norway).
- "Without delay" (Finland).

What are the penalties for failure to file or filing late?

Usually, a first offense will induce only a warning from the regulator unless there is an indication that the violation was willful or intentional. Civil penalties include fines, public reprimands, suspension of voting rights and mandatory divestiture. Criminal penalties, including imprisonment, are generally reserved for the most extreme cases. Advisers must analyze what implications any foreign penalties would have on their U.S. disclosure obligations. There also is the question of damages associated with a mandatory divestiture. If the sale causes transactions costs and/or the realization of losses, the adviser will have to address the potential for liability to its client for those costs and losses.

Aggregation

Generally, an entity must aggregate all of the shares (generally, only voting shares are counted) for which it is the beneficial owner and over which it has voting/dispositive power. Discretionary investment advisers almost always will have to aggregate shares held by all of their clients. For parent companies, the issue becomes more complicated. Certain countries will presume that a parent company exerts influence over its wholly-owned subsidiaries regarding the voting of shares, and only a declaration made by the parent with the regulator may rebut the presumption and avoid a filing on behalf of the parent(s). Certain countries also may impose information barrier requirements between sister affiliates or parents and their subsidiaries to ensure that the appropriate entities are making the substantial shareholding notifications. As is evident by the above, there are similarities between the reporting rules in some foreign jurisdictions and those promulgated under the Securities Exchange Act of 1934. The corollary is equally true. Some countries require aggregate filings.

Investment Limits and Restrictions

Certain countries impose investment limits and restrictions on certain industries and/or issuers. Sometimes these rules are reflected in the substantial shareholding regimes and in other cases may be laws wholly separate from those regarding substantial shareholding. Issuers in the financial services and insurance industries are the most common issuers subject to restrictions. As an example, Mexico passed a law that prohibits the ownership of Mexican financial institutions by foreign governments. Because public pension plans, as instruments of state governments, are included within the scope of the statute, public pension plans were forced to divest any holdings in Mexican financial institutions.

Other rules are not hard line prohibitions, but rather require prior notification to the foreign regulator. Some go even further and require the prior consent of the regulator before a certain amount of an issuer's shares may be acquired. Oftentimes, at a minimum, a declaration will be required stating that the acquisition is being made for investment purposes only.

Finally, there may be additional limits or restrictions built in to the governing or organizational documents of an issuer.

Other Issues and Considerations

There are a number of other issues, apart from substantial shareholding notifications, that investment managers also should be aware of:

- Repatriation (especially in emerging market countries).
- Currency controls.
- Taxes (stamp, capital gains, ordinary income).
- Treaty issues.
- Know Your Customer (KYC).
- Anti-money laundering.
- Privacy.

Investment managers that utilize global investment strategies should seek to find competent local counsel to assist with shareholder notification requirements. K&L Gates LLP has counsel "on the ground" in over 30 jurisdictions, and has worked with its wide network of local counsel in multiple other jurisdictions to assist its clients in complying with the local rules. By obtaining legal advice early on, investment managers will reduce the possibility of overlooking low substantial shareholding thresholds and/or obscure laws or regulatory requirements. Finally, it is important for investment advisers, especially during this time of widespread financial reform, to remain informed of proposed and pending legislation as well as new regulations that may be promulgated abroad that may have an effect on the manager's business. ■

Islamic Financial Product Development: Reverse Engineering versus Innovative Engineering

By Jonathan Lawrence

When any investment management company or other financial services firm decides to innovate in its product offering, there is a relatively well trodden path of product development. This article explores the extra dimensions to be considered when innovating financial products in the Islamic (or Shariah) finance space.

The Market, the Ideal and the Approach to Innovation

In excess of $500 billion in assets are managed in accordance with Islamic principles globally and the sector is growing at more than 10% per year. There are many Islamic finance principles that have been interpreted and adapted over the past thirty years, such as the prohibitions against interest and excessive risk. Products should ideally fulfill the form and spirit of Islamic law.

A majority of Islamic product development has been undertaken within conventional financial institutions. There is therefore an inherent tension between the development of:

- Islamic compliant products based on conventional financial products, a "reverse engineering" approach when a conventional product is amended to fit an Islamic template; and
- truly original products based on the underlying principles of Islamic law, an "innovative engineering" approach whereby the form and spirit of Islamic law is the basis for the product and the clearance of Islamic compliance is more straightforward.

It is this tension that has led to our suggested guidelines for producing further innovation in the Islamic finance space.

Guidelines for Islamic Finance Product Development

1. Assess the demand for Islamic compliant products. It is sometimes said that certain providers of Islamic finance products are pushing the pace of innovation ahead of market demand. Companies therefore need to test consumer interest in a new product before incurring the development expense. We recommend first to carry out market research in the existing and potential customer base to demonstrate that there is a real market for innovative products. Also, we recommend considering the labelling of the new product. Product descriptions are important and may either inhibit the take-up of the product or tempt others to consider it. Ethical finance is a growing market (i.e. financial products that actively seek to take account of the social and environmental impact of investments). Certain Islamic compliant products have been labelled as "ethical" by financial services firms in order to widen their appeal beyond customers of a particular religious faith. It is important to note that demand for products can come from Muslims and non-Muslims and therefore the target market must be closely identified.

2. Consider the jurisdictions and denominations of the customer base. If a company is looking to offer its products to a wide range of Muslims and non-Muslims interested in Islamic compliant products, then the jurisdictions of the customer base are a key consideration. The jurisdictions of different countries have varying approaches to issues such as insolvency or set-off. These country by country variations increase the development costs. In addition, the market for each product is circumscribed by philosophical differences and denominations of the Islamic faith, for example between the Sunni and Shi'a branches. A product may need to be customized for Saudi Arabia, where generally interpretations of Islamic law are stricter than, for example, in Malaysia. The jurisdictions being targeted will also influence the composition of the Shariah boards of scholars. Some scholars have expertise and reputations in certain countries and certain Islamic schools of thought.

3. Utilize outside expertise. Conventional finance firms will need to employ or contract with those able to offer Islamic structuring advice, whether Islamic finance consultants or law firms with specialist capabilities. The structuring and development work is not generally carried out by the Shariah boards of scholars. They more usually opine on products that have been developed by others.

4. Assemble your board of Shariah scholars with care. The Shariah scholars have an important role in sanctioning new products. However, their role in product development is less defined. A board of Shariah scholars will review a product at a relatively advanced stage, and thereafter any changes can only be minor. If there is a major flaw in the product design, months of time and effort potentially can be wasted.

Some financial institutions maintain a board of Shariah scholars, to whom they refer their proposals for new products. Others may need to compose a board for the first time. It is important to know that a number of scholars sit on the Shariah boards of several financial institutions. On the upside, multiple board memberships mean that certain scholars gain exposure to different approaches in varied environments and are able to draw on wider experience gained from working closely with other experts. These multiple roles reflect the international character of the top scholars. On the downside, multiple board memberships reflect the shortage of top rated scholars with religious and financial credentials and lead to the high level of fees that a number of the outstanding scholars are able to command. It is estimated that there are around 360 scholars who are active in the finance arena. However, only 20 to 25 scholars have an international reputation.

Relatively few scholars have an understanding of conventional finance that enables them to opine on complex innovative products. Also, many scholars prefer to work as part of a Shariah board in order to consult one another on new theories which have not previously been the subject of an opinion (or fatwa). This board structure does give a new product more legitimacy in the market. However the stamp of approval for new Islamic finance products does come at a monetary price in scholar fees which must be factored into the overall development costs.

There is a current debate in the Islamic finance world. Certain commentators would like scholars to extend their role to oversee ethical principles and social goals of financial products in addition to pure legal points, arguing that these principles and goals are an equally important part of the Islamic approach. Other commentators argue that the scholars should maintain only their traditional role of legal oversight.

5. Utilize relationships with regulatory authorities at an initial stage. Given the specialised nature of Islamic finance products it is important that relevant regulatory authorities are involved at an early stage in order that the specific characteristics of the proposed product can be approved. For example, if the proposed product requires tax clearance that step should occur early on so any requirement or objections can be included in the submission to the board of scholars.

6. Use identified international standards and indices where possible. The international standard setting regime for the Islamic finance industry is still under formation. One of the key players is the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). It was inaugurated in 1991 and has since established nearly 60 standards on accounting, auditing, governance and ethical and Shariah standards. Although by no means mandatory, AAOIFI standards provide a sound baseline by which to judge the robustness of new products.

Another industry-wide development is the emergence of specialised indices containing Shariah compliant stocks and shares, including:

- Dow Jones Islamic Market Index (launched in 1999 in Bahrain);
- S&P Shariah Indices (launched in 2006). For example, the S&P 500 Shariah;
- FTSE SGX Asia Shariah 100 (launched in 2007).

The screening of stocks and shares to enter these indices is guided by independent Shariah supervisory boards. The indices evaluate the worth of Shariah compliant portfolios based on stringent criteria. The emergence of the indices helps increase the quality of information available and gives companies a benchmark for use in new equity products.

The Future

The product development process in Islamic finance is sometimes haphazard. However, market participants who bear in mind these guidelines can streamline the process and will have first mover advantage in a rapidly expanding market. ■

Mr Lawrence is co-head of the K&L Gates Islamic Finance and Investment Group and holds the Islamic Finance Qualification awarded by the Securities and Investment Institute, London and the Ecole Superieure des Affaires, Lebanon. You may reach him at jonathan.lawrence@klgates.com or +44 (0)20 7360 8242.

In excess of $500 billion in assets are managed in accordance with Islamic principles globally

Private Fund Adviser Regulation In The Dodd-Frank Era

By Edward G. Eisert

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act" or "Dodd-Frank Act"), enacted into law on July 21, 2010, signals the dawning of a new regulatory era for advisers to private funds, i.e., hedge funds, private equity funds and certain other funds that are exempt from registration under the Investment Company Act of 1940. Except as noted, the provisions of the Act became effective July 21, 2011.

The "private fund adviser exemption" from registration, most commonly relied upon by both U.S. and non-U.S. domiciled advisers, has been rescinded. Several new exemptions have been added, but the utility of these exemptions is quite narrow. In addition, the Dodd-Frank Act directly imposes, or mandates the Securities and Exchange Commission to promulgate and enforce, greatly enhanced recordkeeping and reporting requirements and subjects registered advisers to a significantly more robust examination regime. Consequently, most unregistered advisers to private funds will be required to register and all registered advisers will be subject to significantly greater compliance obligations. Other provisions: (i) raise the financial thresholds for (a) investors to qualify to invest in private funds and (b) advisers to be able to register with the SEC as opposed to the states; and (ii) prohibit banking entities, subject to narrow exemptions, from sponsoring or investing in hedge funds, private equity funds and similar funds. The following is a general overview of the provisions of the Dodd-Frank Act that most directly affect advisers to private funds. Please see www.klgates.com/newstand for more detailed discussion and analysis of these provisions.

The New Regulatory Regime Under the Dodd-Frank Act.

Adviser Registration: Out with the Old Private Adviser Exemption - In with New, Narrower Exemptions; Higher AUM Threshold for Federal Registration.

Historically, most advisers to private funds that have not been registered with the SEC have relied upon the private fund adviser exemption, which was available to an adviser that had fewer than 15 clients during any rolling twelve-month period, did not serve as an adviser to a registered investment company (e.g., a mutual fund) or a business development company, and did not hold itself out to the public as an investment adviser.

In place of the private adviser exemption, the Dodd-Frank Act adds six new exemptions from registration that will be available to: (i) foreign advisers with relatively small amounts of assets under management or advisers solely to "mid-sized" private funds; (ii) advisers that manage assets for clients that have special characteristics or investment strategies; or (iii) advisers that are registered with the CFTC and whose investment programs do not entail predominantly the provision of securities-related advice.

In addition, the Dodd-Frank Act prohibits an adviser from registering with the SEC as opposed to the states unless: (i) it is an adviser to a registered investment company or a business development company; or (ii) (a) it is required to be registered as an investment adviser in the state in which it maintains its principal place of business (and, if registered, it would be subject to examination by the state authorities), and (b) it has AUM of at least $100 million; provided, that this prohibition does not apply to an adviser who, as a result of these provisions, would be required to register with 15 or more states.

Changes to the "Accredited Investor" and "Qualified Client" Standards.

1. Accredited Investor Standard. The value of a natural person's primary residence must be excluded in determining whether he or she satisfies the existing $ 1 million "net worth test" alternative for determining that a natural person is an "accredited investor" for purposes of Regulation D under the Securities Act of 1933. This requirement became effective on July 21, 2010.

2. Qualified Client Standard. The Dodd-Frank Act requires that if the SEC uses a dollar amount test to determine who is a "qualified client" under the Investment Advisers Act of 1940, as it now does, it shall, not later than July 21, 2011 and every five years thereafter, adjust such amount for the effects of inflation.

New Recordkeeping and Filing Requirements; New Examination Process.

1. Types of Records and Information. The Dodd-Frank Act provides the SEC with the authority to require advisers to private funds to maintain records, file reports and, upon request or examination, produce records regarding those private funds. The Dodd-Frank Act also requires the SEC to issue rules requiring each adviser to a private fund to file reports containing such information as the SEC deems necessary and appropriate. The Act gave the SEC the ability to establish different reporting requirements for different "classes" of private fund advisers based on the type or size of private fund(s) advised.

2. Sharing of Information with the Financial Stability Oversight Council. Subject to certain confidentiality protections, the SEC must make available to the Financial Stability Oversight Council any "reports, documents, records, and information filed with or provided to the SEC by an investment adviser" regarding a private fund as the FSOC considers necessary for assessing systemic risk.

"Volcker Rule."

The provisions of the Dodd-Frank Act that are known as the "Volcker Rule" generally prohibit any "banking entity" (and, generally, any systemically important nonbank financial company that may be designated) from: (i) engaging in proprietary trading; or (ii) "sponsoring," or investing in, hedge funds, private equity funds, or "such similar funds" as certain federal agencies may determine by rule.

Conclusion

The Dodd-Frank Act dramatically alters the regulation of private fund advisers and mandates that the SEC and other federal regulatory agencies conduct studies and promulgate rules implementing the legislation. Now is the time for all industry participants to assess the potential effect of the Dodd-Frank Act on their individual business models and contribute to the dialogue with the SEC and Congress in a way that will assure the most thoughtful and appropriate regulatory outcomes. ■

SEC Offers Guidance on Fund Derivatives Disclosure

By Gwendolyn A. Williamson

Detailed substantive guidance on derivative instruments disclosure that investment companies should include in their prospectuses, shareholder reports, and financial statements appeared in a July 30, 2010 letter to the Investment Company Institute (the "ICI") from the staff of the SEC's Division of Investment Management. The staff issued the ICI letter prior to the completion of its ongoing study of fund derivative usage (which could be issued sometime this fall) because "the observations may give investment companies immediate guidance to provide investors with more understandable disclosures related to derivatives, including the risks associated with them."

Background

The SEC earlier had announced in March 2010 that it would begin conducting a review and evaluation of the use of derivatives by mutual funds, ETFs, and other investment companies (the "Study"), with the goal of examining "whether and what" additional regulatory protections might be necessary for those funds under the Investment Company Act of 1940 (the "1940 Act"). SEC Chairman Schapiro explained that the Study was appropriate "given the questions surrounding the risks associated with the derivative instruments underlying many funds." Director Donohue, of the Division of Investment Management, added that the Study is intended to ensure that "regulatory protections keep up with the increasing complexity of [derivative] instruments and how they are used by fund managers."

The Study will focus on current fund prospectus disclosures and whether they adequately address the risks inherent in derivative instruments. In addition, the SEC hopes the Study will resolve concerns as to whether:

- "current practices involving derivatives are consistent with the leverage, concentration, and diversification provisions" of the 1940 Act;
- funds investing substantially in derivatives "maintain and implement adequate risk management and other procedures in light of the nature and volume of the fund's derivatives;"
- fund boards provide "appropriate oversight" of fund investments in derivatives;
- existing rules and regulations sufficiently address the proper procedures for pricing and liquidity determinations of fund derivatives holdings;
- funds making derivative investments should be subject to special reporting requirements.

While the SEC did not establish a firm deadline for finishing the Study, it has imposed a stop on the review of new and pending applications for exemptive relief from ETFs planning to "make significant investments in derivatives," pending completion of the Study. ETFs making derivatives-based investment strategies include "actively-managed and leveraged ETFS that particularly rely on swaps and other derivative instruments to achieve their investment objectives." The deferment does not impact any exemptive relief already obtained by an ETF or exemptive applications made by other types of funds.

This deferral of exemptive applications is the only immediate and clear impact of the ongoing Study, but the Study could result in a substantial overhaul of the regulatory framework for funds' use of derivative instruments. The guidance on prospectus disclosure provided by the SEC staff in its July 30 no-action letter to the ICI hints at what the new derivatives rulemaking might look like.

The Study could result in a substantial overhaul of the regulatory framework for funds' use of derivative instruments

Guidance on the Prospectus

In the ICI letter, the SEC staff states that any prospectus disclosure of principal investment strategy/risk related to derivatives should be "tailored specifically to how a fund expects to be managed" and should discuss "the types of derivatives used by the fund, the extent of their use, and the purpose for using derivative transactions." Taking into account "the degree of economic exposure the derivatives create, in addition to the amount invested in the derivatives strategy," a fund's prospectus should:

- address the strategies that the fund (i) expects to be "most important" to achieving its investment objective and (ii) "anticipates will have a significant effect on its performance;"
- describe the intended function of derivatives in the fund's overall portfolio (e.g., for purposes of hedging, speculation, or serving as an economically equivalent substitute for traditional securities); and
- provide investors with "a complete risk profile of the fund's investments taken as a whole, rather than a list of the risks of various derivatives strategies," reflecting the fund's "anticipated derivatives usage."

Funds should avoid derivatives-related disclosure that is "generic, even standardized" – whether abbreviated or highly technical and complex – including disclosure that:

- states as a principal investment strategy that the fund "will or may engage in derivative transactions" instead of stating that "the fund engages in derivative transactions;"
- "enumerate[s] all or virtually all types of derivatives as potential investments;"
- provides a generic purpose for the use of derivatives, such as "for hedging or non-hedging purposes;" or
- broadly characterizes the extent of the transactions by stating, for example, that "the fund may invest 'all' of its assets in derivatives."

These types of disclosure, the staff explains, "may not enable investors to distinguish which, if any, derivatives are in fact encompassed in the principal investment strategies of the fund or specific risk exposures they will entail." In addition, the staff advises that "all funds that use or intend to use derivative instruments should assess the accuracy and completeness of their disclosure," including whether it is presented in understandable "plain English," each year in connection with the annual update of their registration statements.

Guidance on Shareholder Reports

The staff further states that it has observed a variety of discrepancies between the principal investment strategies/risks disclosure in fund prospectuses and the management discussion of fund performance ("MDFP") in fund annual reports, and emphasizes that the adviser's performance discussion "is intended to provide shareholders with information about the factors that materially affected the fund's performance during its most recently completed fiscal year and also should not be limited solely to forward-looking information." More specifically:

- funds with significant derivatives exposure in their financial statements should include a discussion of the effect of those derivatives on fund performance in the MDFP;
- funds whose prospectuses do not disclose principal investment strategies that include the use of derivatives should avoid discussion of derivatives in the MDFP;
- "the MDFP should be consistent with operations reflected in the financial statements, and a fund whose performance was materially affected by derivatives should discuss that fact, whether or not derivatives are reflected in the portfolio schedule at the end of the fiscal year;" and
- a fund's prospectus disclosure – particularly that regarding the investment objective and principal investment strategies and risks – should be fully consistent with the disclosure regarding fund operations included in its annual report.

Guidance on Financial Statements

The SEC staff also suggests ways that funds could improve "qualitative disclosures about their objectives and strategies for using derivative instruments by addressing the effect of using derivatives during the reporting period" in the notes to the financial statements included in their annual reports, as prescribed by FASB accounting standards, specifically Topic 815: *Derivatives and Hedging* ("Topic 815"). Along with such enhanced qualitative disclosures, the staff recommends that, in keeping with the requirements of Topic 815, funds that sell protection through credit default swaps and include credit spreads as part of their disclosure "could improve their disclosures by explaining the relevance of those spreads." Additionally, the SEC staff notes its view that with respect to counterparties to forward currency and swap contracts reported in a fund's schedule of investments, "the identification of the counterparty is a material component of the description and should be disclosed." Basically, "the financial statements and accompanying notes should inform shareholders how a fund actually used derivatives during the period to meet its objective and strategies." ■

New Form ADV Part 2

By Rebecca O'Brien Radford and Abigail P. Hemnes

The SEC adopted a series of significant amendments to the current version of Form ADV Part 2 - commonly referred to as an adviser's "brochure" - on July 28, 2010. These amendments will be effective for a currently registered adviser by its next annual update or, for new registrants, after December 31, 2010. The new Form transforms Part II from its current "check-the-box" format and corresponding disclosure into a publicly viewable, two-part brochure comprised exclusively of narrative disclosures provided in response to specific items or areas. The effect of all items, taken as a whole, is to compel an adviser to make disclosures that describe both the conflicts of interest it faces and how it addresses those conflicts, as well as the adviser's investment strategies and the risks they present. In short, the amended Form requires advisers to conduct a complete overhaul of their disclosure brochure. The most important aspects of the new rule are (1) Part 2A's new, narrative format and the revised disclosure items; (2) the supplemental brochure; (3) the effective dates; and (4) the filing and delivery requirements.

Part 2A: The Firm Brochure

Part 2A, the "firm brochure," contains eighteen separate items, each covering a different disclosure topic that advisers must address. The new Form calls for a succinct, easy-to-understand narrative, in plain English, of the conflicts of interest that may arise in the course of an adviser's business and how the adviser addresses such conflicts. Advisers that provide substantially different advisory services to different clients are allowed to provide clients with different firm brochures as long as each client receives all information about the services and fees that are applicable to that client.

Some of the key disclosure items of Form ADV Part 2A include:

- *Item 2: Material Changes.* Under this new requirement, an adviser must provide a summary that identifies and discusses the material changes to the adviser's firm brochure since the last annual update. This summary is not required if an adviser has not filed any interim amendments to its firm brochure and if the firm brochure continues to be accurate in all material respects. The summary must be presented either on the cover page, the page immediately following the cover page, or as a separate document accompanying the firm brochure.

- *Item 6: Performance Based Fees and Side-by-Side Management.* An adviser that charges performance fees must disclose that fact. Advisers that also manage accounts that are not charged performance fees must describe the conflicts of interest implicated by managing the two accounts with disparate fee structures, such as the adviser's incentive to favor and/or take greater risks in managing accounts that pay a performance fee.

- *Item 7: Types of Clients.* This item now requires advisers to state that they manage funds that rely on one of the private placement exemptions under the Securities Act of 1933. Advisers must be wary that the inclusion of private fund information beyond that which is required could jeopardize those funds' registration exemptions by constituting a public offering or conditioning the market for the securities issued by those funds.

- *Item 8: Methods of Analysis.* Advisers must disclose significant investment strategies and the material risks that each strategy presents. Advisers should be aware that it will be difficult to balance the requirements of the amended Form with the more detailed disclosures contained in their private funds' offering memoranda. Since the disclosure for purposes of Item 8 must be succinct, it generally is not advisable to repeat all of the risk factors contained in an offering memorandum. However, this could leave the door open to a claim that the adviser did not adequately disclose all relevant risks.

- *Item 9: Disciplinary Information.* Advisers must provide material facts about legal and disciplinary events that would be material to a client's evaluation

of the investment adviser. Disciplinary actions are presumptively material if they occurred within the previous ten years, while disciplinary events more than ten years old need only be disclosed if the event is so serious that it remains material to a client's, or a prospective client's, evaluation of the adviser.

- *Item 12: Brokerage.* Advisers must describe, among other items, (1) soft dollar practices, (2) client brokerage practices, (3) directed brokerage practices, and (4) trade aggregation policies. In terms of soft dollar practices, advisers must explain whether they use soft dollars to benefit all accounts proportionately.

- *Item 15: Custody.* If an adviser has custody of client funds and the client receives account statements directly from the custodian, the adviser must explain that clients will receive account statements directly from the qualified custodian that maintains those assets. Pursuant to this new requirement, advisers must explain that clients should carefully review the statements provided by the qualified custodian and compare them to any statements provided by the adviser.

- *Item 18: Financial Information.* Advisers with discretionary power or custody of client assets or who require prepayment of fees must disclose any financial condition reasonably likely to impair the adviser's ability to meet contractual commitments to clients. This item effectively requires advisers to disclose information that will be difficult to disclose, for example, that they are subject to a judgment large enough to cause concern that they can no longer meet their obligations to clients.

Part 2B: The Supplemental Brochure

Part 2B, the "brochure supplement," contains six items advisers must address. The brochure supplement is intended to provide investors with specific information about supervised persons who provide the adviser's clients with investment advice. Advisers must prepare a brochure supplement that provides information responsive to each item of Form ADV Part 2B for every portfolio manager of the adviser who either: (1) formulates investment advice for client assets and has direct client contact; or (2) makes discretionary investment decisions for client assets, even if there is no direct client contact. Advisers may elect to prepare a supplement for each portfolio manager or they can prepare separate supplements for different groups of portfolio managers.

Key requirements of Part 2B include:

- *Item 2: Educational Background and Business Experience.* Advisers must disclose information about the portfolio manager's formal education and business background for the past five years; if a portfolio manager has no formal education or no business experience, this must be disclosed. If an adviser chooses to include information about a portfolio manager's professional designation, it must provide a sufficient explanation of the minimum qualifications required for the designation so that the value of the designation might be understood.

- *Item 4: Other Business Activities.* Advisers must disclose non-investment-related business in which their portfolio managers engage, if the other business activity represents more than 10 percent of a portfolio manager's time and income.

- *Item 6: Supervision.* Advisers must explain how they monitor advice given by portfolio managers. This may create compliance burdens if the supervisory chain changes frequently or is ambiguous, as is the case with many smaller advisers.

Effective Dates

Each adviser applying for registration after January 1, 2011 must file a compliant firm brochure. For currently registered investment advisers, while early compliance is encouraged, a compliant firm brochure must be filed with the next annual updating amendment. Specifically:

- Each registered investment adviser whose fiscal year ends on or after December 31, 2010 must file a compliant firm brochure with its next annual updating amendment (i.e., for advisers with fiscal year ends of December 31, the annual updating amendment containing the compliant firm brochure must be filed no later than March 31, 2011).

- Within 60 days of filing the annual updating amendment, each registered investment adviser must deliver to all of its current clients copies of the firm brochure and the appropriate brochure supplement.

Filing Requirements

Advisers must file all firm brochures with the SEC (but *not* brochure supplements) electronically in searchable PDF format. Firm brochures will be publicly accessible on the IARD website. Advisers must keep the firm brochures filed with the SEC

continued on page 18

The amended Form requires advisers to conduct a complete overhaul of their disclosure brochure

continued from page 1

The Changing Face of Regulation: Significant Changes Impacting Investment Advisers

"Pay-to-Play" Rules.

On July 1, 2010, the SEC adopted Rule 206(4)-5 under the Advisers Act to address "pay-to-play" practices under which direct or indirect payments by investment advisers to state and local government officials are perceived to improperly influence the award of government investment business. The Rule prohibits an investment adviser from (i) providing advisory services for compensation to a government entity client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates; (ii) providing direct or indirect payments to any third party that solicits government entities for advisory business unless this third party is a registered broker-dealer or investment adviser itself subject to "pay-to-play" restrictions; and (iii) soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The Rule became effective on September 13, 2010, and advisers subject to the Rule must be in compliance with the Rule generally within six months of the effective date. For further information, please see our K&L Gates Alert, "SEC Adopts 'Pay-to-Play' Rules for Investment Advisers" (July 2010).

Amended Form ADV Part 2.

On July 28, 2010, the SEC adopted a series of significant amendments to the current version of Form ADV Part II, commonly referred to as an investment adviser's "brochure." In short, the new Form requires advisers to conduct a complete overhaul of their Form ADV Part II (to be renamed, Part 2) and to prepare comprehensive narrative responses to each item. Advisers whose fiscal year ends on or after December 31, 2010 must file a compliant brochure with their next annual amendment (*i.e.*, no later than March 31, 2011). For further information regarding these changes, see the article entitled "New Form ADV Part 2" in this newsletter, page 14.

Dodd-Frank Act.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted into law. Below are some of the key provisions that will have an effect on investment advisers. For further information regarding the Act, see our K&L Gates LLP Client Alerts at (http://www.klgates.com/practices/ServiceDetail.aspx?service=139).

- Registration; Systemic Risk; Changes to Definitions. The Act raises the minimum assets under management required to register with the SEC as an investment adviser from $25 million to $100 million, rescinds the "private adviser exemption" (Section 203(b)(3)) and implements certain changes to the "Qualified Client" and "Accredited Investor" standards. In addition, advisers to "private funds" may become subject to recordkeeping and reporting requirements to be determined by the SEC (and the CFTC for dual registrants). For further information regarding these topics, see the article entitled "Private Fund Adviser Regulation in the Dodd-Frank Era" in this newsletter, page 10.

- Executive Compensation. The Act includes, among other things, new requirements regarding executive compensation of "covered financial institutions," which includes investment advisers registered under the Advisers Act that have $1 billion or more in assets. Within nine months of enactment, the SEC must create rules that require investment advisers to disclose all incentive-based compensation arrangements (not solely executive officer plans) to the SEC in order to determine whether the compensation structure: (i) provides the executive officers, employees or directors or principal shareholders with "excessive compensation, fees, or benefits;" or (ii) could lead to material financial loss to the covered financial institution. In addition, each institutional investment adviser subject to Section 13(f) under the Securities Exchange Act of 1934 must report, at least annually, how it voted any advisory shareholder vote related to executive compensation required by the Act.

- Studies Required under the Act. Pursuant to the Act, the following studies, among others, are required: (i) the Government Accountability Office is required to study the feasibility of forming an SRO to oversee "private funds"; (ii) the SEC is required to conduct a study of the effectiveness of existing standards of care applicable to brokers, dealers and investment advisers in relation to personalized investment advice provided to retail customers; (iii) the SEC is required to conduct a study regarding the adequacy of examinations of investment advisory activities, including whether the creation of an SRO to augment the SEC's efforts in overseeing investment advisers would improve the frequency of examinations of investment advisers; and (iv) the SEC is required to conduct a study regarding the adequacy of disclosures to investors and ways to facilitate investor access to pertinent information.

- Overhaul of the Derivatives Market. The Act imposes substantial requirements on the most active derivatives market participants, including reporting, capital and margin requirements. In addition, swap dealers and major swap participants will be required to register as such with the CFTC and the SEC under the Exchange Act. Thus, investment advisers that qualify as major swap participants may become subject to new regulatory and registration requirements related to derivative trading. ■

The authors wish to acknowledge the valuable assistance of Richard Guidice Jr. and Megan Munafo in the preparation of this article.

continued from page 1

The SEC's Eyes and Ears

the whistleblower must provide information that is "derived from" the whistleblower's "independent knowledge or analysis," that was not previously known to the SEC, and that "led to the successful enforcement of" an SEC proceeding. Determination of the precise amount of a bounty within the mandated 10 to 30 percent range is left to the SEC's discretion, based on the importance of the information and degree of assistance provided.

The program begins immediately, and whistleblowers can qualify for bounties for information provided even before the SEC issues its implementing regulations. Congress plainly wants the SEC to make full use of bounties to entice whistleblowers, and the Act explicitly tasks the SEC's Inspector General with reporting to Congress whether the SEC actively "promotes" and "widely publicizes" its whistleblower program and manages it effectively. The SEC Enforcement Division is recruiting a "Whistleblower Coordinator" to lead a national team to receive, track and evaluate whistleblower claims; to recommend and process awards, subject to Commission review; and to make the public aware of the SEC's whistleblower program. And plaintiffs' lawyers have revealed that they are already gearing up to facilitate the process.

Bounties must be paid even to whistleblowers who are themselves violators, unless they are criminally convicted. However, whistleblowers who provide false information are not entitled to any award, and whistleblowers are not entitled to awards in connection with information acquired while they were employed by a regulator, law enforcement agency or SRO.

The SEC also must pay a bounty where information it gets from a whistleblower leads to an enforcement action by the Justice Department, another federal agency, an SRO or a state attorney general. The SEC will pay bounties from a newly-created "Investor Protection Fund," funded with undistributed sanctions from other SEC cases, in order to be able to fund bounties in cases where the whistleblower's tip in a particular case leads to a monetary sanction that is collected by a non-SEC enforcer such as a state attorney general.

Protecting the Whistleblower

The Act extends significant protections to whistleblowers. Under the Act, whistleblowers have the option to remain anonymous by providing information to the SEC through counsel, at least until the time the whistleblower applies for payment of the bounty. And where an individual provides information to the SEC or testifies in or otherwise assists an SEC investigation or proceeding, an employer may not "discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against" the individual in "terms and conditions of employment." If the employer does so, the whistleblower can bring an action in federal court seeking double back pay, reinstatement with seniority, reimbursement of litigation expenses, and other relief.

These whistleblower protections dovetail with the SEC's new "cooperation" policy for individuals announced in January. Under this policy, whistleblowers who are themselves participants in a violation can limit their civil liability by providing substantial assistance to the SEC. In return, the SEC's enforcement staff can negotiate reasonable settlement terms or, with Commission approval, agree to entirely forego action against the cooperator.

Preparing for the Whistleblower Era

With whistleblowers now assuming such prominence in the SEC's enforcement efforts, financial services firms can take steps now to foster internal detection, communication and correction of possible problems. Most obviously, firms will want to make sure that their compliance efforts are well organized and adequately funded and that they have sent a clear message to employees concerning management's compliance expectations. Firms will, of course, also want to make sure that supervisors understand the importance of avoiding any appearance of retaliation when an employee comes forward with a problem.

Additionally, firms will want to consider beefing up means for employees to communicate information concerning possible violations anonymously or in protected settings to appropriate persons within the organization. These means should be tailored to the needs of each organization, but in general can take the form of a "hot line" voicemail box, an off-site post-office box, or a designated attorney or other person removed from the supervisory chain to receive information in person or by phone. Once information about a possible violation is received, it should be logged and handled according to an appropriate protocol to assure that it gets the attention it deserves. It will be important for firms to educate all employees, including through refresher training modules or other communications, that these mechanisms exist and are credible and safe for employees to use without fear of retaliation. By getting ahead of developing situations and dealing with them directly in their early stages, firms will prevent them from morphing into big problems that well-paid whistleblowers could bring to the attention of the SEC. ■

Whistleblowers can qualify for bounties…even before the SEC issues its implementing regulations

continued from page 15

New Form ADV Part 2

current by updating them at least annually and promptly when any information in the firm brochure becomes materially inaccurate.

Delivery Requirements

Firm Brochure

In addition to the initial delivery requirements stated above, the ongoing regular requirements for delivery will be as follows:

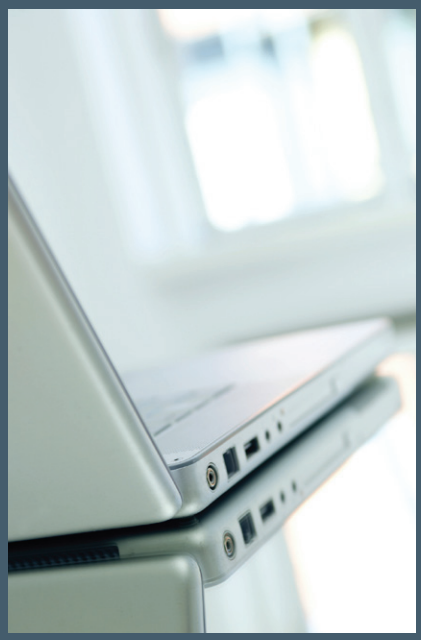
- Effective October 12, 2010, each adviser must deliver a current Form ADV before or at the time it enters into an advisory contract with a client. The current rule requiring delivery either 48 hours before entering into a contract with a client, or upon entering into a contract if the client can terminate within five days without penalty, has been eliminated.
- Annually, after the date on which it files a compliant firm brochure, each adviser must provide each client to whom it is required to provide a firm brochure either (1) a copy of the current (updated) firm brochure that includes the summary of material changes to the firm brochure or (2) the summary of material changes to the firm brochure that includes an offer to provide a copy of the current firm brochure.
- After the date on which it files a compliant firm brochure, each adviser must deliver an updated firm brochure to current clients promptly whenever the firm brochure is amended to add or change a disciplinary event.

Supplemental Brochure

As of the date by which an adviser is first required to electronically file its firm brochure(s), it must begin delivering a portfolio manager's supplement to each new client at or before the time when that specific portfolio manager begins to provide advisory services to that specific client. An adviser is permitted to deliver the brochure supplement electronically. Advisers must make an interim delivery to existing clients when there is new disclosure of a disciplinary event or a material change to disciplinary information already disclosed.

This updating requirement will create compliance challenges since only certain clients will receive certain supplements, depending on which portfolio manager is advising them. Advisers are advised to track carefully which supplements have been sent to which clients to provide them with the appropriate updates. ■

This updating requirement will create compliance challenges



2010 Investment Management Conferences

At these conferences, lawyers from our Investment Management practice will discuss a broad range of topics and practical issues. Each program will also focus on issues confronting the investment management industry, including the regulatory changes that arise from the Dodd-Frank Act and numerous SEC initiatives. Register online at www.klgates.com/events.

Wednesday and Thursday, October 27 and 28	Live at K&L Gates Washington, DC and video conferenced to K&L Gates Charlotte, K&L Gates Dallas, K&L Gates Miami, K&L Gates Newark and K&L Gates Pittsburgh
Thursday, November 4	Live at K&L Gates Chicago
Wednesday, November 10	Live in San Francisco
Wednesday, November 17	Live at K&L Gates Boston
Thursday, November 18	Live at K&L Gates Los Angeles and video conferenced to K&L Gates Orange County, K&L Gates San Diego and K&L Gates Seattle
Tuesday, December 7	Live at K&L Gates New York

Industry Events

Please visit our website at www.klgates.com for more information on the following upcoming investment management events in which K&L Gates attorneys will be participating:

Michael S. Caccese and Mark D. Perlow: NRS Annual Fall Investment Adviser and Broker-Dealer Compliance Conference, National Regulatory Services, October 4-7, 2010, Scottsdale, AZ

Stuart E. Fross: Third Annual National Institute on Investment Management Basics, Boston University, October 14, 2010, Boston, MA

Mark D. Perlow: Oversight of Investment Risk, IDC Investment Company Directors Conference, October 26, 2010, Chicago, IL

Clifford J. Alexander, Ndenisarya M. Bregasi and Michael S. Caccese: National Society of Compliance Professionals Annual Meeting, November 1-3, 2010, Baltimore, MD

Francine J. Rosenberger: Recent Developments in Best Execution, Mutual Fund Directors Forum, November 10, 2010, Webinar

Stuart E. Fross: IAA 2010 Compliance Workshop, Investment Adviser Association, November 10, 2010, Chicago, IL

Jonathan Lawrence: Islamic Finance News Roadshow, November 12, 2010, London, UK

Michael S. Caccese: FRA Hedge Fund Compliance Summit, Financial Research Associates, LLC, November 15-16, 2010, New York, NY

Eric Purple: 2010 Closed-End Fund Conference, Investment Company Institute, November 17, 2010, New York, NY

Stuart E. Fross: IAA 2010 Compliance Workshop, Investment Adviser Association, November 30, 2010, Los Angeles, CA

Please join us for our Seminar

Changes to U.K. Regulation of Alternative Investment Firms

Wednesday, October 20, 2010, K&L Gates New York 8:00 a.m. to 10:00 a.m.

K&L Gates in association with the British Service Providers Association present a free breakfast seminar on the implications of these changes for alternative investment firms establishing and operating businesses in the U.K.

To register for this program, please go to www.klgates.com/events.

Please join us for our Live Seminar and Webinar

Competing Globally in the Asset Management Industry

Tuesday, October 19, 2010, K&L Gates Boston and via Webinar, 8:30 a.m. to 10:00 a.m.

What issues do investment advisers need to address when offering services and funds worldwide? This event will answer that question and many more. Our panel will focus on a few key jurisdictions and how you can penetrate their marketplace

Speakers: Stuart E. Fross, K&L Gates Partner, Boston

Rebecca O'Brien Radford, K&L Gates Partner, Boston

Choo Lye Tan, K&L Gates Partner, Hong Kong

Christina C. Y. Yang, K&L Gates Partner, Taipei

To register for the live program or webinar, please go to www.klgates.com/events.

To learn more about our Investment Management practice, we invite you to contact one of the lawyers listed below, or visit www.klgates.com.

Austin

Robert H. McCarthy, Jr.	512.482.6836	robert.mccarthy@klgates.com

Boston

Joel D. Almquist	617.261.3104	joel.almquist@klgates.com
Michael S. Caccese	617.261.3133	michael.caccese@klgates.com
Mark J. Duggan	617.261.3156	mark.duggan@klgates.com
Stuart E. Fross	617.261.3135	stuart.fross@klgates.com
Mark P. Goshko	617.261.3163	mark.goshko@klgates.com
Nicholas S. Hodge	617.261.3210	nicholas.hodge@klgates.com
Clair E. Pagnano	617.261.3246	clair.pagnano@klgates.com
Rebecca O'Brien Radford	617.261.3244	rebecca.radford@klgates.com
George Zornada	617.261.3231	george.zornada@klgates.com

Chicago

Cameron S. Avery	312.807.4302	cameron.avery@klgates.com
Paul H. Dykstra	312.781.6029	paul.dykstra@klgates.com
David P. Glatz	312.807.4295	david.glatz@klgates.com
Alan P. Goldberg	312.807.4227	alan.goldberg@klgates.com
Thomas F. Joyce	312.807.4323	thomas.joyce@klgates.com
D. Mark McMillan	312.807.4383	mark.mcmillan@klgates.com
Paulita A. Pike	312.781.6027	paulita.pike@klgates.com
Donald S. Weiss	312.807.4303	donald.weiss@klgates.com

Fort Worth

Scott R. Bernhart	817.347.5277	scott.bernhart@klgates.com

Hong Kong

Navin K. Aggarwal	+852.2230.3515	navin.aggarwal@klgates.com

London

Philip J. Morgan	+44.20.7360.8123	philip.morgan@klgates.com

Los Angeles

William P. Wade	310.552.5071	william.wade@klgates.com

New York

David Dickstein	212.536.3978	david.dickstein@klgates.com
Edward G. Eisert	212.536.3905	edward.eisert@klgates.com
Kay A. Gordon	212.536.4038	kay.gordon@klgates.com
Beth R. Kramer	212.536.4024	beth.kramer@klgates.com

Orange County

Gordon F. Peery	949.623.3535	gordon.peery@klgates.com

Raleigh

F. Daniel Bell III	919.743.7335	dan.bell@klgates.com

San Francisco

Kurt J. Decko	415.249.1053	kurt.decko@klgates.com
J. Matthew Mangan	415.249.1046	matt.mangan@klgates.com
David Mishel	415.249.1015	david.mishel@klgates.com
Mark D. Perlow	415.249.1070	mark.perlow@klgates.com
Richard M. Phillips	415.249.1010	richard.phillips@klgates.com

Taipei

Christina C. Y. Yang	+886.2.2175.6797	christina.yang@klgates.com

Washington, D.C.

Clifford J. Alexander	202.778.9068	clifford.alexander@klgates.com
Diane E. Ambler	202.778.9886	diane.ambler@klgates.com
Mark C. Amorosi	202.778.9351	mark.amorosi@klgates.com
Catherine S. Bardsley	202.778.9289	catherine.bardsley@klgates.com
Ndenisarya M. Bregasi	202.778.9021	ndenisarya.bregasi@klgates.com
Beth Clark	202.778.9432	beth.clark@klgates.com
Daniel F. C. Crowley	202.778.9447	dan.crowley@klgates.com
Arthur C. Delibert	202.778.9042	arthur.delibert@klgates.com
Stacy L. Fuller	202.778.9475	stacy.fuller@klgates.com
Susan Gault-Brown	202.778.9083	susan.gaultbrown@klgates.com
Jennifer R. Gonzalez	202.778.9286	jennifer.gonzalez@klgates.com
Robert C. Hacker	202.778.9016	robert.hacker@klgates.com
Kathy Kresch Ingber	202.778.9015	kathy.ingber@klgates.com
Rebecca H. Laird	202.778.9038	rebecca.laird@klgates.com
Deborah A. Linn	202.778.9874	deborah.linn@klgates.com
Cary J. Meer	202.778.9107	cary.meer@klgates.com
Marc Mehrespand	202.778.9191	marc.mehrespand@klgates.com
R. Charles Miller	202.778.9372	chuck.miller@klgates.com
Dean E. Miller	202.778.9371	dean.miller@klgates.com
R. Darrell Mounts	202.778.9298	darrell.mounts@klgates.com
Lawrence B. Patent	202.778.9219	lawrence.patent@klgates.com
C. Dirk Peterson	202.778.9324	dirk.peterson@klgates.com
David Pickle	202.778.9887	david.pickle@klgates.com
Alan C. Porter	202.778.9186	alan.porter@klgates.com
Theodore L. Press	202.778.9025	ted.press@klgates.com
Eric S. Purple	202.778.9220	eric.purple@klgates.com
Francine J. Rosenberger	202.778.9187	francine.rosenberger@klgates.com
Bruce A. Rosenblum	202.778.9239	bruce.rosenblum@klgates.com
Robert H. Rosenblum	202.778.9464	robert.rosenblum@klgates.com
William A. Schmidt	202.778.9373	william.schmidt@klgates.com
Lori L. Schneider	202.778.9305	lori.schneider@klgates.com
Lynn A. Schweinfurth	202.778.9876	lynn.schweinfurth@klgates.com
Donald W. Smith	202.778.9079	donald.smith@klgates.com
Andras P. Teleki	202.778.9477	andras.teleki@klgates.com
Stacy H. Winick	202.778.9252	stacy.winick@klgates.com
Roger S. Wise	202.778.9023	roger.wise@klgates.com
Robert A. Wittie	202.778.9066	robert.wittie@klgates.com
Robert J. Zutz	202.778.9059	robert.zutz@klgates.com

K&L GATES

Anchorage Austin Beijing Berlin Boston Charlotte Chicago Dallas Dubai Fort Worth Frankfurt Harrisburg Hong Kong London Los Angeles Miami Moscow Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh Research Triangle Park San Diego San Francisco Seattle Shanghai Singapore Spokane/Coeur d'Alene Taipei Tokyo Warsaw Washington, D.C.

K&L Gates includes lawyers practicing out of 36 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit www.klgates.com.