LAWYERS TO THE FINANCIAL SERVICES INDUSTRY

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Winter 2006

Take Stock

Consequences of Hedge Fund rule invalidation for Non-US Advisers

Invalidation of the Hedge Fund Rule

Following the US Court of Appeals' decision to vacate the recently adopted Securities and Exchange Commission (the "SEC") rule requiring certain hedge fund advisers to register with the SEC (the "Hedge Fund Rule"), the SEC announced that it would not seek a rehearing of that decision. Instead, as SEC Chairman Cox indicated in his 7 August 2006 announcement, the SEC intends to focus aggressively on rulemaking and enforcement.

The vacated Hedge Fund Rule required investment advisers to treat the security holders in each private fund managed by such advisers as clients for the purposes of determining whether such advisers were required to register under the US Investment Advisers Act of 1940 (the "Advisers Act"). As a result, many investment advisers, including advisers whose principal office and place of business were located outside of the United States ("Non-US Advisers"), were required to register under the Advisers Act and to comply with the Advisers Act requirements. While the applicability of many of the substantive provisions of the Advisers Act to Non-US Advisers hinged on whether the Non-US Adviser had any US clients that directly used the management services of the Non-US Adviser (each, a "Direct US Client"), rather than through a private fund, all Non-US Advisers required to register with the SEC were subject to the SEC's recordkeeping, examination and certain other requirements.

Adviser eligibility to de-register

In light of the SEC's decision not to pursue a rehearing of the US Court of Appeals' decision, all eligible advisers, including Non-US Advisers, are no longer required to remain registered with the SEC. An adviser would be eligible to de-register if it satisfies the requirements of the Section 203(b)(3) exemption from registration under the Advisers Act, the so-called 'private adviser exemption'. This exemption applies if during the course of the preceding twelve months an adviser has had fewer than fifteen clients and neither held itself out generally to the public (effectively meaning the US public) as an investment adviser, nor acted as an investment adviser to any investment company registered under the US Investment Company Act of 1940 (the "Investment Company Act") or to any company which has elected to be a business development company pursuant to the Investment Company Act. A Non-US Adviser not registered with the SEC would generally be permitted under US law to "hold itself out" as an investment adviser vis-à-vis its non-US investors located outside the US to the extent permitted by

Welcome to the Winter Edition.

This edition focuses on several current legal issues that will be of interest to international fund managers and investment advisers, including an update on MiFID which comes into force into 2007 and will introduce substantial changes to UK and EU compliance rules. We also include details of our annual joint US/UK compliance conference at London's Landmark Hotel. The conference will showcase K&LNG's financial services practice, which has over 150 lawyers working on transactional, regulatory, compliance, enforcement and litigation matters for financial services institutions on both sides of the Atlantic.

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other applicable law. Following the invalidation of the Hedge Fund Rule, a hedge fund adviser no longer needs to look through the funds it manages and count the individual investors as clients for purposes of the private adviser exemption. For the Non-US Advisers, only US clients must be counted. Consequently, Non-US Advisers with fourteen or fewer Direct US Clients can now de-register to the extent they otherwise comply with the 'private adviser exemption.'

Non-US Advisers not meeting the above requirements should generally remain registered with the SEC or, alternatively, may bring themselves in compliance with such requirements by reducing the number of their Direct US Clients to fourteen or fewer by the date of their intended withdrawal from registration, and satisfying other applicable requirements.

Benefits of remaining registered; other considerations

Eligibility

Notwithstanding the invalidation of the Hedge Fund Rule, a Non-US Adviser can remain registered under the Advisers Act so long as it engages in the business of advising others for compensation as to the value of securities and/or otherwise meets the definition of "investment adviser" under the Advisers Act, even if it does not have $25 million under management (generally required of US-based investment advisers in order to register with the SEC).

Benefits

Benefits of remaining registered with the SEC may include the following:

- The improved ability to satisfy legal requirements of various jurisdictions in which the adviser has clients or in which it trades in securities or other financial instruments, for example, registration under the Advisers Act may be necessary if the Non-US Adviser desires to have a significant portion of its assets under management represented by US employee benefit plans subject to the US Employee Retirement Income Security Act of 1974 ("ERISA"). In particular, investment adviser registration may be helpful for a Non-US Adviser for the purposes of meeting the "QPAM Exemption," which is an exemption issued by the US Department of Labor under ERISA that provides broad relief for otherwise prohibited transactions between an ERISA plan and certain parties in interest of the plan if the transactions are negotiated on behalf of the plan by a "qualified professional asset manager" ("QPAM");

- The improved ability to satisfy the due diligence requirements of the adviser's potential investors or service providers (for example, a Non-US Adviser's registration with the SEC may help alleviate anti-money laundering and other due diligence concerns of a Non-US Adviser's potential investors and service providers); and

- The ability to hold itself out as an investment adviser to US investors (Registered Non-US Advisers can provide their US investors, including their potential investors, with certain additional information about the Adviser's business and operations, including through their internet sites, without potentially subjecting themselves to the risks of being viewed as "holding themselves out" as investment advisers in violation of US securities laws. Nonetheless, even registered Non-US Advisers should be aware that any private sales of securities to US persons will generally be subject to the limitations of private placement exemptions of the US Securities Act of 1933).

SEC Initiatives

In addition, the SEC has confirmed that in order to eliminate disincentives for voluntary registration and to enable hedge fund advisers that are already registered to remain registered, the registered investment advisers will continue to benefit from the SEC initiatives that were provided in the Hedge Fund Rule. Such initiatives include:

- Allowing investment advisers to private funds which registered with the SEC as a result of the Hedge Fund Rule to continue receiving performance-based compensation from private funds with non-qualified investors and from other clients who are not "qualified clients" if those persons became equity investors in the private fund or entered into investment advisory contracts with the adviser before 10 February 2005 (without this amendment, newly registered Non-US Advisers that remain registered with the SEC would have been required to terminate certain existing advisory contracts and fee arrangements with US clients that provide for performance-based compensation); and

- Not requiring advisers to private funds which registered with the SEC as a result of the Hedge Fund Rule to maintain books and records to support the performance of any private fund or other account for any period ended prior to 10 February 2005. (The rule was designed to accommodate newly registered hedge fund advisers that may not have kept records meeting the requirements of the rule and to prevent them from being at a competitive disadvantage as a result of their inability to use their performance records if they had not maintained records sufficient to meet the requirements of the Advisers Act.).

The SEC has also confirmed that Non-US Advisers with no Direct US Clients will continue to be relieved from various requirements applicable to all other SEC-registered investment advisers. For example, such Non-US Advisers will not be required to designate a 'chief compliance officer' for US purposes and need not have a 'code of ethics'.

Applicability of US Securities Laws

Non-US Advisers that elect to de-register should be aware that they would remain subject to the SEC's guidance and will continue to benefit from certain exemptions applicable to Non-US Advisers. In particular, the SEC previously adopted a 'conduct and effects' test to regulate the activity of non-US advisers. Under the conduct test, conduct that takes place in the United States, wholly or in substantial part, would be sufficient to justify application of the securities laws, even if that conduct has no effect on United States persons or markets. Under the effects test, the securities laws would be applied to conduct outside the territory of the United States that has or is intended to have substantial and foreseeable effects within the United States. Based on this approach, a Non-US Adviser, whether or not registered with the SEC, would generally be exempt from the requirements of applicable US laws (including the Advisers Act as relating to such advisers' fiduciary duties to their clients that apply to both registered and unregistered investment advisers; the US Gramm-Leach Bliley Act; the US Securities Act of 1933; the US Securities Exchange Act of 1934 and the US Insider Trading and Securities Fraud Enforcement Act of 1998), with respect to its non-US clients to the extent that any activity relating to such clients does not take place in the United States and has no intended substantial effects within the United States.

Further Regulation

Furthermore, advisers considering de-registration should also be aware that both the SEC and US Congress may still act in a way that would subject unregistered investment advisers, including the Non-US Advisers, to new rules or regulations, although it is difficult to assess the likelihood of any such event. In particular, a bill has been introduced in Congress that could potentially reinstate the Hedge Fund Rule through legislation. Other potential proposals that are being discussed include the introduction of the additional reporting requirements for investment advisers, the establishment of a self-regulatory regime and the creation of additional incentives for advisers to register and to remain registered under the Advisers Act.

De-registration process

Form ADV-W

If an adviser, including a Non-US Adviser, determines that it is eligible to de-register, and that it would like to do so, such adviser should file Form ADV-W electronically with the SEC. The withdrawing adviser is required by the Advisers Act to maintain certain books and records for the remainder of the period required under the Advisers Act (generally, five years from the end of the fiscal year during which the last entry was made on such record) and to notify the SEC of their location. Accordingly, Form ADV-W, among other things, requires the withdrawing advisers to provide the information relating to such advisers' contact information and the location of their required books and records. The withdrawal is effective upon the SEC's receipt of the filing and its determination that the filing is not deficient.

Timing Considerations

In the event an adviser determines to proceed with de-registration, it should consider doing so before 1 February 2007 to avail itself of the exemptions made available by the SEC for such advisers. In particular, certain Non-US Advisers will be deemed to have custody of their US investors' assets under the Advisers Act even if such assets are held by a third party custodian and will, therefore, upon withdrawal be required to prepare and file a balance sheet as a condition to de-registration. Preparing and filing a balance sheet would not only result in additional costs to the Non-US Advisors, but will also require the Non-US Advisers to reveal information that would otherwise not be publicly available, at least in the US. In order to provide a relief to advisers that would like to de-register as a result of the invalidation of the Hedge Fund Rule, the SEC will not require advisers with custody of their clients' assets to prepare and file a balance sheet as a condition to de-registration, if such advisers de-register by 1 February 2007.

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MiFID - an updated timetable

During October 2006	FSA Consultation on Reforming Conduct of Business Regulation
By 31 October	Close of Consultation period on CP06/14
During December 2006	FSA Consultation on MiFID provisions on marketing communications, as part of the wider FSA financial promotions review
During January 2007	Publication of feedback on CP06/14
By 31 January 2007	EU countries are required to have all their MiFID implementing measures in place.
1 November 2007	MiFID comes into effect across all 25 countries of the EU

Recent developments in MiFID

Since our last MiFID update (Take Stock - Summer 2006 Edition) the FSA has published its Consultation Paper on Systems and Controls (CP06/9) (in May 2006) and a Discussion Paper on "Best Execution under MiFID" (DP06/3) with a draft proposal for implementation due in October 2006 in the Consultation on Reforming Conduct of Business Regulation.

On 15 June 2006 the European Parliament Committee on Economic and Monetary Affairs announced that the European Parliament had voted in favour of the modified draft level 2 measures to implement MiFID. The European Securities Committee published the latest text of the draft level 2 measures on 30 June 2006 and the Regulation and Directive were finally published in the EU's Official Journal on 2 September 2006.

The FSA's consultation paper "Implementing MiFID for firms and markets" (CP06/14) was published in June 2006. This paper dealt with authorisation and passporting, appointment of tied agents, regulatory enforcement and cooperation, principles for business, client assets and certain prudential requirements, regulated markets and multilateral trading facilities, market transparency and transaction reporting.

The FSA published a paper on Implementing MiFID's client categorisation requirements during August 2006.

An updated timetable of events relating to the implementation of MiFID in the UK is above.

New method for calculating capital resources of limited liability partnerships

In section 6 of its July 2006 quarterly consultation paper (CP 06/13) the FSA consulted on a new rule in the interim prudential sourcebook for investment firms relating to the inclusion by limited liability partnerships ("LLPs") of their members' capital in their regulatory capital resources calculations.

At present under FRS 25 (the UK financial reporting standard that implemented international accounting standard IAS 32, and which covers the classification of financial instruments either as liabilities or as equity) some members' capital is accounted for as equity and some is accounted for as a liability. Regardless of the FRS 25 treatment, it is current practice for LLPs to include members' capital in their regulatory capital resources calculations as if it were partners' capital even though, strictly speaking, they have no right to do this under current regulatory rules because of a lacuna in IPRU (INV).

The FSA has recently looked at the way in which LLP members' capital is included in regulatory capital calculations with a view to dealing with the lacuna in IPRU (INV), and clarifying the position.

CP 06/18 proposes that LLPs may include members' capital within the highest tier of their regulatory capital resources calculations, but only subject to certain conditions. These conditions include requirements that the members' capital of the LLP should meet standards of permanency, loss absorbency and discretion over contributions, giving consistency with the characteristics required of other forms of capital that count within the highest tier. The LLP must also document the inclusion of members' capital within regulatory capital through a declaration signed by all members of the LLP and it must be accounted for as equity under FRS 25.

The new rule should come into effect on 1 April 2007, although those LLPs subject to the Capital Requirements Directive (("CRD") the EU's re-cast capital adequacy directive)(being certain types of investment firms) will need to comply with the new rule from 1 January 2007 when the general prudential sourcebook for banks, building societies, investment firms and insurers ("GENPRU") comes into force and which will incorporate the new LLP rules.

Extradition - Is it a real threat and will D&O insurance cover the costs?

There has in recent months been a huge amount of scaremongering in the press following the extradition of the NatWest Three and the jailing of Nigel Potter, former Chief Executive of Wembley, on charges of wire fraud. The US authorities have come under heavy criticism for taking advantage of the UK/US Extradition Treaty (not yet ratified by the US) to extradite British businessmen when its real aim was to assist the war on terrorism. Over half the extradition requests made under the new law appear to relate to white collar crime offences. It seems that executives are being targeted as part of a US crackdown on white collar crime post Enron.

Under the new regime, the US authorities are no longer required to provide evidence of a prima facie case but simply to provide "information" that would justify the individual being arrested for a crime punishable in both countries by a sentence of at least 12 months. In practice, this means that extradition is a real possibility for offences such as bribery, fraud, insider dealing, tax evasion and cartels.

The long arm of US jurisdiction is such that directors of any business with a presence in US markets or with US investors may face prosecution from the US authorities for these type of offences. The US offences of "mail fraud" or "wire fraud" have also been used by the US authorities to extend its jurisdiction even further, to cases where the criminal conduct stems from outside the US but involves the use of the US postal system or electronic communication systems. The NatWest Three is the prime example.

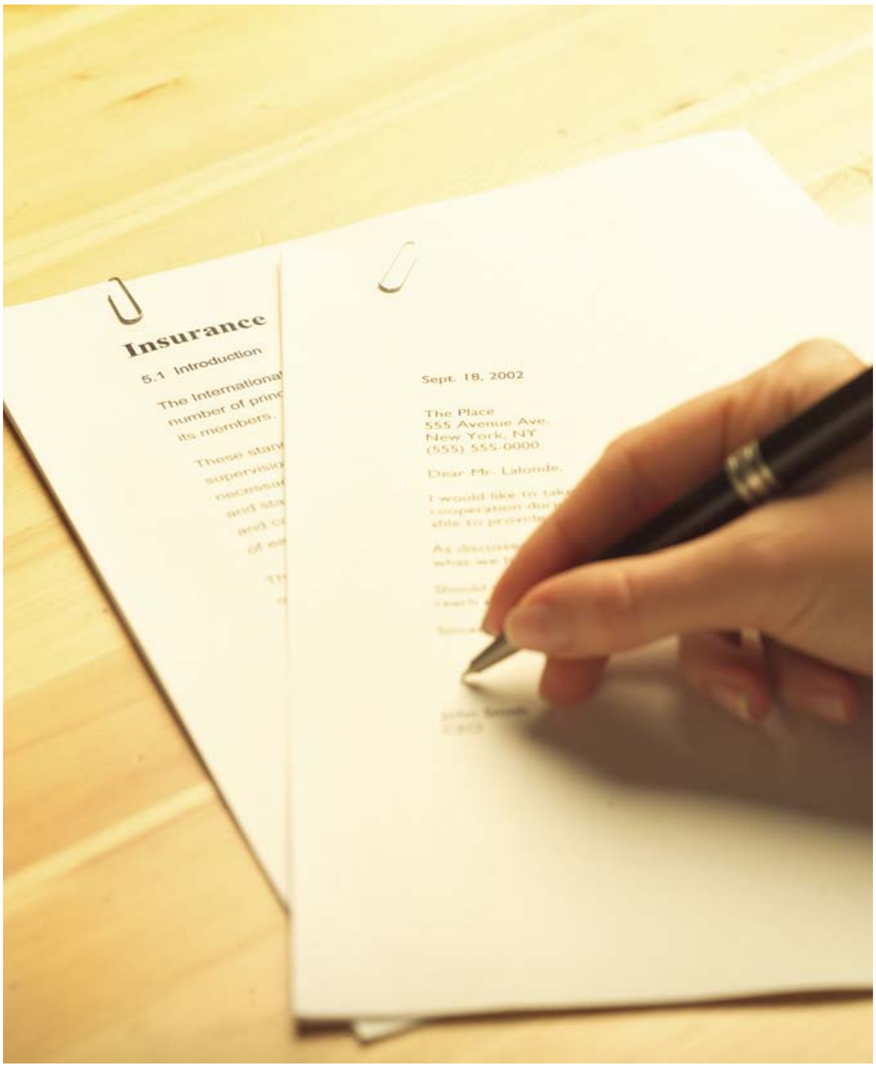
With regard to cartel activity, this was only recently made a criminal offence for individuals in the UK pursuant to the Enterprise Act 2002. Ian Norris, former CEO of Morgan Crucible, is relying on this in his attempts to resist extradition to the US for allegedly conspiring to fix the price of carbon products between 1989 and 2000. The outcome of his case may have knock on implications, with rumours afoot that the US Department of Justice intends to pursue other British and overseas businessmen in relation to alleged price fixing.

The focus has to date been on extradition to the US which is where the majority of extradition requests have come from. It is worth bearing in mind, however, that the more relaxed evidential requirements also apply to requests for extradition made by EU member states and to other states such as Russia and Albania. It is possible that requests from other countries will become more common place.
Until recently, directors and officers liability (D&O) insurance cover has not generally referred to extradition nor to the costs of defending extradition proceedings. This is not entirely surprising given that extradition has not until recently been regarded by policyholders, nor by insurers, as an obvious threat. The D&O policy will typically provide cover for the costs of defending criminal proceedings although such costs may be excluded, or at least become repayable, in certain circumstances, for example in the event of fraud or dishonesty. It is of course arguable that "defence costs" should include the costs of fighting extradition, particularly if this avoids any criminal proceedings being brought. In the light of recent developments, however, policyholders should consider requesting specific confirmation from their D&O insurers that the costs of fighting extradition are covered by the policy.

Policyholders should also check whether their D&O policy does actually cover proceedings and investigations brought in the US. Many D&O insurers expressly exclude US claims and an additional premium will normally be payable for US cover. Even if the policyholder does not have any shares (or ADRs) traded in the US, nor any subsidiaries or other entities operating within the US, the concern is that directors can still be drawn into US regulatory or criminal proceedings.

The long arm of the US jurisdiction is such that policyholders may wish to reconsider the need for US cover, even in circumstances where connections with the US appear somewhat tenuous.

If you would like to attend the Seminar on Directors' Liabilities and D&O Insurance at our London office on Friday 10 November 2006, please contact from our London Insurance Coverage group either Jane Harte-Lovelace (jhartelovelace@klng.com) or Sarah Turpin (sturpin@klng.com). Alternatively, if you would like a review of your D&O cover please let us know.



ERISA: New "Plan Asset" rules for unregistered funds

Among the sweeping changes made by US 'Pension Protection Act of 2006' to the Employee Retirement Income Security Act of 1974 ("ERISA") are significant amendments to the rules for determining whether ERISA applies to unregistered private investment funds and their sponsors, advisers, and managers.

For the past twenty years, private fund managers that permit investment by plans subject to ERISA have looked to a regulation issued by the US Department of Labor to determine whether the assets of their funds are to be treated as "plan assets" for purposes of ERISA. The regulation includes the now-familiar '25% test' which provides that the assets of a privately offered investment fund not registered under the US Investment Company Act of 1940 are treated as ERISA 'plan assets' if 'benefit plan investors' own 25% or more of the value of any class of equity interests in the fund. The 25% test has been changed in two significant respects:

- First, only plans subject to ERISA are to be taken into account in computing the percentage. Before the change, the numerator of the computation included investments by plans of all types, including government plans and non-US plans not subject to ERISA.

- Second, only that portion of the assets of a 'plan-assets fund' that is attributable to investing ERISA plans is taken into account for purposes of applying the 25% test to another private fund in which the first fund invests. Before the change, the entire investment of a plan-assets fund was included in the numerator.

The net effect of these changes (which take effect with respect to transactions occurring on or after 18 August 2006) is that private fund managers will be able to raise significantly more capital from ERISA plans without being subject to the fiduciary responsibility standards or prohibited transaction restrictions of ERISA. Managers that follow a policy of restricting plan investments in order to avoid the application of ERISA are now in a position to permit potentially substantial additional investments by plans. The changes also permit ERISA plans to take advantage of opportunities to invest in private funds that may have been unavailable to them up to now.

Private fund managers have a number of practical issues to address (including, for example, assessing the impact of the revised 25% test on the status of the manager's fund(s) under ERISA and the manager's ERISA compliance procedures).

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Hedge Funds and market abuse: The lessons of The Jabre case

During 2006 the FSA has been focusing its attentions on the regulation of the hedge fund industry and its perceptions of possible market abuse within that industry. The hedge fund market abuse case of Philip Jabre has resulted in the biggest fine ever imposed on an individual and marked a high profile victory for the FSA, providing a useful example of how the FSA deals with regulation and enforcement in the hedge fund industry.

Background

On 28 February 2006 the FSA handed Philippe Jabre a decision notice imposing a financial penalty of £750,000 for:

(a) committing market abuse contrary to section 118 of the Financial Services and Markets Act 2000 ("FSMA") since between 12-14 February 2003 Mr Jabre improperly short sold shares in Sumitomo Mitsui Financial Group Inc. ("SMFG") to the value of $16 million whilst in possession of privileged information;

(b) breaching Principles 2 (Due Skill, Care & Diligence) and 3 (Market Conduct) of the FSA's Statements of Principle for Approved Persons; and

(c) failing to properly consult his compliance department (amounting to a breach of Principle 2).

Mr Jabre's defence focused on two points:

(a) Goldman Sachs had agreed that he could continue with a pre-existing trading pattern of trading SMFG stock and that his trades were consistent with the pre-existing trading pattern; and

(b) the trades in question were not within the FSA's jurisdiction under section 118 of FSMA because they occurred on the Tokyo Stock Exchange which is not a "prescribed market" for the purposes of that section.

These arguments were rejected by the FSA which found that Mr Jabre's activities did occur in relation to investments traded on a prescribed market despite the trades occurring on a non-prescribed market, the Tokyo Stock Exchange. This was because the relevant shares were also quoted on the LSE's "SEAQ International Trading System" (which has since closed and all shares which were traded on SEAQ are now traded on the LSE's ITBU segment).

Key lessons learnt:

- Hedge fund managers will have to be more disciplined in consulting their own compliance officers;
- Hedge fund managers must have a clear understanding as to when they are taken "over the wall" with privileged information and know the distinction between a sounding out proposal and relevant information for the purposes of market abuse;
- Management groups will have to strengthen their compliance departments and create a more pro-active culture of understanding of compliance issues across the firm; and
- The definition of qualifying investments is broadly interpreted and the FSA's powers can extend to foreign stock exchanges where the shares are also listed on the ITBU segment of the LSE's International Bulletin Board (i.e. formerly listed on SEAQ).

The above lessons provide some useful insight as to the direction of FSA regulation of the hedge fund industry. The FSA's preference so far has been to work with the hedge fund industry and not over-regulate the market and push the industry offshore; the Jabre decision confirms its preference for supporting existing regulation in a focused manner.

Forthcoming events

10 November 2006
Seminar on Directors' Liabilities and D&O Insurance (see page 5)

29 January 2007
K&LNG All Day Conference - "Critical Regulatory Issues for International Fund Managers and Investment Advisers", at the Landmark Hotel, Marylebone, London. Topics covered will include:

- New Developments in FSA Regulation of Investment Managers
- New Developments in Hedge Fund and Offshore Fund Regulation
- Ins and Outs of ERISA Prohibited Transaction Exemptions
- 2007 Hot Topics for Investment Managers
- New Developments Affecting SEC Registered Fund Advisers

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