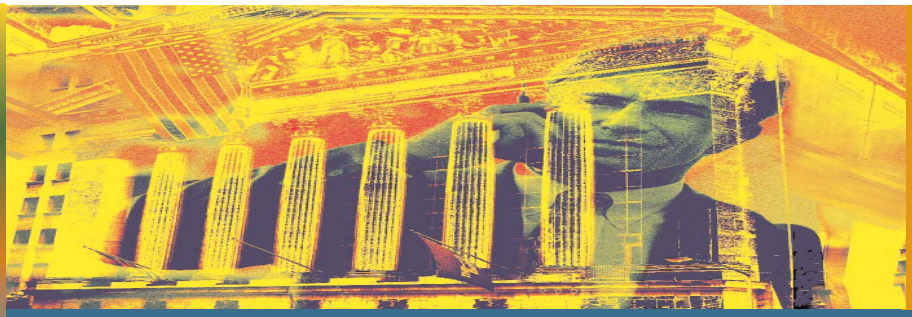

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Spring 2006

Kirkpatrick & Lockhart Nicholson Graham LLP's Investment Management Update

SEC Insights—A Period of Transition

By Diane E. Ambler

The barrage of sweeping new SEC rule proposals and staff actions of the past few years has slowed, and the regulatory environment has begun to settle as the industry and the regulators alike take stock of the impact of all that has occurred. Recent developments affecting previous SEC initiatives include, among other things, the U.S. Court of Appeals for the D.C. Circuit ("Court") vacating, on procedural grounds, the SEC's controversial 2004 fund governance rules; the first appearance of SEC Chairman Cox in testimony before Congress, during which he mentioned little that would raise new regulatory issues for the fund industry; and the imminent deadline for the first annual report of fund CCOs to their fund boards regarding the efficacy of the funds' compliance policies and procedures developed under what may be the SEC's most valuable initiative in past years. With a permanent Director of the Division of Investment Management, "Buddy" Donohue, in place, for the first time in over a year, and a Deputy Director surely soon to follow, key leaders will be in place to set the Division's new direction. Recent news of Chairman Cox's desire to reduce the backlog of SEC exemptive applications from the fund industry is a further sign of new beginnings.

(Continued on page 8)

Disclosure Reform: An Old Crusade Encounters Vast New Possibilities on the Internet

By Arthur C. Delibert

The SEC is once again talking about disclosure reform. Those with long tenures in the industry may be tempted to tune out, because they've heard it all before, but this time around, disclosure reform has a new twist: The Commission is actively exploring ways to exploit the Internet, and especially its interactive features, to make information more accessible and more useable to investors. There are two distinct themes to this new discussion: First, the use of XBRL to permit easier identification and comparison of particular items of information in financial reports; and second, using the power of on-line disclosure as a tool for investor education.

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Welcome to the Spring 2006 Edition of K&LNG's Investment Management newsletter. We offer this publication as a timely aid in addressing the myriad regulatory issues confronting the investment management industry. Watch for future issues discussing up-to-the-minute developments and trends in the industry.

Diane E. Ambler
Editor

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Compliance Corner

CCO Report on Annual Review of Investment Company Compliance Programs: What's in Your Report?

By Francine J. Rosenberger

June 5, 2006 is the deadline by which most mutual fund CCOs must present the first of their annual written reports to the fund's board of directors regarding the adequacy and effectiveness of the fund's compliance policies and procedures. Pursuant to the SEC's mutual fund compliance rules, all funds must have designated (and fund boards approved) a chief compliance officer and adopted (and fund boards approved) compliance policies and procedures satisfying the requirements of the rules by October 5, 2004. The first annual review of these compliance policies and procedures must have occurred no later than eighteen months after the adoption or approval of the compliance policies and procedures, generally April 5, 2006, and annually thereafter. The written report of the CCO to the fund's board of directors must be made within 60 days of the completion of the annual review.

In this first year of implementing the compliance rules, and particularly given the dearth of regulatory guidance identifying expected elements of an annual compliance review, it is unclear what a fund's CCO should include in this written report to the fund board. We have identified below topics the SEC has required be addressed in the CCO's written report and have included some additional topics a written report might include in order to reflect a thorough assessment and evaluation of a fund's compliance environment.

REQUIRED TOPICS IN REPORT

The SEC has provided limited guidance as to what must be addressed in a fund's written report. The investment company compliance rule requires that the written report address, at a minimum:

- The operation of the compliance policies and procedures of the fund and each investment adviser, principal underwriter, administrator, and transfer agent of the fund (service providers);
- Any material changes made to the fund's compliance program and the service providers' programs since the date of the CCO's last report to the board;
- Any material changes to the policies and procedures that are recommended as a result of the annual review; and
- Each material compliance matter involving the fund or a service provider that occurred since the date of the CCO's last report to the board.

ADDITIONAL TOPICS IN REPORT

In addition to the required topics above, many fund CCOs are addressing additional topics that may include some of the following issues, as well as others, in written reports to fund boards:

- Review process—What were the scope and the methods used by the CCO in conducing the review of the fund's and service providers' compliance policies and procedures? To what extent did the CCO rely on third parties in conducting the review?
- Regulatory exams—Have the fund or its service providers been examined by regulators during the reporting period? Were any deficiencies noted? What is the status of their response?
- Personnel—Does the CCO have sufficient support staff? Does the CCO have sufficient resources? What training has the CCO and/or the compliance staff participated in?
- Conclusions of review—Are the fund's compliance policies and procedures adequately designed to prevent and detect violations of the federal securities laws? Are they effectively implemented? How about those of the fund's service providers?
- Plans for the upcoming year—What changes is the CCO considering making to the fund's compliance policies and procedures? Will the CCO conduct another risk analysis? What are the CCO's priority areas for next year? How would the CCO change the review and reporting process for next year?

CCO written reports are taking many forms, as dictated by specifics related to the fund complex, the fund's service providers, the nature of risks present and other matters particular to the circumstances. Over time, as CCOs, fund boards and others become more experienced with this process, and as the SEC may weigh in during the inspection process or otherwise, the nature of the written reports can be expected to evolve.

Blending FSA and SEC Rules for Dually Regulated Non-U.S. Advisers

By Kay Gordon, Philip Morgan and Neil Robson

The establishment of compliance programs and preparation of compliance manuals for investment advisers regulated by the U.K. Financial Services Authority ("FSA") and registered with the U.S. Securities and Exchange Commission ("SEC") can give rise to a number of challenges. Recognising and addressing these challenges is an important step towards creating a compliance program and manual that are practical while remaining reflective of all applicable regulatory requirements. Some of the challenges are considered below.

THE ADVISERS ACT REQUIREMENTS AS APPLICABLE TO NON-U.S. INVESTMENT ADVISERS

The initial challenge for an SEC-registered investment adviser whose principal office and place of business are located outside of the United States ("Non-U.S. RIAs") and whose clients come from multiple jurisdictions is to determine which rules would apply to such adviser's business. The U.S. Investment Advisers Act of 1940 (the "Advisers Act") imposes various requirements on investment advisers registered with the SEC. In particular, rules under the Advisers Act make it unlawful for any SEC-registered investment adviser to provide investment advice to any client unless the registered investment adviser adopts and implements written policies and procedures reasonably designed to prevent violations of the Advisers Act and the SEC's rules by the registered investment adviser or any of its supervised persons. The Advisers Act requirements have to be implemented in conjunction with any local legal requirements applicable to the Non-U.S. RIAs.

The SEC staff has over the years provided guidance in a number of no-action letters to non-U.S. advisers who wish to provide investment advice to U.S. clients. In particular, the SEC staff previously adopted a "conduct and effects" test to regulate the activity of non-U.S. 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 U.S. securities laws, even if that conduct has no effect on U.S. persons or markets. Under the effects test, the U.S. 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-U.S. RIA would generally be exempt from the requirements of the Advisers Act with respect to its non-U.S. 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.

The SEC staff provided further guidance and relief to Non-U.S. RIAs by further refining its views as to what constitutes a U.S. client. Non-U.S. RIAs which do not have any direct U.S. clients (being any U.S. client that directly invests with a Non-U.S. RIA, rather than through a non-U.S. fund) are eligible to take advantage of the so-called SEC "light" compliance regime. These Non-U.S. RIAs are not required to comply with various requirements applicable to all other SEC-registered investment advisers, but remain subject to some of the more fundamental requirements, such as the SEC examination (See "SEC-Light Regime" below).

DIVERGING RULES

A Non-U.S. RIA that is subject to full compliance with both SEC and FSA requirements can look forward to a number of other important challenges. In particular, significant challenges arise when the relevant U.S. and U.K. rules diverge. While there do not seem to be any directly contradictory U.S. and U.K. requirements applicable to dually regulated investment advisers, invariably either the U.K. or the U.S. rules are more onerous on particular issues. The result is that a Non-U.S. RIA must either (1) apply the stricter standard of the two to all of its clients, or (2) treat U.S. and U.K. clients differently because, although FSA rules apply to all clients, SEC requirements only generally have to be implemented with regard to U.S. clients.

Neither choice is entirely satisfactory. Applying the more onerous standard to all clients may impinge on the flexibility of the adviser's business operations and may affect the adviser's competitive position vis-à-vis other managers that are subject to the rules of only one jurisdiction. The alternative, which requires that a Non-U.S. RIA treat its U.S. and U.K. clients differently, could potentially be damaging from a marketing perspective, may result in clients questioning the adviser's loyalties and may be difficult to implement in practice. For example, U.S. rules generally require advisers to disclose to their U.S. clients all conflicts of interest to which they may be subject. U.K. rules impose a duty on an adviser to manage conflicts of interest fairly and permit an adviser to select from a number of possible approaches, only one of which is disclosure to the client.

DIFFERENCES IN TERMINOLOGY

A firm's policies, procedures and compliance manual should be clearly understandable to its employees. Given the different U.S. and U.K. usages of our shared language, the wording of typical U.S. compliance policies and procedures needs to be reviewed in the U.K. to ensure that U.S. usages do not cloud meanings for U.K. staff. As an example, in the U.S., the use of the word "solicitor" has a specific meaning under the SEC rules (a person who refers clients to an investment adviser) whereas in the U.K. the word is almost exclusively associated with the legal profession. Similarly, certain other U.S. legal and business concepts would be confusing for a U.K. employee. Compliance policies, procedures and manuals should be designed to make sure that U.S. legal requirements are clearly explained to U.K. users.

RECORDKEEPING REQUIREMENTS

It may be difficult to develop a single integrated recordkeeping program that satisfies both U.S. and U.K. standards. In particular, depending on whether an investment adviser is subject to a "light" SEC regime, it may be able to keep different sets of records for its U.S. and non-U.S. clients and, therefore, advisers should consider adopting different recordkeeping rules for each category of clients. Advisers should be mindful of differences in specific recordkeeping requirements. For example, under FSA rules, copies of all financial promotions and supporting documentation are required to be retained for a minimum of 3 years; while under the SEC rules, similar, yet not identical types of documents must be maintained for 5 years.

PERSONAL TRANSACTION REPORTING

One important area where there are marked differences between U.S. and U.K. rules is with regard to personal account dealing. U.K. rules require advisers to have written procedures in place for the approval, reporting and monitoring of personal account dealings by staff. Generally this equates to staff members being required to seek the consent of the firm's compliance officer and a record being made with respect to every transaction prior to such transaction's execution. The U.S. rules also call for written procedures requiring any person who is an "access person" (a defined term discussed below) to make reports on commencing employment, and then quarterly and annually regarding all transactions in any securities in which they or any of their family members have beneficial ownership. Unlike the U.K. rules, the U.S. rules do not expressly require a pre-approval of each transaction, except for certain limited circumstances. In fact, however, in order to assure compliance by staff as well as advisers, it is a U.S. industry best practice to require prior authorization.

Identifying persons subject to personal transaction reporting can also be a difficult challenge for Non-U.S. RIAs, especially if any of the Non-U.S. RIAs' U.S. clients are investment companies registered under the U.S. Investment Company Act of 1940 ("1940 Act"). In addition to having to account for the difference between U.K. and U.S. laws, advisers to U.S. registered investment companies must comply with the stricter code of ethics requirements of the 1940 Act. For example, the Advisers Act defines "access person" to only include employees and other "supervised persons" of an adviser. While the Advisers Act definition includes any common employees or officers that an adviser shares with an affiliate, it does not generally apply to officers and employees of affiliates. However, the definition used in the 1940 Act is broader in that it includes any employee of a company "in a control relationship" with the adviser who "in connection with his or her regular functions or duties" has access to confidential information on holdings or transactions of a U.S.-registered investment company.

SEC-LIGHT REGIME

As discussed above, Non-U.S. RIAs with no direct U.S. clients are not required to comply with various requirements applicable to all other SEC-registered investment advisers and, therefore, only need to incorporate a few, if any, applicable U.S. regulatory requirements into their compliance manuals. Investment advisers subject to a "light" regime are not, for example, required to designate a "chief compliance officer" for U.S. purposes, need not have a "code of ethics" and are not subject to various other requirements under the Advisers Act. Nonetheless, light regime RIAs may otherwise become subject to U.S. regulatory requirements often by virtue of their acting as advisers to non-U.S. funds that offer their shares to U.S. investors and trade in U.S. markets (such as the Gramm-Leach-Bliley Act, the Securities Act of 1933, the Securities Exchange Act of 1934 and the Insider Trading and Securities Fraud Enforcement Act of 1988). In such cases, advisers should address the requirements of those U.S. statutes in their compliance programs.

Correspondent Account and Private Banking Account AML Regulations

By Andras P. Teleki

On January 4th of this year, Treasury's Financial Crimes Enforcement Network ("FinCEN") published long-expected final regulations ("Final Regulations") requiring broker-dealers and mutual funds, among others ("Covered Financial Institutions"), to establish and implement due diligence policies, procedures and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts established or maintained for non-U.S. persons ("New AML Procedures"). The New AML Procedures must be part of the Covered Financial Institution's anti-money laundering program ("AML Program") and in the case of mutual funds would need to be approved by the fund's board of directors as a material change to the fund's AML Program.

FinCEN has extended the original compliance date of April 4, 2006 to July 5, 2006 for new accounts; the compliance date for exist-

ing accounts remains October 2, 2006. It should be noted that the implementation of the New AML Procedures is different from the implementation of a customer identification program ("CIP"). In most cases, a CIP is forward looking in that it applies to new customer accounts. The New AML Procedures, however, are applicable to both new accounts opened after July 5th and to existing accounts as of October 2nd.

CORRESPONDENT ACCOUNTS

What They Are. The Final Regulations define "correspondent account" very broadly as an "account" established for a foreign financial institution to handle financial transactions related to the foreign financial institution. As applied to broker-dealers, "account" means any formal relationship established with a broker-dealer to provide regular services to effect transactions in securities. For mutual funds, "account" is defined in the Final Regulations as "any contractual or other business relationship established between a person and a fund to provide regular services to effect transactions in fund shares, including the purchase or sale of shares."

Practically speaking, the definitions of account mean that any account opened by a foreign financial institution with a broker-dealer or mutual fund could be deemed a "correspondent account" subject to the New AML Procedures. Thus, broker-dealers and mutual funds will need to review all of their account relationships, even those not specifically offered as correspondent accounts to clients and investors. Even in cases where a broker-dealer offers accounts only domestically or where a mutual fund makes its shares available only in the domestic market, it is possible that a foreign financial institution may have opened a brokerage or mutual fund account directly with the broker-dealer or mutual fund through domestic channels. It should be noted that in determining whether an account is a correspondent account, it does not matter whether the account was opened for proprietary or intermediary transactions.

The definition of "account" for both broker-dealers and mutual funds includes the concept of providing "regular services." As a result, the definition of correspondent account is limited to arrangements for ongoing services, excluding isolated or infrequent transactions, in contrast to other AML Program obligations, such as broker-dealer suspicious activity reporting and funds share transfer recordkeeping. Thus, according to FinCEN, one-time or infrequent securities transactions outside of the context of an established account relationship would not alone create a correspondent account under the Final Regulations.

What Must Be Done. The New AML Procedures require "appropriate, specific, risk-based, and, where necessary, enhanced policies, procedures, and controls that are reasonably designed to enable the Covered Financial Institution to detect and report, on an ongoing basis, any known or suspected money laundering activity conducted through or involving any correspondent account established, maintained, administered, or managed by such Covered Financial Institution in the United States for a foreign financial institution." This means that a broker-dealer's or mutual fund's AML Program will need to be updated to add specific policies and procedures for (1) identifying correspondent accounts, (2) carrying out the mandated risk assessment, and (3) carrying out any additional monitoring based on the risk assessment.

The Final Regulations specify that the risk assessment shall include, as appropriate: (1) the nature of the foreign financial institution's business and the markets it serves; (2) the type, purpose, and anticipated activity of the account; (3) the nature and duration of the Covered Financial Institution's relationship with the foreign financial institution and any of its affiliates; (4) the anti-money laundering and supervisory regime of the jurisdiction that issued the charter or license to the foreign financial institution, and, to the extent that information regarding such jurisdiction is reasonably available, of the jurisdiction in which any company that is an owner of the foreign financial institution is incorporated or chartered; and (5) information known or reasonably available to the Covered Financial Institution about the foreign financial institution's anti-money laundering record (collectively, the "Risk Factors"). Thus, once an account has been identified as a correspondent account, an analysis of the Risk Factors will need to be carried out to identify whether the correspondent account presents a higher money laundering risk than the average account maintained by the broker-dealer or mutual fund. If it does, then additional monitoring for money laundering is likely warranted. The money laundering risk assessment is inherently subjective in nature, especially given the nature of the Risk Factors. Therefore designing a compliance system will often involve either a strong element of hands-on decision making or extremely sophisticated computer driven analysis of the Risk Factors. For broker-dealers and mutual funds that expect to have a limited number of correspondent accounts, it might be worthwhile to have the entity's anti-money laundering officer lead the risk assessment personally.

Fund/SERV Accounts. With regard to accounts maintained with NSCC Fund/SERV, FinCEN, on March 2, 2006, stated in a letter to the Investment

Company Institute that "provided that the NSCC member is a U.S. financial institution subject to the provisions of Section 312 [of the USA Patriot Act], [FinCEN] believes that the mutual fund is establishing, maintaining, administering or managing an account for the NSCC member, rather than for the NSCC member's customer." Thus, even if the NSCC member's customer is a foreign financial institution, the Fund/SERV account would not be treated as a correspondent account by FinCEN. Therefore, so long as the entity that maintains the NSCC Fund/SERV account with the mutual fund is a U.S. financial institution, the mutual fund should not treat the account as a correspondent account, even if the account is ultimately for the benefit of a foreign financial institution.

PRIVATE BANKING ACCOUNTS

What They Are. The Final Regulations define "private banking account" as an account maintained at a Covered Financial Institution that: (1) requires a minimum aggregate deposit of funds or other assets of not less than $1 million; (2) is established on behalf of or for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account; and (3) is assigned to, or is administered or managed by, in whole or in part, an officer, employee, or agent of the Covered Financial Institution acting as a liaison between the Covered Financial Institution and the direct or beneficial owner of the account. "Non-U.S. Person" is defined as a natural person who is neither a U.S. citizen nor is accorded the privilege of residing permanently in the U.S.

What Must Be Done. The Final Regulations require that the due diligence program for private banking accounts must be designed to ensure, at a minimum, that the Covered Financial Institution takes reasonable steps to: (1) ascertain the identity of all nominal and beneficial owners of the account; (2) ascertain whether any such person is a senior foreign political figure (to identify potential proceeds of foreign corruption); (3) ascertain the source(s) of funds and the purpose and expected use of the account; and (4) review the activity of the account to make sure it is consistent with the foregoing (collectively, the "Private Banking Due Diligence").

In general, broker-dealers and mutual funds do not typically maintain accounts that meet the definition of private banking accounts. Although certain types of broker-dealer or mutual fund accounts may satisfy one or two of the elements of the definition of "private banking account" such as a $1 million dollar minimum threshold or availability to non-U.S. persons, such accounts generally do not meet all three elements of the definition. Traditionally private banking accounts are a service provided by banks to their very wealthy clients. Nevertheless, each broker-dealer and mutual fund will need to ascertain whether it offers or maintains any accounts that meet the definition of private banking account and if so, it will need to implement specific procedures to carry out the Private Banking Due Diligence. Such procedures tend to be quite involved because of the amount and nature of the data that needs to be collected as part of the Private Banking Due Diligence.

THE ROAD TO IMPLEMENTATION

By now, broker-dealers and mutual funds should be well on their way to assessing their account base to determine whether they have any accounts that meet the definition of correspondent account or private banking account and should be developing policies and procedures to implement the New AML Procedures. Mutual funds should be speaking with their service providers regarding how the New AML Procedures might be implemented with respect to fund accounts. Given the subjective nature of the New AML Procedures, it may take significant time to develop processes to implement them. Finally, although the Final Regulations do not set forth any specific record-keeping requirements, Covered Financial Institutions should consider how they will document compliance with the Final Regulations under the general recordkeeping requirements for AML Programs.

E.U. UCITS Funds: Proposals to Clarify the Definition of "Eligible Assets"

By Philip Morgan and Neil Robson

The E.U. Undertakings for the Collective Investment in Transferable Securities ("UCITS") legislation governs how retail funds can be marketed within the European Union and is designed to allow cross-border fund sales to investors of different nationalities. The legislation specifies required core features of UCITS qualifying funds, such as risk-diversification, redemption of units at the request of unit-holders, regular valuation, and oversight by a depositary. The legislation also prescribes which assets a UCITS fund can invest in. Once it has gained UCITS status and is regulated in its home jurisdiction, the fund may apply to be sold in the fifteen pre-May 2004 (principally western European) E.U. countries, and in those of the ten post-May 2004, (principally Eastern European) E.U. countries that have implemented the directive. Throughout Europe approximately €3.5 trillion (U.S. $4.2 trillion) is invested in UCITS funds.

The original UCITS legislation has been amended several times, and the list of investments in which a fund can invest has expanded beyond "transferable securities" to include money market instruments, units of UCITS funds and other collective investment undertakings, as well as banking deposits. The European Commission ("Commission") decided, however, that there was a need for increased certainty as to what a UCITS fund could invest in given

the variety of financial instruments traded on today's financial markets. In October 2004, it therefore asked the Committee of European Securities Regulators ("CESR") (an independent committee made up of representatives from E.U. countries which acts as an advisory group assisting the Commission in its preparation of the finer details of new securities legislation) to conduct a public consultation on possible modifications to the UCITS directive to clarify definitions relating to "eligible assets." The results of that consultation have been incorporated into a proposal to amend the current UCITS legislation. Some of the proposed changes are discussed below.

"TRANSFERABLE SECURITIES" AND CLOSED-END FUNDS

The Commission's proposal notes that there was previously some degree of confusion among fund managers regarding whether units of closed-end funds are "eligible assets." Closed-end fund units, on one hand, are themselves collective investment undertakings, but, on the other hand, their units are often admitted to trading on a regulated market and thus may be considered themselves to be "transferable securities."

The proposal clarifies that units of closed-end funds (whether investment companies or otherwise) can be transferable securities as long as they comply with the general criteria for transferable securities (being those investments which (1) are liquid, (2) have accurate and reliable independent valuation systems, (3) have an issuer that makes information available to the market, and (4) are freely transferable).

MONEY MARKET INSTRUMENTS ("MMIs")

The UCITS directive includes several categories of eligible MMIs. As a result of the range of instruments available, CESR felt it was necessary to provide a more precise set of guidelines as to what is, and what is not, an MMI. The Commission has now proposed that the relevant factors to be taken into account for assessing whether something is an MMI are that it must be possible to repurchase, redeem or sell it in a short period, at limited cost, at low fees, narrow bid/offer spread, and with a very short settlement delay. Accurate and reliable valuations should also be available in respect of it.

DERIVATIVES

CESR and the Commission have considered in detail the need to clarify the criteria for derivatives as there is a wide range of financial indices upon which derivatives may be based. These indices may vary in their composition or in the weighting of their components. In all cases, a UCITS fund must be able to meet its statutory obligations concerning portfolio liquidity and calculation of net asset value. These obligations must not be negatively affected by the features of the underlying index. The Commission has, therefore, clarified that derivatives on financial indices whose composition is sufficiently diversified, that represent an adequate benchmark to the market to which they refer, and that are subject to appropriate public information regarding the index composition and calculation, will be treated as "financial liquid assets" for purposes of the legislation, and therefore, UCITS funds may invest in them.

However, the Commission has also recognized a sub-category of transferable securities with an embedded derivative element (for example, where an investment's return or final value is linked to changes in the price of a commodity, equity or currency (other than that in which the investment is denominated)). Embedding a derivative element into a transferable security incurs the risk that the rules for derivatives imposed by the legislation, such as the limits on exposure or issuer concentration limits, may be bypassed. To avoid this, the proposal suggests that the embedded derivative element should be identified within the host contract, and the impact on the host contract should also be assessed.

INDEX-REPLICATING UCITS

The proposed new UCITS legislation contains criteria to define UCITS that replicate bond or share indices. UCITS funds that comply with the proposed new criteria are permitted to have a higher exposure toward one issuer than was foreseen by issuer concentration limits set out in the original legislation. In view of what may be seen as preferential treatment, the Commission has found it necessary to develop a clear understanding of these criteria and to ensure their uniform application across the E.U. The proposed legislation aims to provide more clarity as to whether a UCITS fund falls under the definition of index-replicating UCITS and thus should provide more certainty about the conditions that justify the preferential treatment of index-replicating UCITS. Otherwise, there is a risk that the increased investment freedoms would be misused, for example, by declaring simple baskets of shares or bonds an "index" in order to circumvent the directive's investment limits.

The Commission's proposals are likely to be implemented as binding regulations later in 2006.

SEC Insights

(continued from page 1)

In what has been one of the more interesting procedural battles in recent times, the SEC's 2004 fund governance rule provisions requiring that funds have independent board chairs and at least 75% independent membership were vacated by the Court in April, in that Court's second review in less than a year of the SEC's process in adopting these rules. This long-awaited decision did little to resolve the debate so well publicized during the leadership of Chairman Donaldson regarding the potential value and concomitant cost of trying to strengthen the hand of independent directors in this way. The Court's most recent ruling focused primarily on the procedural requirements under the Administrative Procedure Act as applied to the SEC's reconsideration of these provisions, mandated by the Court in its first review, which the SEC completed in a matter of days without submitting the issue for additional public comment.

The Court determined to vacate these governance provisions, finding inadequate the SEC's decision to rely on materials outside the official rulemaking record (to estimate the compliance costs of these provisions). Before issuing its mandate, however, the Court allowed 90 days for the SEC to reopen the record for comment on the costs of implementation and file a status report with the Court. SEC Chairman Cox has indicated the SEC will conduct a thorough review of the provisions, including reliable economic data, for presentation to the Court. Unless the SEC prevails on a motion to modify, accelerate, or postpone the mandate before the early July deadline, however, the Court will order the issuance of the mandate, finally resolving the case. This will no doubt be a matter for immediate consideration by the new Division Director.

Chairman Cox's testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs in late April, and his subsequent testimony before the U.S. House Committee on Financial Services, focused primarily on matters not specific to the fund industry. The Chairman did recognize the pending federal court challenge to the SEC's now effective regulation of hedge fund advisers and the continuing discussions regarding SEC regulation of hedge fund advisers, yet he indicated no change in the status of the rule as a result. In that sense, his remarks were consistent with his posture of generally carrying out fund regulatory initiatives set in motion prior to his tenure. The Chairman further indicated that, as a result of the new hedge fund adviser registration rule, the SEC now has access to census data regarding the population of hedge fund advisers, but left open the question of how the SEC or its staff may use that information going forward. This may well be a subject for further discussion once the new Division Director is settled.

The Chairman's prepared testimony dealt principally with the perennial issue of disclosure reform and plain English initiatives, building on a theme of "better access to information and access to better information." In this and other formal remarks, the Chairman has made clear his enthusiasm for developing forms of technology and his eagerness both to permit increased use of technology by registrants in the disclosure process and to better employ technology within the SEC in carrying out its responsibilities. This is a welcome approach from the head of this agency, and one that the fund industry has awaited for some time.

It is a bit early yet for SEC staff inspectors to react with any experience to the content of CCO written annual reports, the first of which are just now due for submission to fund boards. But it can be expected that these reports will provide the staff a wealth of knowledge and basic education regarding best practices as well as general information about comparative compliance operations. The education provided the staff from these reports will, no doubt, be a source for much debate to come. We can expect that gross deficiencies in these reports will be met with enforcement actions, while minor deficiencies will be met with assistance. Where the staff draws the line, and whether events in the middle are addressed cooperatively or combatively, will tell us much about the Cox/Donohue administration.

The Commission could open up the enormous potential of the Internet for investor education with one simple rule change: A declaration that material linked to the prospectus on-line is not a part of the prospectus.

Disclosure Reform

(continued from page 1)

XBRL

XBRL, or eXtensible Business Reporting Language, involves the addition of data tags to each item in the financial statements, to permit users to automatically identify and extract particular bits of data for comparison and analysis. In January 2005, the Commission adopted rules to permit issuers (including registered investment companies) to participate in a voluntary pilot program to use XBRL. The program got off to a very slow start, and the SEC more recently has offered issuers certain benefits, notably rapid review of their filings, if they sign up for the program. (It is not clear that these advantages extend to investment companies.)

One would expect fund managers, as professional investors, to favor the adoption of XBRL. Indeed, the ICI has endorsed the SEC's effort to promote the new disclosure format. Yet fund companies are not rushing to sign up for the pilot program. Why is that?

A recent speech by R. Corey Booth, the SEC's Chief Information Officer, highlighted some of the issues confronting the rapid adoption of XBRL. First, XBRL is not yet an "off-the-shelf" product. Booth noted that there is still a lot of room for technical judgment and interpretation in how to apply the data-tagging structure of XBRL to a particular situation. As a result, there is a perception that the use of XBRL requires considerable technical expertise, and that technical expertise simply does not yet exist on a wide scale. Second, there is for the same reason, a perception that XBRL itself is still evolving, and thus many players may be waiting before they make significant investments. Third, Booth noted that it remains a difficult problem to effectively render XBRL documents in human readable format.

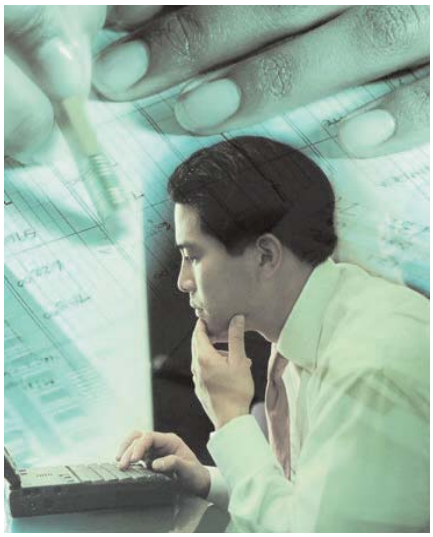
Fourth, and perhaps most surprisingly, Booth noted that they have not yet seen a broad-based demand for XBRL information from the investor community. Hopefully, this is merely a reflection of the lack of widespread use by issuers, which prevents potential users from moving toward an XBRL-based system, and does not mean that XBRL is a solution in search of a problem!

THE INTERNET AS EDUCATIONAL TOOL

XBRL and similar technologies will help savvy investors do a better and faster job at the things they already know how to do. Less talked about, but perhaps more important, is another potential use for interactive disclosure: Educating the "reluctant investor."

Reluctant investors are those who have no interest or aptitude for investing, but are forced to do so by the modern form of retirement or college savings plan. Many are working class and may not have a good education or strong reading or math skills. To these people, the mutual fund prospectus, even in the plainest of "plain English," may not be a helpful document. In fact, they may avoid disclosure documents simply because they lack confidence in their ability to understand them. Yet, as more and more American homes, libraries, offices and union halls go on-line, the Internet offers a wonderful opportunity to bring a whole new approach to investor education through interactive disclosure.

The Commission could open up the enormous potential of the Internet for investor education with one simple rule change: A declaration that material linked to the prospectus on-line is not a part of the prospectus. This would permit fund companies to build up around the prospectus a body of materials that explain graphically a number of concepts that are harder to explain in words. For example, investors who encounter the concept of duration in a



prospectus might be able to click on the word and be taken to a graphic demonstration of what it means, how it differs from simple maturity, and how it affects the value of the fund as interest rates change, together with a chart showing the maturity of the fund in recent times.

Disclosure links could also lead investors into the prospectus. For example, a fund's website might contain a series of straightforward questions about the fund ("What does this fund invest in?" "How has this fund performed in up markets and in down markets?"). Clicking on these questions would take a potential investor first to the relevant portion of the prospectus, and from there to the educational materials if needed.

The beauty of this approach is that it preserves the essential disclosure document, the prospectus, as well as the body of law and expectations that have grown up around the prospectus. It does not require that the various constituencies get used to a world without any prospectus, or with a vastly rewritten, shorter, and perhaps "dumbed down" prospectus. Unlike XBRL, it does not require that the industry learn and fit into a new and complex technical structure, but rather opens up new opportunities for the industry to evolve disclosure in directions that investors would find useful. Thus, it can likely be implemented faster and more easily than any other approach to the problem of using disclosure documents for investor education.

Of course, we know from experience that every loosening of the rules intended to allow the industry to convey more and better information to investors will be seen by a few as an opportunity to better exploit investors. For that reason, the rules would have to provide that any information linked to the prospectus on-line, while not a part of the prospectus, is subject to the anti-fraud rules and established principles of fund advertising. A few other principles might help: To return to our earlier example, a rule that any graphic displaying how duration affects the value of an investment would have to show both an up market and a down market, perhaps with a random selection to determine whether the investor first saw the up example or the down example.

The Internet holds enormous promise for investor education. And the opportunities may not be just educational, but also political. In recent years, the industry has frequently found itself at odds with consumer and labor groups over such issues as fund governance and proxy voting disclosure. A real effort to explore the ways in which new technologies can make disclosure meaningful to investors, and draw in those reluctant investors, offers the opportunity for the industry to work with those same interest groups and perhaps build some bonds that have not previously existed.

Upcoming Events

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

Richard A. Hardwick, Jonathan Lawrence, Anne T. McCarthy, Richard J. Talbot, Clare Tanner, Richard D. Woolich: *What's New?* K&LNG Finance Breakfast Seminar, May 17, 2006, London, U.K.

Michael S. Caccese, Mark Goshko and Richard D. Marshall: *Investment Adviser Compliance Forum*, Financial Research Associates, May 18-19, 2006, New York, NY

Michael S. Caccese, Mark Goshko and Richard D. Marshall: *Hedge Fund Regulation and Compliance Forum*, Financial Research Associates, May 22-23, 2006, New York, NY

Richard A. Hardwick, Jonathan Lawrence, Anne T. McCarthy, Richard J. Talbot, Clare Tanner, Richard D. Woolich: *Confidentiality and Conflicts*, K&LNG Finance Breakfast Seminar, May 24, 2006, K&LNG, London, U.K.

Thomas W. Hickey, III and Philip J. Morgan: *Advanced Asset-Raising Strategies*, Infovest21 Conference, May 24, 2006, London, U.K.

Richard D. Marshall: *How to Utilize the Annual Review Process to Receive a "Highly Compliant" SEC Risk Assessment and Implementing an Effective Compliance Culture*, Building a Successful SEC Exam Strategy Conference, National Regulatory Services Conference, May 24-25, 2006, Boston, MA

Martin Lane and Owen E. Waft: *A Financing Alternative for U.S. Companies: An IPO on the London Stock Exchange AIM Market*, May 25, 2006, London, UK

Michael S. Caccese and Jonathan H. Dinwoodey: *Demystifying Derivatives*, K&LNG Breakfast Briefing, June 1, 2006, K&LNG, Boston, MA

Martin S. Allen, Stuart J. Borrie, Arthur J. Brown, Richard D. Marshall, Michael C. McLean, Cary J. Meer and Philip J. Morgan: *Mergers & Acquisitions in the Investment Management Industry*, K&LNG Breakfast Briefing, June 6, 2006, K&LNG, New York, NY

Michael J. Missal: *Handling an Internal Investigation*, Securities Industry Association, Legal and Compliance Division Conference, June 8, 2006, Chicago, IL

Richard D. Marshall: *How to Utilize the Annual Review Process to Receive a "Highly Compliant" SEC Risk Assessment and Implementing an Effective Compliance Culture*, Building a Successful SEC Exam Strategy Conference, National Regulatory Services, June 15-16, 2006, San Francisco, CA

Neil A. Baylis, Stuart J. Borrie, John N. Elgar, Richard D. Marshall, Cary Meer and Philip J. Morgan: *Mergers & Acquisitions in the Investment Management Industry*, K&LNG Breakfast Briefing, June 21, 2006, London Chamber of Commerce & Industry, 33 Queen Street, London, U.K.

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

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

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

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

Diane E. Ambler and Richard D. Marshall: *REG NMS and Soft Dollar Compliance Forum*, Financial Research Associates Conference, July 17-18, 2006, Bethesda, MD

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

STOP THE PRESS

Join **Kirkpatrick & Lockhart Nicholson Graham LLP** for a Breakfast Briefing on **Mergers & Acquisitions in the Investment Management Industry**

New York
Tuesday, June 6, 2006

London
Wednesday, June 21, 2006

Join K&LNG lawyers in discussing key trends driving the merger wave, innovative structures in recent transactions, client and employee retention, tax structuring issues and regulatory issues.

To register in New York contact Jennifer Garrett at 212.536.3963 or jgarret@klng.com by May 30th.

To register in London contact Kathie Lowe at +44 (0) 20 7360 8248 or klowe@klng.com by June 14th.

Just Published

Fund Director's Guidebook, Third Edition

Written for directors of both open-end investment companies and closed-end funds, this new third edition has been thoroughly updated to reflect the broad range of reforms undertaken by the SEC.

If you have questions or would like more information about K&LNG's Investment Management Practice, please contact one of our lawyers listed below:

BOSTON

Joel D. Almquist	617.261.3104	jalmquist@klng.com
Michael S. Caccese	617.261.3133	mcaccese@klng.com
Mark P. Goshko	617.261.3163	mgoshko@klng.com
Thomas Hickey III	617.261.3208	thickey@klng.com
Nicholas S. Hodge	617.261.3210	nhodge@klng.com
Derek M. Meisner	617.261.3114	dmeisner@klng.com
George Zornada	617.261.3231	gzornada@klng.com

LONDON

Philip Morgan	+44.20.7360.8123	pmorgan@klng.com

LOS ANGELES

William P. Wade	310.552.5071	wwade@klng.com

NEW YORK

Robert J. Borzone, Jr.	212.536.4029	rborzone@klng.com
Jeffrey M. Cole	212.536.4823	jcole@klng.com
Alan M. Hoffman	212.536.4841	ahoffman@klng.com
Ricardo Hollingsworth	212.536.4859	rhollingsworth@klng.com
Beth R. Kramer	212.536.4024	bkramer@klng.com
Richard D. Marshall	212.536.3941	rmarshall@klng.com
Keith W. Miller	212.536.4045	kmiller@klng.com
Scott D. Newman	212.536.4054	snewman@klng.com

SAN FRANCISCO

Elaine A. Lindenmayer	415.249.1042	elindenmayer@klng.com
David Mishel	415.249.1015	dmishel@klng.com
Mark D. Perlow	415.249.1070	mperlow@klng.com
Richard M. Phillips	415.249.1010	rphillips@klng.com

WASHINGTON

Clifford J. Alexander	202.778.9068	calexander@klng.com
Diane E. Ambler	202.778.9886	dambler@klng.com
Mark C. Amorosi	202.778.9351	mamorosi@klng.com
Catherine S. Bardsley	202.778.9289	cbardsley@klng.com
Arthur J. Brown	202.778.9046	abrown@klng.com
Arthur C. Delibert	202.778.9042	adelibert@klng.com
Jennifer R. Gonzalez	202.778.9286	jgonzalez@klng.com
Robert C. Hacker	202.778.9016	rhacker@klng.com
Kathy Kresch Ingber	202.778.9015	kingber@klng.com
Michael J. King	202.778.9214	mking@klng.com
Rebecca H. Laird	202.778.9038	rlaird@klng.com
Deborah A. Linn	202.778.9874	dlinn@klng.com
Cary J. Meer	202.778.9107	cmeer@klng.com
Dean E. Miller	202.778.9371	dmiller@klng.com
R. Charles Miller	202.778.9372	cmiller@klng.com
Charles R. Mills	202.778.9096	cmills@klng.com
R. Darrell Mounts	202.778.9298	dmounts@klng.com
C. Dirk Peterson	202.778.9324	dpeterson@klng.com
David Pickle	202.778.9887	dpickle@klng.com
Alan C. Porter	202.778.9186	aporter@klng.com
Theodore L. Press	202.778.9025	tpress@klng.com
Francine J. Rosenberger	202.778.9187	francine.rosenberger@klng.com
Robert H. Rosenblum	202.778.9464	rrosenblum@klng.com
William A. Schmidt	202.778.9373	william.schmidt@klng.com
Lori L. Schneider	202.778.9305	lschneider@klng.com
Lynn A. Schweinfurth	202.778.9876	lschweinfurth@klng.com
Donald W. Smith	202.778.9079	dsmith@klng.com
Fatima S. Sulaiman	202.778.9223	fsulaiman@klng.com
Martin D. Teckler	202.778.9890	mteckler@klng.com
Roger S. Wise	202.778.9023	rwise@klng.com
Robert A. Wittie	202.778.9066	rwittie@klng.com
Robert J. Zutz	202.778.9059	rzutz@klng.com

Kirkpatrick & Lockhart Nicholson Graham LLP

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