In recent years, the SEC has brought a number of high-profile enforcement actions against well-known investment advisers and broker-dealers. In March 2008, the SEC settled an enforcement action against an investment adviser for failure to enforce the firm’s policies on gifts and entertainment and to “detect, deter, and prevent” the improper receipt of gifts and entertainment.

There are no explicit regulatory guidelines for the gifts and entertainment policies of investment advisers. Typically, investment advisers develop their policies by reviewing a myriad of statutory and regulatory requirements dealing with conflicts of interest, including: the anti-fraud provisions of the Investment Advisers Act of 1940, the affiliated broker provisions of the Investment Company Act of 1940, the prohibited transactions provisions of the Employee Retirement Income Security Act of 1974, the reporting requirements of the Labor-Management Reporting and Disclosure Act of 1959 (“LMRDA”), state pension plan laws and Financial Industry Regulatory Authority rules for broker-dealers. This article summarizes the legal framework for the gifts and entertainment policies of advisory firms and the components of those policies.

Regulatory Framework

The Advisers Act does not expressly require investment advisers to adopt gifts and entertainment policies. However, Section 203(e)(6) of the Advisers Act requires investment advisers to “reasonably supervise” their employees “with a view to preventing violations” of the laws and regulations governing their advisory activities. In addition, Section 206 of the Advisers Act makes it unlawful for an investment adviser, whether or not registered with the SEC, to employ a device, scheme or artifice to defraud a client or prospective client, to engage in a transaction, practice or course of business that would defraud a client or prospective client, or engage in any act, practice or course of business that is fraudulent, deceptive or manipulative.
For more than twenty-five years, fund boards have looked to the Second Circuit Court of Appeals’ decision in Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), for guidance in evaluating an adviser’s fee structure. The Seventh Circuit has now rejected the Gartenberg approach, in an opinion written by Judge Easterbrook, as unsupported by the statutory language. Accordingly, rejecting what it called a “judicial rate regulation” methodology of the Second Circuit, Judge Easterbrook finds the competitive market for mutual funds a superior method for setting fees.

Interpreting Section 36(b) of the Investment Company Act of 1940 in 1982, the Second Circuit identified six factors to be considered in evaluating management fees and set the benchmark for judicial review: fees must be within the range of what would be produced by arm’s-length bargaining. Subsequently, Second Circuit decisions have affirmed and elaborated on the Gartenberg approach. The “Gartenberg factors” have achieved virtually universal acceptance by the industry and fund boards, and the SEC has almost codified them by adopting a rule requiring that funds disclose their boards’ deliberations on these and other related factors during the fee-setting process. While Section 36(b) by its terms imposes fiduciary duties only on investment managers, fund boards have long looked to the Gartenberg line of decisions for guidance in their deliberations because most courts in Section 36(b) cases have closely examined boards’ consideration of these factors. The Gartenberg factors have shaped the process followed by independent directors under Section 15(c) of the 1940 Act in determining whether to approve a new, or to renew an existing, advisory fee contract. Most other Section 36(b) decisions have followed Gartenberg and examined the directors’ consideration of the Gartenberg factors to answer the ultimate question: whether “a [fee] charge [is] within the range of what would have been negotiated at arm’s length” and the fee “was not so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been a product of arm’s length bargaining.” For years, Section 36(b) cases have been litigated under the Gartenberg standards, and defendants generally have prevailed.

In Harris Associates, Judge Easterbrook found that Gartenberg is flawed because “it relies too little on markets”; it does not give sufficient regard to the role of competition in controlling fees. Earlier decisions under Section 36(b), including Gartenberg, had cited the 1970 legislative history to find that no competition existed for mutual fund advisory services; therefore, in addition to fees charged to other comparable funds, an examination of the nature and quality of an adviser’s services, as well as costs and profits, was necessary to determine whether a fee was excessive. Judge Easterbrook dismisses this history as inconclusive and concludes that, in any event, such distrust of fees charged by comparable funds is not justified by the competitive conditions in today’s mutual fund industry. Referring to classic sources of fiduciary law, Judge Easterbrook notes that, when it comes to asking for a fee, a fiduciary “must make full disclosure” and satisfy its “obligation of candor in negotiation, and honesty in performance,” but otherwise it “may charge whatever it can negotiate.” Unless the adviser deceived the trustees or otherwise “hindered their ability to negotiate a favorable price for advisory services,” the courts may not substitute their judgment for the trustees’ judgment.

Despite its broad pronouncements, Harris Associates should not presage a change in how directors should approach the fee approval process. The Gartenberg standards have not been disapproved by any other court, and many circuits are not sympathetic to the law-and-economics jurisprudence that Judge Easterbrook’s opinion represents. In addition, Gartenberg has been strongly and repeatedly embraced by the SEC. The SEC has express statutory authority to bring Section 36(b) cases, although it has not done so. The agency continues, however, to cite Section 36(b) as a basis for investigation, and it has further tied itself to Gartenberg by adopting rules requiring fund boards to disclose their analysis of each Gartenberg factor. Moreover, the Harris Associates opinion deals only with the fiduciary duties of an adviser proposing a fee, not with the responsibilities of fund directors accepting
or negotiating the proposal. Taken together, the 1940 Act and state corporation law require that directors act for the funds and make an informed business judgment on how much advisory services are worth and what to pay for them.

Gartenberg may not be an ideal statement of all factors that directors should consider. But Gartenberg is a widely accepted statement of the types of information and processes that will yield a reasonable business judgment with respect to fund management fees. Notwithstanding Judge Easterbrook’s emphasis on the primacy of disclosure and competition, directors should continue to engage in a thoroughgoing Section 15(c) process that considers the Gartenberg factors, along with other information the directors deem important, in determining the reasonableness of management fees.

If an offshore fund is certified as a distributor fund, U.K. individual taxpayers will pay capital gains tax on the disposal of their interests in the fund. If an offshore fund is not certified as a distributor fund, U.K. individual taxpayers will pay income tax on the disposal of their interests in the fund (40% for U.K. taxpayers whose earnings are greater than £36,000 (approximately $72,000) per annum).

Before the 2008 Treasury Budget, U.K. individual taxpayers whose income was greater than £36,000 per annum only enjoyed a small benefit investing in a distributor fund as they received a personal allowance of £9,200 (approximately $18,400) before any capital gains tax was charged. The capital gains tax rate and higher income tax rate were otherwise equal at 40%.

The 2008 Treasury Budget, besides increasing the personal capital gains tax allowance from £9,200 to £9,600 (approximately $19,200), reduced the capital gains tax rate from 40% to 18%. Offshore funds now have a clear incentive to attain distributor status as it is likely there will be an increase in demand from U.K. individual taxpayers seeking better tax treatment.

What does an offshore fund need to do to attain “distributor” status?
Under the old rules, an offshore fund could only be certified by Her Majesty’s Revenue & Customs as a distributor fund if it distributed 85% of its income to U.K. individual taxpayers. “Income” in this respect included dividends and interest from the fund’s investments and trading profits from the sale of short-term investments (i.e., investments bought and sold for gain alone). “Income” did not include gains made from long-term investments (i.e., interests held in order to receive interest/dividends). U.K. individual taxpayers paid income tax on the 85% distributed income but capital gains tax on the disposal of a material interest in the distributor fund. However, relatively few hedge funds sought distributor status as the tax advantages for a U.K. taxpayer were relatively small and many hedge funds prefer to roll up, rather than distribute, their income.

The 2008 Treasury Budget confirmed that draft legislation will be included in the Finance Bill 2008 which will provide that distributor funds no longer have to make a physical distribution of income but will instead be able to “report” income to U.K. taxpaying individuals. U.K. individual taxpayers paid income tax on the 85% distributed income but capital gains tax on the disposal of a material interest in the distributor fund. However, relatively few hedge funds sought distributor status as the tax advantages for a U.K. taxpayer were relatively small and many hedge funds prefer to roll up, rather than distribute, their income.

The 2008 Treasury Budget confirmed that draft legislation will be included in the Finance Bill 2008 which will provide that distributor funds no longer have to make a physical distribution of income but will instead be able to “report” income to U.K. taxpaying individuals. U.K. individual taxpayers will then be subject to income tax on the reported income. This will allow hedge funds to roll up their income.

It is likely that more offshore funds will seek to become certified as distributor funds in the U.K., whether they actually distribute income or not, in order to meet an increase in demand from U.K. individual taxpayers wishing to benefit from the U.K.’s new capital gains tax rate.
The proposed amendments to Regulation S-P would add to these requirements by requiring every registered investment company broker-dealer (other than notice-registered broker-dealers), investment adviser and transfer agent to develop, implement and maintain a comprehensive “information security program” (a “Program”). The proposed amendments set forth in greater detail the various elements that must be covered by a Program. In addition to the current Program Objectives, under the proposed amendments, each Program would need to include written policies and procedures that provide administrative, technical and physical safeguards for protecting personal information. Furthermore, the proposed amendments would require:

- designating, in writing, which employee(s) are responsible for coordinating the Program;
- identifying, in writing, reasonably foreseeable internal and external risks to the security, confidentiality and integrity of personal information and systems that could result in the unauthorized disclosure, misuse, alteration, destruction or other compromise of such information or systems (i.e., the policies and procedures should address recent identity theft-related incidents such as the loss of data tapes, theft of laptop computers and hijacking of online brokerage accounts by hackers);
- designing and implementing safeguards to control the risks identified and maintaining a written record of such safeguards;

Information Security and Security Breach Response Requirements

The “safeguards rule” in Regulation S-P currently requires registered investment companies, broker-dealers (other than notice-registered broker-dealers) and investment advisers to adopt policies and procedures that address administrative, technical and physical safeguards to protect confidential customer records and information. These policies and procedures must be reasonably designed to:
(i) ensure the security and confidentiality of customer records and information; (ii) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (iii) protect against unauthorized access to or use of customer records and information that could result in substantial harm or inconvenience to any customer (collectively, the “Program Objectives”).

A number of high-profile losses of customer-related data have come to light over the past few years including customer data losses in the securities industry resulting from “hacking” or “phishing” attacks and loss of electronic media containing customer information (e.g., lost or stolen computer laptops or computer backup tapes). To help prevent and address such breaches in the securities industry, on March 4, 2008, the SEC issued a series of detailed proposals that would significantly increase the responsibilities of securities and investment firms to address data security. The SEC proposed to amend Regulation S-P in five principal ways; if adopted, these proposed amendments would:

- impose new information security above and beyond the current “safeguards rule” (i.e., Section 30(a) of Regulation S-P);
- impose new security breach response requirements;
- expand the application of the “safeguards rule” to transfer agents registered with the SEC;
- expand the scope of the current disposal of consumer report information and records requirements under Regulation S-P; and
- create a new exception from the notice and opt-out requirement to allow investors to more easily follow a representative who moves from one brokerage or advisory firm to another.

The following is a brief summary of the highlights of the proposed amendments.
The proposed amendment to Regulation S-P significantly increases the disclosure obligations of registered investment company broker-dealers, investment advisers and transfer agents for security breaches.

If the proposed amendments are adopted, registered investment companies, broker-dealers and investment advisers will likely need to substantially overhaul their existing policies and procedures currently maintained pursuant to the "safeguards rule" in order to bring them in line with the more detailed and robust requirements of the proposed amendments. In practice, such an overhaul would involve identification of specific risk areas for the business and development of specific policies and procedures to address such risks. In addition, the proposed amendments would require a much closer look at service providers and the precautions they take with customer information, as well as contractual provisions regarding the implementation and maintenance of appropriate safeguards.

**Security Breach Response Requirements**

The proposed amendments include a new provision that would require each Program to include procedures for responding to incidents of unauthorized access to or use of "personal information" (a "Breach"). The proposed amendments define "personal information" as "any record containing consumer report information or non-public personal information that is identified with any consumer or with any employee, investor or security holder who is a natural person, whether in paper, electronic or other form, that is handled or maintained by [the business] or on [the business’s] behalf."

Currently, Regulation S-P does not require any specific action be taken when "personal information" is lost.

Under the proposed amendments, the Program must include written procedures to: (i) assess the nature and scope of any such Breach; (ii) take appropriate steps to contain and control the Breach; (iii) conduct a reasonable investigation to determine the likelihood that the information has been or will be misused; and (iv) if a determination is made that misuse of the information has occurred or is reasonably possible, notify each individual with whom the information is identified as soon as possible. The proposed amendments specify what type of information must be contained in the notice to individuals who are affected or may be affected by the Breach. In addition, the proposed amendments would require broker-dealers (other than notice-registered broker-dealers) to notify FINRA, and investment companies, investment advisers and transfer agents to notify the SEC, in certain circumstances regarding the Breach. Such notification would be made using new Form SP-30.

**Impact of the Proposed Amendments on Registered Transfer Agents**

Registered transfer agents, like registered broker-dealers (other than notice-registered broker-dealers), investment companies and investment advisers, are currently subject to certain requirements regarding the disposal of consumer report information and records. The "safeguards rule," however, currently does not apply to transfer agents. The proposed amendments would, however, apply the new information security and security breach response requirements to transfer agents registered with the SEC. This means that registered transfer agents would be required to implement a Program.
Expansion of the Disposal of Consumer Report Information and Records
Requirements under Regulation S-P
The proposed amendments would require every registered broker-dealer (other than notice-registered broker-dealers), investment company, investment adviser and transfer agent, as well as every natural person who is an associated person of a broker-dealer (other than notice-registered broker-dealers), a supervised person of an investment adviser or an associated person of a transfer agent, that maintains or otherwise possesses personal information for a business purpose to properly dispose of the information by taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal. The proposed amendments would require the adoption of written policies and procedures that address the proper disposal of personal information and require the institution to document in writing “its proper disposal of personal information” in compliance with its written policies and procedures with respect to the disposal.

Exception for Limited Information Disclosure When Personnel Leave Their Firms
The proposed amendments include an exception from the notice and opt-out requirement in the current rules to allow limited disclosure of a consumer’s confidential information in the event that a registered representative of a broker-dealer or supervised person of an investment adviser moves to another firm. Such disclosed information may be used by the departing representative to contact the customer to determine whether the customer wishes to follow the representative and transfer its account to the new firm. The SEC believes regulation is necessary to monitor the type of information available for disclosure as well as the manner in which it is transferred because there is a strong incentive for the representative to secretly disclose such information to its new firm. The disclosed information would be limited and would not include a customer’s account number, Social Security number or securities positions.

The comment period for the proposed amendments to Regulation S-P ended May 12, 2008. There have been 103 comment letters to date on the proposed amendments. In general, the comment letters focus on issues such as how certain terms are defined, the breadth of the proposed amendments, costs of implementing the changes required by the proposed amendments, how the proposed amendments would be applied to the introducing broker-clearing broker relationship and the implementation/completion of security incident reporting on Form SP-30.
ETNs: IRS Issues Ruling, Requests Comments on Exchange-Traded Notes

Mutual Funds: Still No Congressional Action on Extension of Withholding Tax Exemption

By Roger S. Wise

The IRS recently issued guidance on the treatment of certain kinds of exchange-traded notes, but many unanswered questions on the treatment of these instruments remain. Separately, Congress has yet to take action to extend provisions that expired on December 31, 2007, exempting from U.S. withholding tax certain types of mutual fund distributions made to non-U.S. shareholders.

Exchange-Traded Notes

ETNs are generally long-term securities, often with terms of 30 years, issued by a bank with a return tied to the performance of some type of index, such as commodities, foreign currencies, or a basket of equity securities. ETNs typically do not guarantee a return of principal and provide no interest or similar payment prior to maturity, but provide liquidity through periodic redemptions or through sales. ETNs are targeted at retail investors and in some ways represent an alternative to mutual funds, because ETNs can offer exposure to asset classes (such as commodities) that mutual funds generally cannot and because ETNs may offer a lower fee structure.

The tax treatment of ETNs – at least as claimed by ETN issuers – also gives them an advantage over mutual funds. An investor will typically be subject to tax each year as a result of an investment in a mutual fund, because mutual funds must distribute at least 90% of their income each year in order to qualify as regulated investment companies (“RICs”) under the Internal Revenue Code. By contrast, ETN issuers typically take the position that ETNs are prepaid forward contracts and that no income inclusion is required until the holder disposes of the instrument. This is the case even though the ultimate return generally includes a “time value of money” return on the holder’s prepayment. Although current accrual of income would be required with a debt instrument, issuers generally take the position that ETNs are not treated as debt for tax purposes because the repayment of principal is not guaranteed.

Late in 2007, the IRS released Revenue Ruling 2008-1, holding that current accruals of income are required with respect to an ETN tied to the euro. This ruling, however, is somewhat limited in that it relies on separate rules that are specific to the treatment of foreign currencies to conclude that the ETN in question is a debt instrument, and therefore subject to the rules on interest accruals. Because the ruling relies on a particular provision in the rules dealing with foreign currencies to conclude that the euro-linked ETN is debt, the ruling does not directly implicate the treatment of other types of ETNs, or foreign currency ETNs with different terms. At the same time, the IRS issued Notice 2008-2, requesting comments on how prepaid forward contracts such as ETNs should be treated for tax purposes. In particular, the IRS requested comments on whether the parties to these transactions should be required to accrue income and expense during the term of the transaction.

The treatment of ETNs may also be affected by legislation. On December 19, 2007, Congressman Neal introduced legislation, H.R. 4912, that would require current accrual of an interest equivalent amount on certain prepaid forward contracts.

Still No Extension of Withholding Exemption for Interest-Related, Short-Term Capital Gains Dividends

Although non-U.S. investors are generally subject to U.S. withholding tax (imposed at a rate of 30% or possibly at a lower rate under a tax treaty) on the receipt of passive income, such as dividends, from U.S. sources, this withholding tax does not apply to most U.S.-source interest (referred to as “portfolio interest”) and capital gains (other than gains from U.S. real property investments).

Before 2004, a non-U.S. investor would generally obtain worse tax results by earning this type of income indirectly through a RIC rather than directly, because mutual fund distributions...
(other than distributions designated as long-term capital gains dividends) are generally treated as dividends, and are thus subject to withholding tax, even if the underlying income would not be subject to withholding. To correct this disparity and encourage non-U.S. investment in mutual funds, the American Jobs Creation Act of 2004 added section 871(k) to the Code, permitting a mutual fund to designate “interest-related dividends” and “short-term capital gains dividends” that are not subject to withholding tax, to the extent of the fund’s underlying interest income or short-term capital gains, respectively. These provisions were effective for dividends with respect to tax years beginning after 2004 and expired on December 31, 2007.

Although several bills have been introduced to extend these provisions for one year, retroactively to the beginning of this year, no extension has yet been enacted. Since January 1, 2008, the above-mentioned withholding tax has applied to mutual fund distributions to non-U.S. shareholders that would otherwise have qualified as interest-related or short-term capital gains dividends. It is possible that many non-U.S. shareholders withdrew from RICs before the end of 2007 because legislation was not enacted to extend these provisions, at least where a direct investment in the RIC’s underlying assets — or an investment through a different type of vehicle — would produce a better tax result. Non-U.S. investors that did not withdraw would be entitled to a refund for any taxes withheld on such dividends if legislation is enacted this year with a retroactive effective date of January 1, 2008. In order to obtain a refund, however, a non-U.S. shareholder would need to file a U.S. tax return, and the refund at any rate would generally not be available until 2009.

In the SEC enforcement action mentioned above, the adviser was charged with violations of the anti-fraud provisions and the disclosure and recordkeeping requirements of the Advisers Act for, among other things, permitting employees to consider the receipt of travel, entertainment and gifts in selecting brokers to execute client transactions and not disclosing these factors to clients. The SEC took the position that the receipt of gifts and entertainment by employees of the adviser resulted in the “substantial possibility of higher execution costs” for the firm’s advisory clients.

In addition, the SEC charged the adviser for failing to supervise its employees with a view toward preventing the employees’ violations of the 1940 Act provision that restricts affiliates from receiving payments from third parties in connection with the business activities of registered investment companies. The SEC order states that a senior officer of the adviser “failed to monitor the traders’ receipt of travel, entertainment and gifts from brokers on any systematic basis, and failed to take reasonable steps to enforce . . . [the] gifts and gratuities policy or ensure that the traders did not receive compensation from brokers for purposes of Section 17(e)(1) of the [1940] Act.” Section 17(e) of the 1940 Act makes it unlawful for an investment adviser to accept compensation, other than regular wages or compensation, in connection with the purchase or sale of securities for an investment company. The Section 17(e) charges were predicated on the receipt by the adviser’s executives and traders of compensation from brokers in the form of gifts, travel and entertainment.

Advisory firms also may be subject to the IMRDA as a result of their relationships with labor organizations whose employees are covered by pension plan clients. The IMRDA requires every private sector business or organization that has one or more employees and engages in specific financial transactions or arrangements with a labor organization, labor organization officer, employee or representative, labor relations consultant, or others to file a report on Form LM-10 on an annual basis. All gifts and payments must be reported unless they (1) have a value of $250 or less per year; (2) are sporadic or occasional; and (3) are given under circumstances unrelated to the recipient’s status in a labor organization.

In 2005, DOL issued guidance indicating that all employers, including advisers, making any gift or payment to a covered person must report the gift on Form LM-10. DOL has taken the position that banks, investment advisers and other firms that do business with and provide services to union-affiliated pension plans are subject to LM-10 reporting requirements. This means that an investment adviser or pension consultant to a union-affiliated pension plan would have to report items routinely offered to clients and prospective clients, such as dinners, golf outings, tickets to baseball games, attendance at holiday parties and other marketing expenses.

Advisory firms that provide services to state and local pension plans not subject to ERISA nevertheless may be subject to numerous state and local government pension regulations governing gifts and entertainment. These rules are complex and vary widely (even within the same city) and

Continued from page 1

Gifts and Business Entertainment: An Overview for Investment Advisers
Generally, gift and entertainment policies include the basis or as a part of the firm’s code of ethics. And Los Angeles County prohibits gifts with a value of $390 per employee in any single month.

In contrast to the legal requirements for advisory firms, FINRA rules impose very specific limits on the provision and receipt of gifts and entertainment by brokerage firms. National Association of Securities Dealers Rule 3060 prohibits any NASD member or person associated with a member from giving gifts in excess of $100 per year to any person, principal, proprietor, employee, agent or representative of another person where the payment is in relation to the business of the recipient’s employer. The NASD has interpreted Rule 3060 as not limiting “ordinary and usual business entertainment,” such as an occasional meal, sporting event, theatre production or comparable entertainment, provided a person associated with the member is present. Under NASD interpretations, anything that does not qualify as business entertainment is a gift.

Gifts and Entertainment Policies
As a function of the duty to supervise imposed by the Advisers Act, it is generally considered a “best practice” for investment advisers to adopt gifts and entertainment policies either on a stand-alone basis or as a part of the firm’s code of ethics. Generally, gift and entertainment policies include an introductory statement communicating the purpose of the policies. Most typically, the stated purpose is to prevent principals and employees from: providing gifts and entertainment in order to receive business through improper influence, accepting gifts or entertainment that could influence their decision making, and providing or accepting gifts or entertainment that would result in an actual or perceived conflict of interest. In addition, these policies typically include the following provisions:

- **Types of Gifts and Entertainment.** The types of gifts and entertainment that the firm considers to be inappropriate and the types of gifts and entertainment that may be provided and accepted.
- **Valuation.** Guidance on how to value gifts and entertainment. Gifts and entertainment should be valued at the higher of cost or face value.
- **Preapproval Provisions.** The gifts and entertainment that require the prior written approval of an officer of the adviser.
- **Reporting Provisions.** The types and required content of periodic reports that must be made to a firm’s chief compliance officer. To facilitate compliance with LM-10 reporting requirements, a policy should require the reporting of all gifts and entertainment provided for union officials.
- **Exclusions from Pre-Approval and Reporting Requirements.** The types of gifts and entertainment that are not subject to pre-approval and reporting requirements including, for example, gifts and entertainment of a de minimis value, or gifts and entertainment given on a personal basis.
- **Supervision and Implementation.** Supervision and implementation by qualified individuals. The policy could itself enumerate the qualification standards or allocate responsibility for a qualification determination.
- **Recordkeeping.** The maintenance for six years, the first two years in an easily accessible place, of reports submitted by employees, detailed records of gifts given to clients or prospective clients and detailed records of business entertainment expenses provided to clients or prospective clients.

**ERISA and State and Local Laws and Regulations.** If the firm serves as a trustee of an ERISA plan, the policy should prohibit the receipt of all gifts or entertainment. If the firm provides services to unions, union officials or union-affiliated pension plans, the policy should require the reporting of all transactions with such entities to facilitate the firm’s compliance with LM-10 reporting requirements. If a firm provides services to public employee pension plans, the policy should incorporate the requirements of applicable state laws and local regulations.

An investment adviser’s gifts and entertainment policies must be tailored to the firm’s business and risk exposure. There is no “one size fits all” policy. In light of the recent enforcement activity in this area, it is a good idea for advisory firms to review existing policies or develop and implement new policies, train their personnel, and establish internal controls to identify and address potential conflicts associated with provision or receipt of gifts and entertainment. It is also important for firms to implement effective systems and internal controls to monitor and enforce compliance with their gift and entertainment policies.

“It is generally considered a ‘best practice’ for investment advisers to adopt gifts and entertainment policies either on a stand-alone basis or as a part of the firm’s code of ethics.”
The SEC’s Proposal seeks to simplify mutual fund disclosure and, importantly, to utilize the benefits of technology through expanded use of the Internet.
required disclosure regarding ongoing costs as well as new disclosure regarding portfolio turnover. Finally, the Proposal will permit funds to include expense reimbursements or fee waivers as separate captions in the fee table, more accurately reflecting a fund’s actual operating expenses. It is important to note that the SEC has proposed making this section more prominent to investors by having it immediately follow the fund’s investment objectives.

- **Principal Investment Strategies, Risks and Past Performance.** The Proposal does not amend any of the current disclosure requirements regarding a fund’s investment strategy, risk and past performance.

- **Top Ten Portfolio Holdings.** As a new item of disclosure, the Proposal requires a fund to list its top ten portfolio holdings, in descending order, as well as the percentage of net assets each holding represents. The holdings would need to be current as of the most recent calendar quarter. Additionally, a fund may continue to group certain securities under a “Miscellaneous Securities” heading, thus retaining the practice currently allowed in Forms N-CSR and NQ filings.

- **Identity of Investment Adviser and Portfolio Managers.** Another new item of disclosure is a section that would include the name of each investment adviser and subadviser to the fund, followed by the portfolio manager(s)’ name, title and length of service.

- **Brief Purchase and Sale Information.** This new section would discuss the fund’s minimum investment amounts, how investors purchase shares of the fund, the redeemable nature of these shares and the process by which shareholders can redeem their shares.

- **Tax Information.** Additionally, the Proposal requires new disclosure of information relating to distributions and dividends.

- **Standardized Statement Regarding Payments to Broker-Dealers and Other Financial Intermediaries.** The summary prospectus would conclude with a new standardized statement alerting investors to the fund’s payments to broker-dealers and other financial intermediaries, the potential conflicts of interest these payments may cause and ways that investors could obtain further information regarding the payments. The Proposal allows funds to modify a standardized statement as long as the modified statement contains information comparable to the standardized example.

Funds will have to disclose the above items on a fund-by-fund basis, although they may integrate disclosure for multiple classes of shares. The Proposal mandates disclosure of all information listed above and prohibits funds from including any additional or extraneous information.

**The Second Layer of Disclosure: The Statutory Prospectus**

The Proposal’s second layer of disclosure is the statutory prospectus, which will be made available online and upon request. To provide uniformity between a fund’s statutory prospectus and its summary prospectus, the Proposal also amends the disclosure forms for statutory prospectuses to require funds to include most of the summary prospectus disclosures discussed above at the beginning of every statutory prospectus, replacing the risk/return summary.

The same standards required of a summary prospectus on a stand-alone basis regarding the required content, order and presentation also apply when included in the full statutory prospectus. No other disclosure may precede the summary prospectus disclosures. Funds, however, will not be required to repeat later in the statutory prospectus any disclosure already contained in the summary prospectus portions.

**The Third Layer of Disclosure: Online Access to Documents**

The final layer of disclosure is an online library of other fund documents – the fund’s statement of additional information and shareholder reports, along with the summary prospectus and the statutory prospectus. By using this layered disclosure regime, the Proposal seeks to utilize modern technological resources and provide investment information to investors via the Internet. The SEC has stated that this will make information easier for investors to digest while, at the same time, retaining the comprehensive quality of the information currently available to investors.

All of the electronic documents must be made available to an investor at no charge and maintained until ninety days after use of the summary prospectus. This requirement is critical to meeting a fund’s delivery obligations under Section 5 of the Securities Act.

The Proposal requires ease of movement between these electronic documents. The electronic versions of both the statutory prospectus and SAI must allow investors to move with a single click of their mouse between the documents’ table of contents and the related sections of text within the documents. In addition, funds must provide investors with the capability to move back and forth between electronic copies of the summary prospectus, statutory prospectus and SAI, either through single- or double-click access. An example of double-click access is when an investor clicks from the summary prospectus directly into the statutory prospectus or SAI’s table of contents. The investor then clicks again within the table of contents and is transported into the related section of the statutory prospectus or SAI.

“The innovative concept introduced by the Proposal is its layered disclosure approach.”
Funds also must provide investors with electronic versions of the summary prospectus, statutory prospectus, SAI and shareholder reports in a format that is convenient to read, print and permanently retain. Although the Proposal does not elaborate, it appears that a PDF version of such documents would meet this requirement.

\section*{Filing and Updating Requirements for the New Summary Prospectus}

The Proposal also sets forth filing and updating requirements for the summary prospectus. Given that the summary prospectus may be used both on a stand-alone basis as well as the beginning summary of the statutory prospectus, the SEC proposed not to require a fund to file a summary prospectus prior to first use. The SEC noted that its staff will have an opportunity to review the summary prospectus disclosure while reviewing a fund’s statutory prospectus. Thus, the Proposal states that the summary prospectus must be filed with the SEC under Rule 497 of Regulation C within five days of first use, much like a typical prospectus supplement. Performance data and information regarding top ten portfolio holdings in the stand-alone summary prospectus will need to be updated quarterly. Assuming the summary prospectus meets the Proposal’s other requirements, the SEC will not require any other updates to the stand-alone summary prospectus until the next quarterly update is due or the fund files its annual registration statement, whichever is earlier. Of course, the summary prospectus would be supplemented to update other disclosures as currently is the practice with statutory prospectuses.

\section*{Comments Received by the SEC}

The SEC requested comments on all aspects of its Proposal. The comment period for the Proposal closed on February 28, 2008. In all, there were over 130 comment letters filed with the SEC regarding the Proposal and reflected overall support for the Proposal. The comments generally agreed that the current disclosure regime provides too much information for the average investor, effectively making the disclosures unreadable for them. All commentators supported the Proposal generally, but some raised a number of concerns with the operation and implementation of various aspects of the Proposal. Below are just a few:

- **Page Limit for the Summary Prospectus.** The SEC requested guidance whether to limit the total number of pages of a summary prospectus. Many commentators did not support limiting the number of pages of a summary prospectus. Some remarked that funds already have the incentive to reduce the amount of disclosure in a summary prospectus, thus negating the need for page limits. Others remarked that page limits are necessary in order to prevent funds from including unneeded and extraneous information.

- **Standardized Formatting.** The SEC requested guidance whether to standardize the formatting of the information to be contained in the summary prospectus. It appears that a majority of commentators supported standardizing the format of the summary prospectus.

- **Portfolio Holdings and Portfolio Turnover.** Most mutual fund industry commentators did not support including a fund’s top ten portfolio holdings and portfolio turnover information in the summary prospectus. They generally argued that such information is not important to shareholders and requested the SEC to eliminate inclusion of it in the summary prospectus.

- **Quarterly Update Requirement.** Many of those who commented on the Proposal stated that the SEC should eliminate the quarterly update requirement. These commentators generally felt that mutual fund websites provide more current information and, as such, the information reported in a summary prospectus, even when updated quarterly, would actually be out of date compared to information found on a fund’s website.
Support Provided for both Electronic and Print Options. Many commentators viewed the requirement of electronic access favorably, remarking that many investors have already chosen to receive fund documents electronically. A number of commentators also supported the delivery of a summary prospectus as long as the more detailed statutory prospectus was made available online or by mail.

Conclusion
The SEC staff is reviewing and assessing the numerous public comments on the Proposal. The SEC appears to be motivated to address both investor and industry comments on the Proposal, keeping in mind that the new delivery option would be on a voluntary basis and that the industry did not embrace the profile prospectus. Nevertheless, based on the extent and nature of the public comments on the Proposal, there appears to be a strong likelihood that, if adopted with appropriate modifications, the summary prospectus could help propel the mutual fund industry into the Internet age. SEC Chairman Cox recently stated that finalizing and adopting the Proposal is a high priority for the SEC in 2008. The SEC staff also has suggested that the Proposal could be adopted by the end of the summer. We look forward to the SEC’s final release.

On July 7, 2008, the SEC and the Federal Reserve signed a memorandum of understanding (MOU) setting forth the terms of cooperation between the two agencies. The MOU is a response to the collapse of Bear Stearns and the Fed’s subsequent extension of credit through the Primary Dealer Lending Facility to the major investment banks, which are regulated by the SEC under the Consolidated Supervised Entities (CSE) program. Since the Fed was perceived to be standing behind the liabilities of the CSEs, it needed information regarding their capital and liquidity positions as well as input into capital and liquidity requirements, which currently only the SEC has the authority to provide. The MOU goes farther than this, however, essentially institutionalizing all forms of cooperation between the two agencies. The MOU addresses (1) information sharing and confidentiality, (2) coordinating examinations, (3) expectations regarding capital, liquidity and funding requirements, and (4) cooperation on AML and Regulation R for: CSEs, Alternative Net Capital Holding Companies, Primary Dealer Holding Companies, and the clearing companies (DTC, NSCC, FICC). Notably, under the MOU, shared information can only be referred for criminal enforcement purposes with the consent of the agency providing it.
K&L Gates combines with Kennedy Covington

Partners from the law firms of Kirkpatrick & Lockhart Preston Gates Ellis LLP (K&L Gates) and Kennedy Covington Lobdell & Hickman, LLP (Kennedy Covington) voted to combine the two firms, effective July 1, 2008. The combination creates a firm of more than 1,700 lawyers in 28 offices located throughout the United States, Europe and Asia, including the largest Carolinas presence of any global law firm. The firm will maintain North Carolina offices in Charlotte, Raleigh and Research Triangle Park.

“Our combined firm is now positioned to serve as the Carolinas’ legal bridge to the globalized economy of the 21st Century,” said K&L Gates Chairman and Global Managing Partner Peter J. Kalis and Kennedy Covington Managing Partner Eugene C. Pridgen.

The combined firm, which will have the K&L Gates name, will have offices in Anchorage, Austin, Beijing, Berlin, Boston, Charlotte, Dallas, Fort Worth, Harrisburg, Hong Kong, London, Los Angeles, Miami, Newark, New York, Orange County, Palo Alto, Paris, Pittsburgh, Portland, Raleigh, Research Triangle Park, San Francisco, Seattle, Shanghaim, Spokane/Coeur d’Alene, Taipei and Washington, D.C.

K&L Gates Enhances Asia Presence with Launch of Shanghai Office

K&L Gates has established its fourth Asia office with the opening of a Shanghai office, following the grant of a license by the Chinese government. The Shanghai office is K&L Gates’ second representative office in China.

Peter J. Kalis, K&L Gates Chairman and Global Managing Partner, said: “With our Shanghai office joining sister offices in Beijing, Hong Kong, and Taipei, K&L Gates has established an unsurpassed presence for international law firms in the Greater China market.”

“Opening an office in Shanghai reflects the strong growth of K&L Gates’ China practice and strengthens our capabilities and reach in serving clients in China and in the financial sector,” said David K. Y. Tang, K&L Gates Managing Partner, Asia. “Our lawyers there are fully integrated with our lawyers in other Greater China offices and with our entire global platform.”

K&L Gates Lawyers Earn National, State Honors in 2008 Chambers USA Guide

Sixty K&L Gates lawyers have been recognized as leaders in their respective practices in the 2008 Chambers USA Client’s Guide, published by Chambers and Partners. The 2008 guide lists K&L Gates lawyers in 25 categories of law. Our Financial Services Regulation: Consumer Financial Services Regulation and our Investment Funds: Registered Funds practices were among those recognized nationally. Additionally, the following K&L Gates Investment Management lawyers were recognized: Diane E. Ambler, Washington, DC (Investment Funds: Registered Funds, National); Mark P. Goshko, Boston (Hedge & Mutual Funds, Massachusetts); Richard M. Phillips, San Francisco (Investment Funds: Registered Funds, National); William A. Schmidt, Washington, DC (Employee Benefits & Executive Compensation, District of Columbia) and Robert J. Zutz, Washington, DC (Investment Funds: Registered Funds, National). Chambers’ listings are based on thousands of in-depth interviews conducted with lawyers and clients to assess the reputations and expertise of business lawyers in 175 countries around the world.
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:

David Dickstein and Rebecca O’Brien Radford: Understanding Disclosure; Form ADV, Advertising and Performance, NRS Center for Compliance Professionals, June 24, 2008, New York, NY


Rebecca O’Brien Radford: Understanding Disclosure, NRS Center for Compliance Professionals, September 23, 2008, Chicago, IL


Rebecca O’Brien Radford: Understanding Disclosure, NRS Center for Compliance Professionals, September 23, 2008, Chicago, IL

Clifford J. Alexander, Michael S. Caccese, Mark P. Goshko, Michael J. King and Ndenisarya Meekins: NSCP National Membership Meeting, October 20, 21, 22, 2008, Philadelphia, PA

Please join our London office for a program on Rogue Traders and Other Nightmares, Their Fallout and How to Deal with Them

Tuesday, September 16, 2008

K&L Gates speakers: Clifford J. Alexander
Danny Brower
Robert V. Hadley
Michael J. Missal
Philip Morgan

To be held at K&L Gates, 110 Cannon Street, London EC4N 6AR

To register for this event, please go to www.klgates.com/events or for additional information email eventslo@klgates.com

Coming Soon at our San Francisco, Boston and New York offices and via Webinar:

Bank Collective Trust Funds – “What You Need to Know”

Collective Investment Funds maintained by banks and trust companies are experiencing a resurgence of popularity among institutional investors, particularly employee benefit plans, and money managers. This program will discuss why these vehicles are so popular, how they are regulated, and how they compare with mutual funds and hedge funds.

September 10, 2008 – San Francisco

September 17, 2008 – Boston – Live and via Webinar

September 18, 2008 – New York

To register for this event, please go to www.klgates.com/events
K&L Gates comprises approximately 1,700 lawyers in 28 offices located in North America, Europe and Asia, and represents capital markets participants, entrepreneurs, growth and middle market companies, leading FORTUNE 100 and FTSE 100 global corporations and public sector entities. For more information, visit www.klgates.com.

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

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