

Contents

Agenda and Speaker bios

Combined Morning Session

Tab 1 Overview of Investment Advisory Industry and Regulations, presented by Rebecca O'Brien Radford/George Zornada

Tab 2 Portfolio Valuation: Marketing Pricing and Fair Valuation, presented by Michael Caccese/George Zornada

Tab 3 Brokerage and Trading: Best Execution, Soft Dollars, Trade Allocation, Side-by-Side Management, presented by Michael Caccese

Tab 4 Derivatives Program, presented by Gordon Peery

Tab 5 Overview of Federal Tax Aspects Affecting Funds, presented by Joel Almquist

Hedge Fund Track

Tab 6 Hedge Fund Basics, presented by Nicholas Hodge/Rebecca O'Brien Radford

Tab 7 Conflicts of Interest, Distribution and Compliance Issues Associated with Hedge Funds, presented by Nicholas Hodge

Tab 8 Prime Brokerage Issues, presented by Gordon Peery

Tab 9 Investment Adviser Advertising Issues Applicable to Hedge Funds, presented by Michael Caccese

Registered Fund Track

Tab 10 Mutual Fund Basics, presented by George Attisano/Candace Cavalier

Tab 11 Fund Distribution and Advertising, presented by Trayne Wheeler

Tab 12 Closed-End Funds, presented by Clair Pagnano

Tab 13 Compliance Programs and Conflicts of Interest (Affiliated Transactions and Codes Ethics), presented by Clair Pagnano/George Attisano

Combined Afternoon Session

Hot Topics, presented by Nicholas Hodge, Rebecca O'Brien Radford, Clair Pagnano and George Zornada

Boston Investment Management Training Program

November 12, 2008

Combined Morning Session 8:30 a.m.–12:00 Noon

8:30 a.m.–8:35 a.m.	Welcome <i>Presented by Michael Caccese</i>
8:35 a.m.–9:15 a.m.	Overview of Investment Advisory Industry and Regulations <i>Presented by: Rebecca O'Brien Radford/George Zornada</i> • Investment Advisory Organizations: Advisers, Banks, Trust Companies, Insurance Companies, Broker-Dealers • Investment Vehicles: Registered Funds and ETFs, Hedge Funds, Bank Collective Funds, SMAs • Regulation of the Investment Advisory Industry: General Fiduciary Principles, Securities Laws, ERISA, Banking Regulation
9:15 a.m.–10:00 a.m.	Portfolio Valuation: Market Pricing and Fair Valuation <i>Presented by: Michael Caccese/George Zornada</i>
10:00 a.m.–10:15 a.m.	Break
10:15 a.m.–11:00 a.m.	Brokerage and Trading: Best Execution, Soft Dollars, Trade Allocation, Side-by-Side Management <i>Presented by: Michael Caccese</i>
11:00 a.m.–11:30 a.m.	Derivatives Program <i>Presented by: Gordon Peery</i>
11:30 a.m.–12 Noon	Overview of Federal Tax Aspects Affecting Funds <i>Presented by: Joel Almquist</i>
12 Noon–1:00 p.m.	Lunch

Afternoon Session 1:00 p.m.–4:30 p.m.

* Note: we will be breaking the afternoon sessions into a hedge fund track and a registered fund track in order to cover more ground

Hedge Fund Track 1:00 p.m.–3:45 p.m.

1:00 p.m.–2:00 p.m.	Hedge Fund Basics <i>Presented by: Nicholas Hodge/Rebecca O'Brien Radford</i> • Investment Strategies • Private Placement Memorandum and Limited Partnership Agreement • Capital Accounts and Performance Allocations • Agreements with Investors: Subscription Agreement and Side Letters

2:00 p.m.–2:45 p.m.	Conflicts of Interest, Distribution and Compliance Issues Associated with Hedge Funds <i>Presented by: Nicholas Hodge</i> • Principal Transactions • Side Letters • Side pockets • Side by Side Management
2:45 p.m.–3:00 p.m.	Break
3:00 p.m.–3:15 p.m.	Prime Brokerage Issues <i>Presented by: Gordon Peery</i>
3:15 p.m.–3:45 p.m.	Investment Adviser Advertising Issues Applicable to Hedge Funds <i>Presented by: Michael Caccese</i>

Registered Fund Track 1:00 p.m.–3:45 p.m.

1:00 p.m.–1:45 p.m.	Mutual Fund Basics <i>Presented by: George Attisano/Candace Cavalier</i> • Organization and Form • Prospectus and Registration • Contracts: Required Elements and Board Approval • Investment Restrictions and Capital Structure
1:45 p.m.–2:30 p.m.	Fund Distribution and Advertising <i>Presented by: Trayne Wheeler</i> • Mutual Fund Sales Charges and Revenue Sharing • Performance Advertising & Restrictions on Advertising • Advertising Rules—Rule 134, Rule 135a and Rule 482 • FINRA Role and Limitations • Distribution Financing Arrangements (Sales Loads/Rule 12b–1 Plans) • Section 22(d) and Rule 12b–1 • Multiple Class/Master-Feeder Arrangements
2:30 p.m.–2:45 p.m.	Break
2:45 p.m.–3:15 p.m.	Closed-End Funds <i>Presented by: Clair Pagnano</i>
3:15 p.m.–3:45 p.m.	Compliance Programs and Conflicts of Interest (Affiliated Transactions and Codes Ethics) <i>Presented by: Clair Pagnano/George Attisano</i>

Combined Session at End of Day 3:45 p.m.–4:30 p.m.

Hot Topics	<i>Presented by: Nicholas Hodge, Rebecca O'Brien Radford, Clair Pagnano and George Zornada</i> • Short Selling and Derivatives • Money Market Funds: Breaking the Buck and Credit Ratings • Regulators Reactions



Joel Almquist

617.261.3104 joel.almquist@klgates.com

Mr. Almquist counsels clients on a full range of domestic and cross-border tax issues. Mr. Almquist advises clients on the tax aspects of public and private asset management transactions, including open-end and closed-end mutual funds, hedge funds, private equity funds and funds involving special alternative investment strategies. Representative offerings involve U.S. and non-U.S. organized entities, master-feeder structures, fund-of-funds strategies, notional principal contracts and other derivative products, tax hybrid entities and other customized offshore structures. Mr. Almquist also provides clients with tax advice in connection with acquisitions, dispositions, reorganizations, financings and partnerships of every type and structure, as well as providing family tax planning and representation in tax controversies.



George Attisano

617.261.3240 george.attisano@klgates.com

Mr. Attisano focuses his practice on various issues and matters under the Investment Company Act and the Investment Advisers Act. Mr. Attisano has extensive experience with a wide variety of SEC filings, including registration statements, proxies and shareholder reports. He has counseled open-end and closed-end fund boards on a variety of legal issues. He also has counseled funds and investment advisers on developing new products and in connection with SEC staff examinations, preparing responses to SEC inquiries and addressing issues raised in SEC staff deficiency letters.



Michael Caccese

617.261.3133 michael.caccese@klgates.com

Mr. Caccese is one of three Practice Area Leaders of K&L Gates' Financial Services practice, which includes the firm's Investment Management and Broker Dealer practice groups. Mr. Caccese focuses his practice in the areas of investment management, including mutual funds, closed-end funds, registered fund of hedge funds, hedge funds and separately managed accounts, in addition to advising on investment management and broker-dealer regulatory compliance. Mr. Caccese also advises on structuring investment management professional team "lift-outs" and "placement", "soft dollar" compliance, investment performance, the Global Investment Performance Standards ("GIPS"), AIMR Performance Presentation Standards ("AIMR-PPS"), and the CFA Soft Dollar Standards and the Trade Management (Best Execution) Guidelines, along with other investment management industry standards of practice. His focus is on serving the needs of investment advisory firms of all sizes, including helping them design and comply with the investment industry's "best practices" and policies, under GIPS, AIMR-PPS and Soft Dollar Standards.



Candace Cavalier

617.951.9188 candace.cavalier@klgates.com

Ms. Cavalier focuses on general investment management matters. She has experience representing open and closed-end investment companies. Ms. Cavalier advises mutual fund complexes on regulatory and compliance matters; including registration, proxy issues and fund closings. She also has experience with Sarbanes-Oxley Act requirements as they relate to registered investment companies.



Nicholas Hodge

617.261.3210 nicholas.hodge@klgates.com

Mr. Hodge concentrates his practice in securities law with a focus on investment management, hedge funds, real estate investment trusts and partnerships, timber funds, complex partnership reorganizations, tender offers, and mergers and acquisitions. He has extensive experience in public and private offerings of securities, SEC and FINRA regulatory requirements, and Investment Company and Investment Advisers Act compliance. Mr. Hodge represents numerous domestic and offshore hedge funds, ranging from startup funds to major fund complexes.



Rebecca O'Brien Radford

617.261.3244 rebecca.radford@klgates.com

Ms. Radford is a partner in the investment management practice group where she focuses her practice on investment management and securities law. She counsels investment companies and hedge funds on fund formation, legal, regulatory and compliance issues, including mergers, acquisitions, reorganizations and proxy statements. Ms. Radford also advises clients dealing in futures contracts and options on futures contracts on applicable provisions of CFTC and NFA regulations.



Clair Pagnano

617.261.3246 clair.pagnano@klgates.com

Ms. Pagnano concentrates her practice in the investment management area. She has experience representing open and closed-end investment companies and their boards of directors. Ms. Pagnano advises mutual fund complexes on regulatory and compliance matters; including registration, proxy issues, mergers and reorganizations. She has advised registered investment companies on exemptive applications and no-action letter requests to the Securities and Exchange Commission. Ms. Pagnano also has experience with Sarbanes-Oxley Act requirements as they relate to registered investment companies.



Gordon Perry

617.261.3269 gordon.peery@klgates.com

Mr. Peery works exclusively as a derivatives lawyer. He represents a wide range of clients in the firm's Investment Management, Derivatives and Structured Products practice groups and is a leader of the firm's Derivatives Task Force.



Trayne Wheeler

617.951.9068 trayne.wheeler@klgates.com

Mr. Wheeler concentrates his practice in the corporate, securities and investment management areas. His practice focuses on advising registered and unregistered investment companies, investment advisers, broker-dealers and other financial service providers. Mr. Wheeler advises mutual fund complexes on various regulatory and compliance matters including registration, mergers and reorganizations, and negotiations with fund service-providers. He has worked on internal policies, procedures, compliance checklists, CCO policies and procedures, advisory contracts and corresponding disclosures in SEC forms for investment companies and investment advisers. Mr. Wheeler also has experience with the launching of new mutual funds and has drafted numerous registration statements for open- and closed-end investment companies and has assisted in the drafting of opinions as well as assisted clients in discussions with the SEC staff. He has acted as Fund counsel and independent director counsel for various mutual fund complexes. Mr. Wheeler has also acted as special counsel organizing the launch of closed-end funds.



George Zornada

617.261.3231 george.zornada@klgates.com

Mr. Zornada practices investment management and securities law. He regularly represents investment advisers, open and closed-end investment companies and their boards of directors, and private investment entities such as hedge funds and fund of funds.

Overview of Investment Advisory Industry and Regulations

George J. Zornada
Rebecca O'Brien Radford

November 12, 2008

www.klgates.com

AGENDA

- I. Investment Advisory Organizations
- II. Investment Vehicles
- III. Regulation of the Investment Advisory Industry

I. Investment Advisory Organizations

- Advisers
- Banks
- Trust Companies
- Insurance Companies
- Broker-Dealers

II. Investment Vehicles

- Registered Funds
 - Mutual Fund
 - Closed-End Funds
 - ETF's
 - Money Market Funds
 - Registered Funds of Hedge Funds
- Hedge Funds
 - Onshore
 - Offshore
 - Master-Feeders
- Separately Managed Accounts
- Bank Collective Funds

III. Regulation of the Investment Advisory Industry

- General Fiduciary Principles
- Securities Laws
 - Investment Advisers Act of 1940
 - Investment Company Act of 1940
 - Securities Act of 1933
 - Securities Exchange Act of 1934
- ERISA
- Tax
- Banking Regulation
- **2009?**

Pricing and Fair Valuation

Michael Caccese, Partner
George Zornada, Partner

www.klgates.com

Overview—

- Adequate valuation procedures important for all investment advisers whether individual accounts, hedge funds or registered investment companies
- Improper valuation can impact fee and performance calculations
- Focus on mutual fund valuations because relatively well developed and regulators tend to follow these practices

Overview— The Importance and the Complexity of Valuation Determinations

- Rule 22c-1 (the “forward pricing rule”) effectively requires that open-end investment companies accurately value their portfolio securities on a daily basis.
- Accuracy in the daily pricing of portfolio securities is essential.
- Valuation must be accomplished quickly, usually in the roughly 2-hour period between the NYSE close and the NASD reporting deadline.
- Nevertheless, for a long time—probably for about half of the current life span of the 1940 Act—this did not appear to be a particularly difficult or challenging endeavor.
- This is no longer true for most funds.

Regulatory Framework

Section 2(a)(41) and Rule 2a-4 view valuation issues in terms of a simple dichotomy between Market Value and Fair Value.

- Securities “for which market quotations are readily available” are to be valued at “market value.”
- All other securities are to be valued at “fair value as determined in good faith by the board of directors.”
- The special responsibilities placed on fund boards for fair value determinations, appear to arise out of a kind of objective vs. subjective distinction:
 - The implicit notion is that market valuations are essentially objective, while fair valuations require more judgment (*i.e.*, are more subjective) and thus require more direct board involvement.

Regulatory Framework (continued)

When should securities be fair valued?

- When market quotations are not readily available.
- When market quotations are not reliable.
- This may (but will not necessarily) occur if:
 - sales have been infrequent;
 - there is a thin market for the security; or
 - the validity of the market quotations appears questionable due to (among other things):
 - an unreliable source;
 - staleness;
 - significant post-quotation events.

Regulatory Framework (continued)

The Effect of Significant Events

- The question of how significant events should affect fund valuations dates back at least to a 1981 no-action letter issued to Putnam.
- This letter established the principle that it is appropriate to use fair value methodologies to reflect material events that occur after the closing of the relevant foreign markets but before the fund's normal pricing time.

Regulatory Framework (continued)

The Effect of Significant Events (continued)

- In 2001, the Staff effectively mandated fair valuation when a “significant event” occurs.
- But questions remain:
 - When is an event “significant?”
 - What should be the basis for a fair valuation when a significant event occurs?

Regulatory Framework (continued)

Bases for Making Fair Value Determinations

- No single correct way.
- Methodologies and factors that may be used include:
 - multiples of earnings;
 - discount from market of similar, freely traded securities;
 - for debt instruments, yield to maturity;
 - fundamental analytical data; and
 - combinations of the foregoing.

FAS 157

Eliminating the Market Value/Fair Value Dichotomy

- FASB's September 2006 Statement on Fair Value Measures, FAS 157, does not reflect the same market value/fair value dichotomy that is reflected in the 1940 Act.
- Instead, FAS 157 makes clear that market quotations—whether obtained from an exchange closing price or from dealer quotes—are merely means (“inputs”) for determining the fair value of an asset.
- FAS 157 establishes a somewhat different dichotomy—between “observable” and “unobservable” inputs.
- The Statement presents a hierarchy of these inputs that is substantially similar to what is called for under existing SEC guidance.

FAS 157 (continued)

Techniques, Approaches and Inputs

- FAS 157 articulates three types of valuation “approaches”—market, income and cost—that may be chosen as appropriate for valuing particular assets.
- The Statement then refers to various valuation “techniques” that are consistent with, and that serve to describe, these approaches.

FAS 157 (continued)

Techniques, Approaches and Inputs (continued)

- The heart of FAS 157 is a hierarchy of valuation “inputs” that are to be used to apply the chosen valuation approach and technique.
 - Inputs are divided into two categories: observable and unobservable.
 - “Observable” inputs are based on market data obtained from sources independent of the reporting entity.
 - “Unobservable” inputs reflect the reporting entity’s own assumptions as to how market participants would approach pricing.

FAS 157 (continued)**The Fair Value Hierarchy**

- Level 1—the highest level of inputs—comprises unadjusted quoted prices in active markets for identical assets.
- Level 2 inputs are inputs other than quoted prices that are “observable” either directly or indirectly.
- Level 3 inputs are those that are unobservable.
- The difference in the categories used by FAS 157, as compared to those used in the SEC guidance is revealing. It emphasizes the extent to which pricing data, if not the valuation itself, is primarily objective and comes from third party sources.

FAS 157 (continued)

Disclosure

- FAS 157 requires that entities (including mutual funds) disclose the following information for each annual and interim financial reporting period:
 - The fair values of their assets;
 - The “level” within the fair value hierarchy in which the assets fell;
 - For the assets valued using Level 3 (unobservable) inputs, a reconciliation showing beginning and ending balances broken down to show gains and losses, purchases and sales and transfers in and out of the Level 3 input category.

FAS 157 (continued)

Disclosure (continued)

- Unrealized gains or losses relating to those assets still held at the end of the reporting period and a description of where those unrealized gains or losses are reported in the income or activities statement.
- FAS 157 also requires that entities report in their annual (not interim) financial reports the valuation techniques used to measure fair value and a discussion of any changes in those techniques during the period.

Delegation and Controls

- Despite the emphasis on board responsibility, delegation of day-to-day responsibility for fair valuation determinations is both necessary and contemplated by SEC guidelines.
- For most funds, direct board determinations of valuations and “continuous” board review of day-to-day decisions is impractical.
- The appropriate role for the board is to act as the highest level of oversight in a multi-tiered system of supervision and controls.
- Effective controls are central to the discharge of the board’s responsibilities.

Delegation and Controls (continued)

- The key elements of an effective control system include:
 - Identification of acceptable sources of regular pricing information, preferably from third parties, and verifying that those sources have internal controls for verifying the validity of the information they provide.
 - Review and supervision by the primary pricing group—generally fund accounting or administrators or the fund's custodian.
 - Oversight of the primary pricing group by a special valuation committee or other supervisory personnel within fund management.

Correction of Pricing Errors

- Errors of less than 1¢ per share are immaterial and do not require corrective action.
- Errors of 1¢ or more per share require financial adjustments in favor of the fund, but no payments to affected shareholders or reprocessing of shareholder accounts is required unless the errors amount to at least $\frac{1}{2}$ of 1% of per share NAV.

Liquidity Procedures

- SEC policies require that no more than 15% of an open-end fund's net assets (10% for money market funds) be illiquid.
- A security normally is considered illiquid if it cannot be “sold or disposed of in the ordinary course of business within 7 days at approximately the value” at which it is being carried by the fund.
- Funds need to establish a guidelines for identifying illiquid portfolio securities at or prior to the time that they are purchased and for monitoring liquidity (or illiquidity) thereafter.

Liquidity Procedures (continued)

- Procedures for determining that presumptively illiquid securities are liquid:
 - The SEC has indicated that certain types of securities are presumed to be illiquid but that that presumption if appropriate findings are made pursuant to procedures approved by the fund's board.
- Factors used to overcome the presumption of illiquidity include:
 - Frequency of trades or quotes;
 - The number of dealers or others willing to purchase the security;
 - dealer undertakings to make a market in the security; and
 - the nature of the marketplace (i.e. mechanics of transfer; available methods of soliciting offers, etc.).

VALUATION, FAIR VALUING, AND PRICING

I. OVERVIEW – THE IMPORTANCE OF PORTFOLIO VALUATION TO ALL INVESTMENT MANAGERS.

A. General Significance

1. Adequate portfolio valuation procedures and methodologies are important for all investment advisers, whether they manage individual accounts, hedge funds or registered investment companies.
2. Improper portfolio valuations can lead to miscalculation of investment advisory fees as well as misleading performance representations in the mutual fund, the hedge fund, and the non-fund sectors of the investment management industry. Inadequate valuation procedures or methodologies have been responsible for many SEC enforcement actions under the anti-fraud provisions of Section 206 of the Advisers Act on charges of misleading performance portrayals or excess fee deductions from client accounts, which have been brought against separate account and hedge fund managers as well as investment company advisers.

B. Mutual Funds

1. Adequate valuation procedures and methodologies are particularly critical in the mutual fund industry because fund shares are issued and redeemed on a daily basis at a price based upon net asset value (“NAV”) next calculated after receipt or purchase or the sale order. See Rule 22(c)-1.
2. If valuations are too low, purchasing shareholders will be undercharged, redeeming shareholders will be underpaid and if purchases exceed redemptions, the remaining shareholders will be diluted.
3. Moreover, if valuations are too high, redeeming shareholders will be overpaid, purchasing shareholders will be overcharged, and if redemptions exceed purchases, the remaining shareholders will be diluted.
4. Moreover, mutual fund valuation must be accomplished quickly, usually within a 2 hour period between the close of the NYSE and the reporting deadline for media publication.

C. Trends

1. Historically, valuation did not appear to be a particularly difficult or challenging endeavor, since most investment advisers invested their clients' accounts almost exclusively in exchange listed securities for which closing market prices were readily available.
2. Today, valuation has become a complex and challenging process because portfolios of investment management clients contain a diversity of investment products many of which are not actively traded and are difficult to value particularly in times of market crises.

D. General Applicability

1. This outline focuses on mutual fund valuation procedures, methodologies, and practices since they are the most complex and well developed within the investment management industry.
2. Both SEC examiners and members of its Enforcement Staff are most familiar with these procedures, methodologies and practices, they tend to apply them to non-mutual fund products.
3. A material departure, without disclosure, from the basic procedures, methodologies and practices used in the mutual fund industry could raise serious questions in SEC examinations and enforcement investigations.

II. PRICES BASED ON NET ASSET VALUE

Every open-end fund, every principal underwriter of, and dealer in, fund shares, and every other person authorized in a fund's prospectus to consummate trades in fund shares, must issue and redeem those shares at a price based on the net asset value ("NAV") next calculated after receipt of the purchase or sell order. See Rule 22c-1.

A. Forward Pricing

Rule 22c-1 reflects an unusual feature of fund pricing: the price is that next determined after receipt of the investor's order.

1. Thus, investors do not know the price of their shares when they place their order; if the order is in terms of a dollar amount (rather than a number of shares), they also do not know how many shares they are buying.
2. The SEC imposed forward pricing because it believed that backward-looking prices allowed those close to the market an unfair opportunity to profit at the expense of the fund. Entities that have dealer agreements with

a fund's underwriter, or that act as the fund's agent in receiving orders, may transmit their clients' orders after the time when the price is calculated, provided these entities received the orders before the pricing time.

B. What Days to Price

Funds are required to calculate net asset value at least once every day, Monday through Friday, except:

1. customary national business holidays described in the fund's prospectus, and local or regional business holidays listed in the prospectus;
2. days on which changes in the value of portfolio securities will not materially affect the fund's current NAV; and
3. days on which no purchase or redemption orders are received.

In practice, virtually all funds price every day the New York Stock Exchange is open, except specified local holidays.

C. Time of Pricing

The rule does not specify the time of day at which a fund must price, except that it must be determined by the fund's board of directors. See Rule 22c-1(b).

1. In practice, almost all funds specify the close of regular trading on the New York Stock Exchange, which is normally 4 p.m. New York time, as the time at which they will price.
2. Funds may price at other times. Many money market funds price at 12 noon and 4 p.m. Since money market funds usually settle on their investments by 12 noon, purchase orders received before 12 noon will receive that day's dividend, while later orders will not. The 4 p.m. pricing allows for convenient exchanges between the money funds and other funds.
3. The Exchange may stop trading early, either because of extreme volatility or because of unusual events, such as a heavy snowstorm or a political crisis. In that event, funds should follow their prospectuses.
 - a. Those that say the fund will price as of the close of the Exchange may price early, while those that specify 4 p.m. may have to wait.

- b. There are advantages to each approach. Because of forward pricing, funds whose shares are available through a far-flung network of brokers or pension administrators may find that unexpected midday trading halts create severe administrative difficulties for those entities. But pricing as of 4 p.m. on a day when the Exchange closed at 1 p.m. imposes the burden of determining the prices of portfolio securities hours after the market has closed.

III. WHAT IS “NET ASSET VALUE”?

Net asset value consists of the total assets of the fund, minus its liabilities, divided by the number of share outstanding.

In order to implement this calculation, funds must be able to price their portfolio securities and any other assets, and must accrue their liabilities. Rule 2a-4 sets forth certain requirements for these calculations:

- A. Changes in holdings of portfolio securities must be reflected no later than the first calculation on the first business day following trade date.
- B. Changes in the number of outstanding shares resulting from distributions and redemptions must be reflected no later than the first calculation on the first business day following such change.
- C. Expenses must be included to the date of the calculation.
- D. Dividends receivable must be included to the date of calculation, either at the ex-dividend date or the record date, as appropriate.
- E. Interest income must be included to the date of calculation.
- F. Expenses and interest income may be disregarded if collectively, when netted, they do not amount to one cent per share.

IV. VALUING PORTFOLIO SECURITIES

The largest component of net asset value generally relates to the value placed by the fund on its investment portfolio. The SEC generally requires that material errors in NAV be corrected, perhaps with payments to shareholder accounts that were significantly harmed by the mispricing (see below). Accordingly, portfolio valuation is a highly sensitive function.

A fund's board of directors is responsible for ensuring that appropriate procedures are established for pricing securities. Fund management should develop written securities

valuation procedures, including a system of control and supervision. The valuation procedures should be approved by the fund's board and set forth key elements of the valuation process, including delegation and oversight, sources for and review of pricing information, and correction of errors.

V. **BASIC METHODS OF VALUATION UNDER THE 1940 ACT**

A. **The Basic Dichotomy: Market Value or Fair Value**

Section 2(a)(41) of the 1940 Act defines "value" and groups securities to be valued in two categories:

1. securities "for which market quotations are readily available" are to be valued at "market value;"
2. all other securities are to be valued at "fair value as determined in good faith by the board of directors."

B. **SEC Interpretive Guidance**

In 1970, the SEC issued Accounting Series Release No. 118, ("ASR 118") which provides general guidance about the methods by which funds should value securities under both the "market value" and the "fair value" approaches. A year earlier, the SEC had issued Accounting Series Release No. 113 ("ASR 113"), which principally addressed valuation practices with respect to restricted securities, and also offered guidance on certain other aspects of the valuation process. It is clear from SEC enforcement action that these releases are regarded as operative sources. See, e.g., In the Matter of Parnassus Investments, Admin. Proc. File No. 3-9317 (Sept. 3, 1998) and In the Matter of Van Wagoner Capital Management, Inc., Admin. Proc. File No. 3-11611 (Aug. 26, 2001).

In December of 1999, the SEC released a letter to the Investment Company Institute providing guidance on mutual fund fair valuation responsibilities during emergency or unusual situations. The SEC clarified the 1999 letter by issuing a second letter in April of 2001, providing additional guidance on the concept of "significant events" in the context of fair value pricing and the inappropriate use of fair valuation for securities for which market quotations are readily available.

VI. **SECURITIES FOR WHICH MARKET VALUE IS READILY AVAILABLE**

A. **Securities Listed or Traded on an Exchange**

1. Security traded on valuation date. If the security was traded on the valuation date, the value generally is the last quoted sale price. If the security is listed on more than one securities exchange, the value is the last

quoted sale price up to the time of valuation, on the exchange on which the security is principally traded. If there were no sales on the principal exchange on the valuation date, the value is the last quoted sale price, up to the time of valuation, on the other exchanges.

2. Security for which there was no sale on the valuation date. If there were no sales of the security on the valuation date, the value of the security should be within the range of the published closing bid and asked prices, if available. In determining a security's value within this range, the SEC has stated that the following methodologies are acceptable, so long as a fund applies its methodology consistently:
 - a. bid price;
 - b. mean of bid and asked prices; or
 - c. valuation within the range of the bid and asked prices considered to be the best representation of value under the circumstances.

Normally, the use of the asked price alone is not appropriate. If only a bid price or an asked price is available on the valuation day, or the spread between bid and asked prices is substantial, quotations for several days should be reviewed to establish a value.

3. Indications that market quotations are unavailable. Where sales are infrequent, or the size of the reported trades is considered not representative of the fund's holding (as in the case of certain debt securities), further consideration should be given as to whether "market quotations are readily available" for the security. If not, a fund may use the alternative method of valuation prescribed by section 2(a)(41) – "fair value as determined in good faith by the board of directors."

B. Over-the-Counter Securities

Closing prices usually are not readily available for debt or equity securities traded over-the-counter. In these cases, regular quotations for securities are generally available in the form of inter-dealer bid and asked prices and financial reporting services.

1. Individual broker dealers. Quotations for a security should be obtained from more than one broker-dealer, particularly if quotations are available only from broker-dealers not known to be established market makers in that security.
2. Valuation policy. A fund may adopt a policy of using:

- a. a mean of the bid prices;
- b. a mean of the bid and asked prices;
- c. a mean of the prices of a representative selection of broker-dealers quoted on a particular security; or
- d. a valuation within the range of bid and asked prices considered best to represent the security's value under the circumstances.

Any of the above policies is appropriate so long as it is consistently applied. Asked prices alone normally are not acceptable.

- 3. Indications that market quotations are unavailable. If the validity of quotations appears to be questionable, or if the number of quotations indicates a thin market, then further considerations should be given to whether "market quotations are readily available" for the security. If not, a fund may use the alternative method of valuation prescribed by section 2(a)(41) – "fair value as determined in good faith by the board of directors." However, a fund is not required to use fair value methods in these circumstances. For example, a fund could use available market data for thinly traded securities if it considered the data to be reliable.

C. Money Market Investments.

Generally, debt securities with remaining maturities of 60 days or less can be valued by their amortized cost. Money market funds, most of which attempt to maintain a constant net asset value of \$1.00 per share, generally value all of their portfolio securities using amortized cost, pursuant to Rule 2a-7.

VII. FAIR VALUE PROCEDURES

A. When to Use the Fair Value Method

When there are no "readily available market quotations" for a security, the fund must value it at "fair value as determined in good faith by the board of directors." There is no definitive set of circumstances under which a fund must elect to use the fair value method to value a security. Funds choose to use the fair value method in connection with:

- 1. Securities whose market price is not available from a generally recognized pricing source;
- 2. Restricted securities (securities which may not be publicly sold without registration under the Securities Act of 1933). The SEC has set forth its

views with respect to the evaluation of restricted securities in ASR 113. This is less of a problem today than it was when ASR 113 was first adopted, because of the advent of the Rule 144A trading market, where institutional investors trade unregistered securities;

3. Securities whose trading has been suspended;
4. Debt securities that have recently gone into default and for which there is no readily available current market quotation;
5. Securities that are thinly traded or where there is only one market maker or dealer;
6. Securities with unchanged market values (stale prices); and
7. A security whose price, as provided by a generally recognized pricing source, does not reflect the security's "fair value" in the opinion of the fund's adviser. This situation may be especially relevant with respect to foreign securities, where certain foreign markets close some hours before the fund portfolio is priced, and intervening events raise questions about the foreign securities' price.

B. Significant Events

Many funds hold foreign securities that trade in markets that close hours before the fund values its holdings. The SEC has cautioned that funds must monitor for "significant events" occurring during that time interval, which may indicate that the closing price on the foreign market is no longer "readily available."

Significant events can include extreme market volatility, wars, natural disasters, or events specific to a particular issuer. If the manager concludes that a significant event has occurred, it must fair value the security. The same concerns would affect a security traded in domestic markets where either the security or the exchange is subject to a trading halt before the fund's normal pricing time.

In recent years, a consensus has developed that the term "significant event" includes a significant movement of U.S. securities prices occurring after the daily close of the foreign markets. This approach is based on the observation that significant movements in the U.S. markets are generally reflected in the next day's opening prices on foreign markets. Thus, a fund that prices at 4 p.m. New York time and contains securities that trade primarily in European or Asian markets, will have to consider whether the closing prices on those foreign markets are still valid if there has been a significant movement in the U.S. markets since the foreign markets closed. Several commercial vendors now offer to calculate revised prices of foreign equity securities in these situations, based on a number of factors that appear to correlate the prices of the foreign securities to movements

in the U.S. markets. Fund boards that approve the use of such services generally have to select a trigger point, *i.e.*, a percentage movement in a suitable U.S. market index that triggers the use of the fair value prices. Such funds monitor the appropriateness of their particular trigger point and the quality of the valuation service by looking to see whether the adjusted price is closer to or farther away from the next day's opening price on the foreign market, as compared to the unadjusted price.

C. Factors to be Considered in Determining Fair Value

The SEC staff states in ASR 118 that “no single standard for determining ‘fair value in good faith’ can be established, since fair value depends on the circumstances in each individual case. As a general principal, the current ‘fair value’ of an issue of securities being valued by the board of directors would be the amount which the owner might reasonably expect to receive for them upon their current sale. Methods which are in accord with this principle may, for example, be based on a multiple of earnings, or a discount from market of a similar freely traded security, or yield to maturity with respect to debt issues, or a combination of these and other methods.”

ASR 113 and ASR 118 suggest that fundamental analytical information is among the most important factors for fund boards to evaluate when determining a method for fair value pricing portfolio securities. In the 1999 letter to the ICI, the SEC acknowledged that the appropriateness of such factors, however, depend on the particular facts or circumstances precipitating the need for fair valuation. In the case of a significant event, therefore, fund boards may need to incorporate other, external sources of information in their fair value determinations.

1. General and Specific Factors for Determining Fair Valuation Methods

ASR 118 indicates that funds should consider certain general factors in determining a valuation method for an individual security, including the fundamental analytical data relating to the investment; the nature and duration of restrictions on disposition of the securities; and an evaluation of the forces which influence the market in which these securities may be purchased and sold. In particular, the SEC has indicated funds should consider certain specific factors to determine a valuation method, including the following:

- a. Type of security;
- b. Financial statements;
- c. Cost at date of purchase;

- d. Size of the holding;
- e. Discount from market value of unrestricted securities of the same class at time of purchase;
- f. Special reports prepared by analysts;
- g. Information as to any transactions or offers with respect to the security;
- h. Existence of merger proposals or tender offers affecting the securities;
- i. Price and extent of public trading in similar securities of the issuer or compatible companies;
- j. If debt, the value of any collateral;
- k. Any shelf registration of restricted securities; and
- l. Any right to require the issuer to register restricted securities.

The SEC guidelines in the ASRs “[do] not purport to delineate all factors which may be considered” when using the fair value method. The guidelines state that fund directors “should take into consideration all indications of value available to them in determining the ‘fair value’ assigned to a particular security.” For example, it may be appropriate to consider additional factors with respect to foreign securities, such as currency exchange ratios and their fluctuation, currency restrictions, and other factors.

2. Other External Factors

The 1999 ICI letter lists some examples of external factors that a fund may incorporate in their fair value determinations, such as information derived from world financial markets and various financial products. Such factors include:

- a. The value of other financial instruments, including derivative securities, traded on other markets or among dealers;
- b. Trading volumes on markets, exchanges, or among dealers;
- c. Values of baskets of securities traded on other markets, exchanges, or among dealers;

- d. Changes in interest rates;
- e. Observations from financial institutions;
- f. Government (domestic or foreign) actions or pronouncements and other news events; and
- g. In the case of foreign investments, the value of foreign securities traded on other foreign markets, ADR trading, closed-end fund trading, foreign currency exchange activity and the trading prices of financial products that are tied to baskets of foreign securities.

During an emergency or other event, the fund should evaluate the nature and duration of the event and the forces influencing the operation of the financial markets.

VIII. FAS 157

- A. It is enlightening to consider all of this SEC guidance in the context of Financial Accounting Standards Board's new statement on Fair Value Measures, FAS 157, which was issued in September, 2006 and which will be effective for financial statements issued for fiscal years beginning after November 15, 2007.
- B. Eliminating the Market Value/Fair Value Dichotomy
 - 1. Notably, FAS 157 does not reflect the same dichotomy between "market" and "fair" valuations that exists under the 1940 Act and the various SEC pronouncements.
 - a. Instead, FAS 157 makes clear that market quotations – whether obtained from an exchange closing price or from dealer quotations – are merely means ("inputs") for determining the fair value of an asset.
 - b. In the long run, the absence of that dichotomy under GAAP may be significant in assessing the relative roles and responsibilities of fund boards with respect to the various means used in the value process.
 - 2. FAS 157 establishes a somewhat different dichotomy, discussed below. This dichotomy is between "observable" and "unobservable" inputs, and the Statement presents a hierarchy of these inputs that is substantially similar to what is called for under existing SEC guidance.
- C. Techniques, Approaches and Inputs

1. FAS 157 articulates three types of valuation “approaches” – market, income and cost – that may be chosen as appropriate for valuing particular assets.
 - a. The Statement then refers to various valuation “techniques” that are consistent with, and that serve to describe, these approaches.
2. The “market” approach is described as the use of “prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.”
 - a. Matrix pricing is described as a valuation “technique” that is consistent with the market approach to fair valuing assets.
3. The “income” approach is described as “us[ing] valuation techniques to convert future amounts (for example, cash flows or earnings” to a single present amount” that is discounted.
 - a. Present value and option pricing models, such as the Black-Scholes-Merton formula, are described as techniques that are used under this approach.
4. The “cost” approach is based on replacement cost and utilizes techniques that seem generally best suited for tangible assets, rather than the financial with which funds are concerned.
5. While the market approach appears to be the most appropriate valuation “approach” for most of the financial assets held by funds – i.e., stocks and bonds – the income approach appears might be thought to be appropriate to some derivative assets.
 - a. However, the Section 2(a)(41) and Rule 2a-4 requirements that priority be given to market valuations may present obstacles for funds that might wish to apply the income approach to valuing such assets.
 - b. FAS 157 recognizes that in some cases multiple valuation techniques may be appropriate for use in connection with a given valuation approach. However, while a change in technique may be appropriate as long as it yields a value that is “equally or more representative of fair value,” techniques are to be consistently applied.

6. The heart of FAS 157 is a statement of a hierarchy of valuation “inputs” that are to be used in order to apply the chosen valuation approach and technique.
 - a. “Inputs” are described as being “the assumptions that market participants would use” in pricing, including assumptions about risk.
 - b. Inputs are divided into two categories: observable and unobservable.
 - (1) “Observable” inputs are inputs that are based on market data obtained from sources independent of the reporting entity.
 - (2) “Unobservable” inputs are inputs that reflect the reporting entity’s own assumptions as to how market participants would approach pricing.
 - (a) These are to be based on “the best information that is available in the circumstances.”
 - (b) But the key distinction is that they are not from independent, third party sources.
 - c. The Statement requires that valuation techniques “maximize the use of observable inputs and minimize the use of unobservable inputs.”
 - (1) In other words, FAS 157, like the 1940 Act and the SEC’s guidance, prefers third party market data to internally generated calculations.
 - (2) But this is not quite the same as a distinction between “market” values and “fair” values.

D. The Fair Value Hierarchy

1. FAS 157 describes three “levels” of inputs.
2. Level 1 – the highest level of inputs – comprises unadjusted quoted prices in active markets for identical assets.
 - a. This is to be used “whenever available.”

- b. However, the Statement recognizes that quotes from active markets “might not represent fair value” in some instances, including where there have been “significant events.”
 - (1) As under the SEC’s 2001 letter, the Statement requires that reporting entities “establish and consistently apply a policy for identifying those events that might affect fair value measurements.”
 - (2) When adjustments are made by reason of such events, however, the input ceases to be “Level 1.”
 - c. The Statement also makes clear that a quoted price “should not be adjusted because of the size of the position” held relative to trading volume. This is expressly prohibited.
 - (1) This is consistent with the long standing SEC position that liquidity determinations should be made by reference to the ability to dispose of normal trading unit of securities, not the ability to dispose of the entirety of a large block of shares. (Inv. Co. Rel. 19399 (April 7, 1993))
- 3. Level 2 inputs are inputs other than quoted prices that are “observable” either directly or indirectly. These include (seemingly, but not clearly, in order of preferability):
 - a. Quoted prices for similar assets in active markets – e.g., matrix pricing;
 - b. Quoted prices for either identical or similar assets in markets that are not active;
 - c. Inputs other than quoted prices that are observable – e.g., interest rates and yield curves that are observable at commonly quoted intervals, prepayment speeds, loss severities, credit risks and default rates; and
 - d. Inputs that are “derived principally from or corroborated by observable market data by correlation or other means. These are called “market corroborated inputs.”
- 4. Level 3 inputs are those that are unobservable.

- a. This is in effect an “all other” category that seems to equate to what most people would have considered “fair valuing” under the traditional SEC guidance.
- 5. The difference in the categories used by FAS 157, as compared to those used in the SEC guidance is revealing. It emphasizes the extent to which pricing data, if not the valuation itself, is primarily objective and comes from third party sources.

E. Disclosure

- 1. The aspect of FAS 157 that may have the most significant short-term effect on funds is its requirement regarding disclosure.
- 2. FAS 157 requires that entities disclose the following information for each of its annual and interim financial reporting periods:
 - a. The fair values of their assets;
 - b. The “level” within the fair value hierarchy in which the assets fell – in other words:
 - (1) if the entity reported total assets fair valued at \$100 million, what portion was valued using Level 1 inputs (e.g., \$75 million was valued using quoted prices in active markets), what portion using Level 2 inputs (e.g., \$20 million was valued using “other observable inputs”) and what portion using Level 3 inputs (e.g., \$5 million using unobservable inputs).
 - c. For the assets valued using Level 3 (unobservable) inputs, a reconciliation showing beginning and ending balances broken down to show gains and losses, purchases and sales and transfers in and out of the Level 3 input category.
 - d. Unrealized gains or losses relating to those assets still held at the end of the reporting period and a description of where those unrealized gains or losses are reported in the income or activities statement.
- 3. FAS 157 also requires that entities report in their annual (not interim) financial reports the valuation techniques used to measure fair value and a discussion of any changes in those techniques during the period.

IX. SOURCES OF PRICING INFORMATION AND PRICING METHODOLOGIES

A. Third Party Pricing Services

Most funds obtain almost all of their initial pricing information from third party pricing services, which generally offer the convenience and efficiency of obtaining a large quantity of information from a few sources. Funds use pricing services both to collect and transmit market prices to the funds and to provide prices for those securities for which market quotations are not available.

1. Methodology. Pricing services employ a variety of methodologies. For listed securities, pricing services are likely to obtain prices directly from the relevant exchanges or the Nasdaq Stock Market. For pricing unlisted equity securities and fixed income securities, pricing services maintain databases of current (or most recent) quotations from dealers who make markets in those securities. With respect to fixed income securities, the majority of which are not exchange-traded, pricing services generally rely on matrix pricing and valuation models to derive prices. Matrix pricing essentially involves valuing portfolio securities by reference to other securities considered comparable with respect to certain relevant characteristics (rating, interest rate, due date, etc.). Finally, some pricing services provide “hand pricing” for certain portfolio securities using a variety of analytical methods.

Although the staff permits the use of pricing services and matrix pricing, it has noted that “prices provided by third parties should be subject to appropriate controls” and that boards should focus on controls when overseeing the proper valuation of fund shares.

B. Dealer Quotations

Funds may obtain dealer quotations when prices are not available from pricing services, or when fund management determines that it would be more reliable and efficient to obtain prices directly from dealers who are active market makers in the particular securities.

1. Methodology. Like pricing services, dealers may use matrix pricing or analytical techniques to derive valuations for securities that they are not actively trading. Dealers may use these techniques, even if they are active market makers in a particular security, to establish a bid or offer price for that security. Because these pricing techniques are complex and involve a degree of subjectivity, fund management should consider obtaining documentation from dealers regarding the basis upon which they will determine their quotes. The documentation provides some assurance that dealers will determine their quotes on a basis that is consistent with the

fund's own pricing procedures. Where more than one dealer makes a market in a particular security, fund management may need to determine which quote is likely to be the most reliable or, if practicable, whether to use an average of several quotes.

C. Valuations Generated by the Fund

As discussed above, although funds typically rely on third party pricing services, fund procedures may identify situations where prices should be generated internally. Valuation procedures should specify the circumstances under which the fund will use internally generated prices and the board-approved methodologies to be used in the internal valuation process. It is important that the fund document in detail:

1. the reason for use of a particular fair value methodology;
2. the factors considered by the board or other supervisory personnel in their approval of a particular methodology; and
3. the regular review of the continuing appropriateness of a particular fair value methodology. See In the Matter of Parnassus Investments, above.

X. OVERSIGHT OF SECURITIES VALUATION

A. Valuation Process and Obligations

A fund's board of directors, officers, investment adviser or administrator, portfolio manager, and the service provider that provides primary pricing information all should play a role in the valuation process. When the SEC adopted Rule 38a-1 requiring funds to develop compliance policies and procedures, the adopting release stated that a fund must adopt written procedures that require the fund to monitor for circumstances that may necessitate the use of fair value prices; establish criteria for determining when market quotations are no longer reliable for a particular portfolio security; provide a methodology or methodologies by which the fund determines the current fair value of the portfolio security; and regularly review the appropriateness and accuracy of the method used in valuing securities, and make any necessary adjustments.

B. The Board of Directors

A fund's board of directors should ensure that appropriate procedures are in place to make both market value and fair value determinations. The board's role in the development of such procedures typically consists of approving the procedures, monitoring their implementation and reviewing fair valuation pricing reports, error reports and changes to any of the procedures. A board may establish a

valuation committee to assist in valuation issues for the fund, and the valuation committee members may include investment personnel, accountants and/or the chief investment officer. If a board delegates such responsibilities to a valuation committee, it should adopt a written charter to define the authority delegated to the committee, or it should define such authority in the written valuation procedures.

1. Day-to-Day Pricing Operations. ASR 118 states that fund boards must “determine the method of arriving at the fair value of each such security . . . [and] consistent with this responsibility continuously review the appropriateness of the method used in valuing each issue of security in the company’s portfolio.”

However, several factors make it impractical for fund boards to be significantly involved in a fund’s day-to-day pricing operations, except in unusual circumstances. The pricing function can be highly technical and complex, and there is often a very short time frame in which to work. Independent directors typically are not securities professionals and can devote only a few days per month to board service.

The release contemplates that the board may delegate the responsibility for development and implementation of pricing procedures to those who have substantive expertise, time and resources to discharge those functions effectively. ASR 118 notes that directors “may appoint persons to assist them in the determination of value and to make the actual calculations.”

2. Internally Generated Prices. The board of directors is assigned a greater level of responsibility with respect to fair valued securities. Since prices for some fair valued securities are generated internally, a heightened level of scrutiny may be appropriate in light of the potential for conflicts of interest. Accordingly, the full board should review fund procedures and methodologies for internally generated prices, as well as consider periodically the continuing appropriateness of any such methodology. This review and reasons for any board determinations should be well documented in the minutes of the board’s meetings when it considers such matters.

C. Oversight Roles within the Fund Operational Structure

Fund Operations Pricing Group. This operational group is responsible for collecting initial pricing information for the fund. Fund valuation procedures should establish the types of review that it expects the pricing group to perform and identify the parties to whom the pricing group is to report any potential problems.

The pricing group typically is expected to review daily pricing information that it receives and to challenge valuations that appear questionable by inquiry to the pricing service or dealer. Pricing groups employ the following procedural safeguards:

1. Verification of Data. Pricing groups generally take reasonable steps to confirm that the pricing sources have recorded the proper identifying information for each security and that the pricing data is accurately transmitted and recorded. Pricing groups also typically verify that the correct pricing source is being used.
2. Cross-Checking of Valuations and Quotes. To confirm that the valuation process is operating correctly, many pricing groups periodically cross-check the prices received from pricing services against:
 - a. quotes from other pricing services;
 - b. quotes from dealers making a market in the particular securities;
 - c. prices from actual sales in the particular securities, when they occur; and
 - d. prices for comparable securities.

Valuation procedures may specify the method and frequency of such testing. The pricing group should also be looking for stale prices, *i.e.*, those that have not changed in several days, as this can indicate that the price is no longer reliable or “readily available.”

3. Cross-Checking Dealer Quotes. ASR 118 states that bid and asked quotes ordinarily should be obtained from more than one dealer. However, in the context of pricing a security, as opposed to executing an actual transaction, obtaining multiple quotes on a daily basis for the numerous securities in a fund’s portfolio is not practicable. Regular cross-checking of dealer quotes by a fund’s pricing group can provide assurance to the fund.
4. Automated or Other Flagging Systems. The pricing group also may monitor valuations against specified criteria to identify potential pricing errors or problems. Funds may employ automated flagging systems to check prices against indices or other data. The pricing group reviews the automated report and analyzes issues raised by the flags. Typical flags may identify:

- a. securities for which market quotations are not available or which cannot be obtained from a regular source;
- b. securities whose current price differs from its previous price by a particular range, or whose price movements differ significantly from those of specified indices;
- c. securities whose price has not changed over a specific period of time (*e.g.* 10 days);
- d. securities that have traded at a price that differs from the most recent valuation by more than a specified percentage;
- e. securities that have undergone stock splits or received dividends.

D. Investment Personnel

A fund's portfolio manager and its analysts or traders can play an important role with respect to identifying pricing issues and proposing specific solutions to valuation problems. A portfolio manager or other investment professional is likely to have knowledge of specific circumstances that can explain a discrepancy in a security's price, and to be in the best position to identify an alternative pricing source for a security when necessary. The portfolio manager can also review portfolio security prices to identify discrepancies not uncovered by other fund personnel. However, because portfolio managers have a professional and personal interest in portfolio securities' performance, funds may be well advised to limit portfolio managers' direct involvement in individual pricing decisions.

E. Review and Testing of Valuation Policies and Procedures

The SEC requires funds to regularly review and evaluate the accuracy and appropriateness of fair valuation methodologies employed. Testing of actual fair valuation prices determined over specific periods will assist a fund in identifying and addressing problems with fair valuation methodologies. An ICI white paper released in September, 2005 recommends methods for back-testing fair valuations.

1. Testing actual trades. A fund may compare the fair value price of a security generated by the fund to prices received in actual reported trades for that security. If there is a significant deviance between the two prices, the fair valuation should be brought to the attention of the valuation committee or the board of directors, per the valuation policies and procedures of the fund. If a pattern occurs over a period of time, the fund and the board may want to review and modify the fair valuation methodology to correct for such issues.

2. Testing against subsequent market prices. Fair value prices may also be tested against the last market price and the next available market price, such as the next-day opening price for foreign securities. This type of testing can show whether the fair value used by a fund was generally closer to the subsequent market price, both in terms of the direction and magnitude, than was the previous market price.

XI. CORRECTION OF PRICING ERRORS

A. Pricing Errors

Funds sometimes discover pricing errors that have had an effect on the prices paid or received by shareholders over a period of time. Retroactive correction of these errors can be expensive, both in the time and effort required to recalculate account values and in payments to shareholders who were disadvantaged by the error. The cost and complexity may be compounded where the fund has a number of omnibus accounts for various institutions, each representing a large number of individual investors. These institutions may have their own policies on the correction of pricing errors, and may want the fund or its administrator to pay their costs.

B. Guidelines for Correction of Errors

Because of the potential costs involved in correcting pricing errors, fund groups would usually prefer not to correct errors that are not material to the fund or individual investors. The SEC staff has informally acceded to guidelines used by various fund groups to determine when and in what way pricing errors must be corrected. The basic rules are as follows:

1. If the error in NAV amounts to less than one cent per share, no retroactive corrective action is required.
2. If the error amounts to one cent per share or more, the responsible party should reimburse the fund for the net loss to the fund.
3. If the error is less than $\frac{1}{2}$ of one percent of NAV, no further action need be taken regarding individual shareholder accounts.
4. If the error amounts to one cent per share or more and equals or exceeds $\frac{1}{2}$ of one percent of NAV, adjustments must be made to individual shareholder accounts that suffered more than a *de minimis* loss, perhaps \$10 or more.

XII. LIQUIDITY PROCEDURES

A. Regulatory requirements

1. SEC policies require that no more than 15% of an open-end fund's net assets (10% for money market funds) be illiquid.
2. A security normally is considered illiquid if it cannot be "sold or disposed of in the ordinary course of business within 7 days at approximately the value" at which it is being carried by the fund.

B. Establishing responsibility for monitoring and making liquidity determinations

1. Funds need to establish a guidelines for identifying illiquid portfolio securities at or prior to the time that they are purchased and for monitoring liquidity (or illiquidity) thereafter.
 - a. Unlike valuation determinations, the initial liquidity determination frequently is made by the portfolio manager.
 - b. Managers should identify events that may change the liquid or illiquid status of particular securities and report those events to identified supervisory personnel.
 - (1) Most funds do not establish regular monitoring of securities to verify their liquidity.

C. Procedures for determining that presumptively illiquid securities are liquid

1. The SEC has indicated that certain types of securities are presumed to be illiquid but that that presumption if appropriate findings are made pursuant to procedures approved by the fund's board.
2. Presumptively illiquid securities include:
 - a. Rule 144A securities
 - b. Municipal lease obligations
 - c. Fixed rate government IOs and POs
 - d. Section 4(2) commercial paper
3. Factors used to overcome the presumption of illiquidity include:

- a. Frequency of trades or quotes;
- b. The number of dealers or others willing to purchase the security;
- c. dealer undertakings to make a market in the security; and
- d. the nature of the marketplace (i.e. mechanics of transfer; available methods of soliciting offers, etc.).

XIII. ROLE OF VALUATION IN LATE TRADING AND MARKET TIMING

A. Late Trading

Late trading is the illegal process of placing or permitting trade orders for fund shares to be placed after the time at which net asset value for the fund is calculated (generally 4:00 p.m.).

- 1. Late trading is a violation of the forward pricing requirement of Rule 22c-1, because it allows those placing such trades to receive a price calculated at an earlier time.
- 2. Late trading allows those who place such trades to profit through the use of information that becomes available after pricing and is likely to affect the next day's price. By obtaining the share price determined prior to such information being released, a late trader stands to profit through this change in price.
- 3. As previously discussed, various distribution channels and intermediaries exacerbate the problem of late trading, since current practice permits various intermediaries to act as limited agents for funds in accepting orders from their customers. As long as those customer orders are received by the intermediary before 4:00 p.m., the intermediary may transmit the orders to the fund companies at a later time that same evening, and in some cases early the next morning.
- 4. To the extent that any intermediary allows a customer to place an order (or to retract an order earlier placed) after 4:00 p.m., the intermediary is in violation of the late trading prohibitions of Rule 22c-1.

B. Market Timing

Market timing refers to frequent buying and selling of mutual fund shares to take advantage of information that becomes available following the close of certain markets, typically foreign markets that close several hours ahead of the U.S. markets.

1. Market timing is not per se illegal, but many fund prospectuses state that the funds discourage such frequent trading. Problems result when funds permit certain investors to engage in market timing while preventing other customers from doing so.
2. As mentioned above, funds will often try to correct for late-breaking information by “fair-valuing” portfolio securities that may be particularly affected by such information. For example, if negative economic or political news in Asia appears after the close of the Asian markets but before pricing occurs in the U.S., many fund groups will attempt to account for such information in their daily pricing by reducing the valuation of certain Asian and foreign funds.
3. The difficulties that arise with such fair valuing include whether positive or negative news is sufficiently strong to trigger fair valuation and, if so, what the magnitude of the pricing correction should be.
4. The SEC approved new Rule 22c-2 in March of 2005 that gives a mutual fund’s board of directors the discretion to impose redemption fees on short-term trades. This final rule, which differs from the proposed rule mandating a redemption fee on all short-term trades, states:
 - a. Funds may impose a redemption fee of up to 2% on shares redeemed within seven days of purchase, but are not required to adopt such a fee.
 - b. The board of directors will determine on a fund-by-fund basis if there is a need for a redemption fee based on the level of activity.
 - c. Mutual funds must also negotiate written contracts with their intermediaries to obligate the intermediaries to provide shareholder trading information and to follow fund instructions for implementing trading restrictions against traders the fund has identified as violating the fund’s market timing policies.
 - d. There is no provision for sanctions, which was present in the proposed rule, if the mutual fund suspects a trader is engaged in market timing.

XIV. REQUIRED DISCLOSURE

In May 2004, the SEC adopted amendments to Form N-1A requiring funds, other than money market funds, to explain briefly in their prospectuses both the circumstances under which they use fair value pricing and the effects of fair value pricing.

A. Circumstances under Which Fair Value Pricing is Used

The required disclosure should be specific to the fund. For example, if a fund invests heavily in foreign securities, the disclosure should include a discussion of the effects of specific events occurring after the close of a foreign exchange and affecting the value of a foreign security that might cause the fund to use fair value pricing.

B. Effects of Fair Value Pricing

In addition, the disclosure must include a discussion of the effects of fair value pricing. For example, fair valuation of securities will cause a security to be valued on subjective judgment of the board of directors or the valuation committee, and not based on market prices. In addition, fair valuation may serve to reduce arbitrage opportunities available to market timers.

Brokerage and Trading: Best Execution, Soft Dollars, Trade Aggregation and Allocation, Side-by-Side Management

Michael S. Caccese

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Best Execution

I. What is best execution?

- No precise legal definition – no single objective standard
- Adviser has a duty to seek best price and execution of client trades under the circumstances
- Price important element, but best price does not necessarily equal best execution
- Best execution requires obtaining the best quantitative and *qualitative* transaction

What can be considered when deciding where to trade?

- Price
- Speed and promptness of execution
- Responsiveness
- Confidentiality
- Back office capabilities
- Willingness and ability to handle complex trades
- Knowledge of and access to potential market participants
- Willingness to commit capital/adequately capitalized
- Reputation, overall knowledge of market and financial stability
- Past experiences

Best Practices

II. What are best execution best practices? (Source: CFA Institute recommendations)

Processes

- Difficult to evaluate every transaction, processes provide guidance for transactions
- Enable monitoring

Examples of processes:

- Establish internal oversight committees
- Implement trading policies and procedures, including guidelines on selecting counterparties
- Review counterparty usage
- Identify potential conflicts (disclose in ADV/fund documents)
- Review available third-party data, where possible
- Create broker selection guidelines
- Maintain records

Disclosure

- Broker selection practices
- Conflicts of Interest

Recordkeeping

Why?

- Facilitate best execution
- Meet Disclosures obligations
- Support order routing practices to regulators

Recordkeeping

What?

- Broker selection
- Overall broker performance
- Post trade analysis of execution quality
- Soft dollar practices
- Broker commissions
- Client instructions
- Broker commissions
- Committee materials

Soft Dollars

I. What are soft dollars?

- Arrangements where an adviser uses brokerage commissions in exchange for research or other products or services from broker-dealer
- Soft dollars allows adviser to obtain research at no out-of-pocket cost to adviser and thus minimizes adviser's costs
- Generally limited to equity trading

Safe Harbor

II. Section 28(e) safe harbor

- Adviser must exercise discretion over the accounts
- Product/service must qualify as eligible “research or “brokerage” under Section 28(e)
- Product/service must actually provide “lawful and appropriate assistance” in the performance of adviser’s investment decision-making
- Adviser must make good faith determination that commissions paid are “reasonable in light of the value of products or services provided by broker-dealer”

Eligible Research

III. What is eligible “research”?

- “Advice,” “analysis,” or “reports” that reflect the “expression of reasoning or knowledge”
- Research reports, investment seminars, meetings and discussions with research analysts and company execs, trade analytics, certain data services
- NOT research: mass marketed publications (WSJ), proxy voting research, operational overhead (salaries, rent, equipment), computer hardware, travel

Eligible Services

IV. What are eligible “brokerage” services?

- Effecting securities transactions and performing incidental functions
- Temporal standard for “eligible brokerage”
 - Begins when adviser communicates with the broker-dealer for purpose of entering an order and ends when securities/funds are delivered/credited to the advised account

Mixed Use

V. Mixed Use

- Research product/service with non-research uses
- Inherent conflict since the non-research product benefits adviser
- Adviser must make reasonable allocation

Practices

VI. Broker Selection/Soft Dollars practices

- Disclose policies in ADV
- Review policies and procedures of subadvisers
- Some advisers establish committees to oversee soft dollar usage
- Refrain from arrangements obligating adviser to generate a specified level of business for research provider
- Establish processes to evaluate the quality and value of research/services received
- Retain records and monitor counterparty usage to discern trends and monitor compliance with internal policies

Role of Mutual Fund Directors Regarding Adviser Portfolio Trading Practices

- I. Directors' responsibilities generally
 - Overall management of fund's business
 - State and common law fiduciary duties
 - Duty of Care
 - Duty of Loyalty
 - Federal Law – Investment Company Act
 - Supervise fund's operations – Monitor conflicts of interest and management of conflicts
 - Monitor and direct adviser's management of fund in best interest of fund's shareholders

Regulatory Guidance

II. SEC Proposed Guidance

- July 31, 2008 proposal to assist fund boards fulfill oversight responsibilities regarding adviser's portfolio trading practices
- Addresses board responsibilities regarding adviser's potential conflicts of interest
 - Best execution and transaction costs
 - Use of fund brokerage commissions

Best Execution

- Relevant data for fund board consideration
 - Identity of broker-dealers to which the adviser has allocated fund trading and brokerage
 - Commission rates or spreads paid
 - Total brokerage commissions and value of securities executed that are allocated to each broker-dealer during a particular period
 - Fund's portfolio turnover rates

Best Execution (cont.)

- Other Considerations
 - Factors vary depending on fund's investment objective, trading practices, personnel
 - Examples
 - The process for making trading decisions and selecting execution venues and broker-dealers
 - How the adviser assesses best execution and execution quality
 - The process for negotiating commissions
 - How the adviser evaluates “execution-only” trades versus “soft-dollar” trades
 - How the adviser evaluates its traders

Adviser's Use of Brokerage Commissions

- Potential Adviser Conflicts
 - Use of commissions to buy research - otherwise paid for with “hard dollars” from adviser’s resources
 - Trading a fund’s portfolio to earn soft dollar credits
 - Selection of broker-dealer based on its research services as opposed to quality of execution
 - Use of soft dollars that disguises its true cost, thus enabling adviser to charge fees that do not reflect true costs of portfolio management services

Use of Brokerage Commissions (cont.)

- Possible board directives to adviser:
 - Refrain from using soft dollar trading for certain types of trades
 - Alter the mix of trades applying soft dollars; or
 - Use soft dollar trading only for commission recapture or expense reimbursement programs

Trade Aggregation and Allocation

I. What is trade aggregation?

- “Blocking or “bunching” trade orders on behalf of multiple clients
- Larger (aggregated) trades may result in better execution
- Ultimately, written procedures should be instituted to ensure fairness for all accounts
- Procedures should address when to block and when not to block

Trade Allocation

II. What is trade allocation?

- Dividing scarce or limited investment opportunities among clients
- Each client is owed the same duties
- Potential conflicts when accounts pay different fees

Standard Procedures

Principles of “fair and equitable” allocation

- Pro-rata allocation of each day’s transaction
 - Factors considered for pro-rata allocations:
 - asset size of account
 - account’s current holdings of issuer
 - proportion account’s targeted amount of that security bears to total amount desired for all accounts
- Rotational allocation – accounts receive full allocation on rotating basis
- *De minimis* allocation – smaller accounts or accounts with small initial allocation receive entire allocation before pro-rata allocation to larger accounts.

Standard Procedures (cont.)

- Timing of allocation: generally at or before order is submitted for execution
- Post-execution allocation acceptable if:
 - all clients' orders receive fair and equitable treatment
 - allocation is consistent with adviser's fiduciary duties and duty of best execution
 - Revised post-trade allocations if existing order not filled or pro-rata allocation would result in small holdings or odd lot holdings

Standard Procedures (cont.)

- Monitoring of hedge fund's trades and performance for evidence of patterns that unfairly favor hedge fund
- Disclosure of allocation procedures
- Disclosure of trading activity of mutual funds and hedge funds to mutual funds' boards of directors for monitoring allocation procedure effectiveness

Trade Error Correction

I. What are trade errors?

- Errors are inevitable
- Examples
 - Buying/selling the wrong security for an account
 - Buying/selling a security for the wrong account
 - Buying/selling the wrong amount of security
 - Buying instead of selling (and vice versa)
 - Buying in contravention of an account restriction

Trade Errors

II. How do trade errors get fixed ?

- If prior to settlement, trade is unwound and error account used
- If post-settlement, reverse trade in the market
- Adviser makes account whole for any losses
- If error leads to gain, account keeps gain
- Cannot net gain from one error against loss from another
- Procedures should outline loss calculations

BROKERAGE AND TRADING**I. BEST PRICE AND EXECUTION****A. Introduction**

Investment advisers, as fiduciaries, have an obligation to seek to obtain best price and execution of clients' transactions under the circumstances of the particular transactions.

B. Definition of Best Price and Execution

One of the basic duties of a fiduciary is the duty to execute securities transactions for clients in such a manner that the clients' total costs or proceeds in each transaction are the most favorable under the circumstances. There is no precise legal definition of "best execution" and no single objective standard to identify it.

1. A key element is securing the best price for the transaction. Best price means the highest price when the adviser is selling a security and the lowest price when the adviser is buying a security.
2. In addition to price, best execution encompasses obtaining the best qualitative transaction for the client (*e.g.*, low commission rates, placing a large order in pieces so as to not affect the market). Other factors in determining whether the adviser has achieved best execution include the confidentiality provided by the broker; the promptness of execution of securities transactions; the broker-dealer's clearance and settlement capabilities; the broker-dealer's willingness and ability to handle complex trades, including committing capital where necessary; and the reputation and financial stability of the broker-dealer. An adviser may also consider the quality of research and other services that are obtained with client commissions and their value *to the client* in evaluating best execution. See Part D below.
3. Generally, advisers should make periodic evaluations of the execution performance of the broker-dealers it selects for client transactions to measure the varying factors considered in determining best execution.
4. SEC rules require brokers to make available data on the market centers to which they direct customer trades for execution, and require market centers to publish data on the timeliness and price at which orders have been executed. Advisers may want to use this information in evaluating the performance of the brokers they use.

C. Conflicts of Interest Regarding Best Execution

If an investment adviser has a potential conflict of interest in its selection of a broker-dealer to execute securities transactions for its clients, *e.g.*, through an affiliation or relationship, it must disclose this conflict of interest. Otherwise, if the investment adviser uses such a broker-dealer, an argument may be raised that transactions through that broker-dealer did not achieve best execution. SEC enforcement actions focus more on conflicts of interest than on particular trades. Certain of these potential conflicts are discussed below.

D. CFA Institute Trade Management (Best Execution) Guidelines

1. The CFA Institute (formerly AIMR) has published a set of Trade Management Guidelines that are intended as a compilation of recommended best practices with respect to the obligations of investment management firms and other investment professionals regarding the execution of securities trades and management of trading functions.

2. The guidelines focus on three areas addressing the concept of best execution: processes, disclosure and recordkeeping.

a. Processes

In order to create a standard methodology for seeking best execution, the guidelines recommend that a firm establish trade management policies and procedures that include establishing a trade management oversight committee, identifying conflicts of interest resulting from trading activities and requiring disclosure of those conflicts to clients, establishing policies and procedures addressing client-directed brokerage arrangements, implementing reports and analyses regarding firm trading costs and execution trends, creating broker selection guidelines, an approved brokers list and a brokerage allocation plan, and establishing controls to monitor and evaluate broker performance and execution quality.

b. Disclosure

The guidelines recommend that on a regular basis the firm's trade management practices and conflicts (actual as well as potential) be clearly disclosed in full. More specifically, the guidelines note that a firm should disclose its broker selection practices, including the information considered in the trade management process and a list of factors used in the broker selection process. As to actual or potential conflicts of interest, the guidelines note that disclosure may be warranted for step-outs, trade allocation and aggregation policies, soft dollar arrangements, affiliated broker usage, material business relationships with market makers or market centers,

directed brokerage arrangements, use of client brokerage to pay for referrals or other arrangements promoting the firm's business, and use of client brokerage to acquire goods or services that do not constitute research or brokerage services.

c. Recordkeeping

The guidelines recommend that the firm maintain meaningful and complete trading records to facilitate pursuit of best execution for clients, meet disclosure obligations and support order routing practices to applicable regulatory authorities. These should include records pertaining to broker selection, broker performance on an aggregate basis, post-trade analysis of execution quality, conflicts of interest, committee materials, broker commissions, client instructions, and soft dollar practices. Each firm should determine the appropriateness of making these records available to clients.

II. SOFT DOLLARS

A. Introduction

The term "soft dollars" generally is used to describe arrangements where an investment adviser uses client brokerage commissions to pay for investment research or other products or services from a broker-dealer. The research may be generated by the broker-dealer itself or it may be obtained by the broker-dealer from a third party. (When an adviser purchases research or other products with its own money, it pays with "hard dollars.") The use of soft dollars by an investment adviser presents the question as to whether that adviser is receiving best price and execution. It also presents the question of whether the adviser is acting improperly by using client assets, namely the client's brokerage commissions, to purchase investment research -- something the client seemingly pays for already through its advisory fee.

B. Section 28(e) of the Securities Exchange Act of 1934

1. Section 28(e) provides a safe harbor against claims of breach of fiduciary duty under state and federal law for money managers who direct a client's equity trades to broker-dealers to acquire research and other products and services. Section 28(e) provides that a money manager can use a broker-dealer charging more than the lowest commission rates available ("pay-up") if the money manager determines in good faith that the higher commission is reasonable in relation to the brokerage and research services provided. Because Section 28(e) is a "safe harbor," an adviser cannot violate that section. If, however, the soft dollar arrangement falls outside of the section, it may violate the Advisers Act, other federal or state laws, or the adviser's common law fiduciary duties to the client. An

adviser's soft dollar practices relating to registered investment companies and ERISA accounts must fall entirely within the scope of the safe harbor.

2. On July 18, 2006, the SEC issued an interpretive release (*See Securities Exchange Act Release 54165 (July 18, 2006)*) (the "2006 Release") on soft dollars that clarifies the scope of the Section 28(e) safe harbor and provides the following analytic framework for determining whether the Section 28(e) safe harbor is available:
 - a. the product or service must qualify as eligible "research" or "brokerage" under Section 28(e);
 - b. the product or service must actually provide "lawful and appropriate assistance" in the performance of the adviser's investment decision-making responsibilities; and
 - c. the money manager must make a good faith determination that the client commissions paid are "reasonable in light of the value of products or services provided by the broker-dealer."
3. The requirements of Section 28(e) in light of the 2006 Release:
 - a. The manager must be provided eligible brokerage and research services, not some other products or services. If a broker-dealer provides products to an investment adviser that encompasses both eligible research and brokerage services and non-eligible items, the investment adviser must make a good faith effort to allocate the cost of the product according to its use and should maintain adequate records of such allocations for mixed-use items.

Notably, items that do not constitute eligible "research" may nevertheless qualify for the safe harbor as eligible "brokerage" and vice versa.

Eligible "research": The 2006 Release defines eligible "research" as "advice," "analyses," or "reports" that reflect the "expression of reasoning or knowledge." In addition, the "research must relate to the subject matter categories set forth in Section 28(e)(3)(A) or (B)—*i.e.* "the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities" or "analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts."

Examples of eligible research include: traditional reports on companies and stocks; seminars that provide substantive content relating to the subject matter categories above; discussions with

research analysts; meetings with corporate executives to obtain oral reports on performance; pre-trade and post-trade analytics (including trade analytics available through order management systems); data services that provide market or economic data such as stock quotes, last sale prices and trading volumes; trade journals that serve the interests of a narrow audience; advice on order execution, execution strategies, and market color; and software that provides market research.

Examples of products that are not eligible research include: “mass-marketed publications” such as newspapers and magazines that are intended for and marketed to a broad, public audience; research or advice on how to vote proxy ballots; operational overhead; administrative expense; computer hardware or accessories; computer terminals and accessories; travel/entertainment expenses associated with seminar attendance; office equipment, salaries, rent, and marketing.

Eligible “brokerage”: Section 28(e)(3)(C) defines eligible “brokerage services” as effecting securities transactions and performing functions incidental thereto, such as clearance, settlement, and custody. The 2006 Release established a new temporal standard such that eligible brokerage begins at the time when the money manager “communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder’s agent.”

Examples of eligible “brokerage” include: post-trade matching of trade information; communications relating to trades; allocation instructions; settlement instructions; comparison services required by SEC or SRO Rules; dedicated lines between the broker-dealer and the money manager or the order management systems; trading software for routing orders or providing trading strategies, and short-term custody services.

Examples of items that are not eligible as “brokerage” include: hardware such as telephones or computer terminals; software functionality used for administrative or recordkeeping purposes; compliance products and services such as trading surveillance systems; error correction trades or services; and long-term custody services falling outside the temporal standard.

- b. The services must be provided by the broker-dealer:

The broker-dealer must either: 1) have prepared the research; 2) be financially obligated to pay for the research; or 3) pay the

research preparer directly and take steps to ensure that the services fall within the safe harbor. Third-party research is therefore eligible for the safe harbor if the “provided by” requirement is met.

- c. The investment adviser must have investment discretion in placing the brokerage.
 - (1) Plan sponsors for pension funds are themselves not protected by Section 28(e)’s safe harbor provisions.
 - (2) Directed brokerage transactions, where the client is choosing the broker, do not fall within the safe harbor of Section 28(e) because the client does not exercise investment discretion.
- d. The commissions paid must be reasonable in relation to the services provided. Section 28(e) requires investment advisers to make a good faith determination that higher brokerage commissions costs resulting from the purchase of brokerage research and services are reasonable relative to the value of the brokerage and research services received, either in terms of the particular transaction or the money manager’s overall responsibilities for discretionary accounts.
- e. The “safe harbor” has been extended to be available for certain riskless principal transactions.
 - (1) While the safe harbor in Section 28(e) previously applied only to the amount of commission paid to a broker-dealer acting in an agency capacity, the SEC has expanded its interpretation of the term “commission” to include transaction costs in riskless principal transactions on the Nasdaq National Market and SmallCap Market. A riskless principal trade is one where the dealer does not bear the risk of holding the security in its inventory because he or she purchases it to fill an existing customer order and both legs of the transaction are executed at the same price.
 - (2) The SEC also held out the possibility that the safe harbor would be available in markets that have developed regulations that ensure transparency equivalent to that ensured by FINRA regulations.
 - (3) The expanded interpretation of the term “commission” does not apply to transactions in debt markets, OTC Bulletin Board stocks, Pink Sheet stocks, and convertible securities. In addition, under existing trade reporting and confirmation

rules, markups, markdowns and commission equivalents charged (i) on net trades by market makers in Nasdaq securities and (ii) on traditional dealer principal trades to and from inventory will not qualify for the Section 28(e) safe harbor.

- f. The brokerage placed must be for securities transactions. Section 28(e) is not available for transactions in commodities or financial futures.

C. Disclosure Requirements

Section 28(e) requires an investment adviser to disclose its policies and procedures with respect to commissions that will be paid for effecting securities transactions.

1. Form ADV requires an adviser to disclose certain information regarding its brokerage practices and soft dollar arrangements. (See Items 12 and 13 of Part II of the Form ADV.)
2. An adviser may need to provide additional information and material to clients where necessary in light of a particular soft-dollar activity.
3. Disclosure of soft dollar arrangements is required under the 1940 Act, including in certain books and records, in semi-annual reports on Form N-SAR, in investment company registration statements, and pursuant to Section 15 of the 1940 Act, which requires an investment adviser to an investment company to make certain disclosures concerning its brokerage practices and soft dollar arrangements in advisory contracts and to the board of directors of such companies.

D. Suggested Compliance Procedures - Broker Selection/Soft Dollar Arrangements

1. An adviser should specifically describe in its Form ADV: (a) what factors are used in selecting brokers; (b) what types of soft dollar arrangements may be entered into and when this may occur; (c) the nature of any directed brokerage arrangements; and (d) any potential conflict of interest concerning brokerage placement.
2. An investment adviser's compliance manual should provide that it is the adviser's policy to adhere to SEC interpretations regarding the permissible use of soft dollars. It may be advisable to require that (a) the investment adviser's principals, or an appropriate committee, determine which brokers can provide research and brokerage services; (b) the adviser not obligate itself to generate a specified amount of commission from any one or more broker-dealers; (c) appropriate records will be created and

retained concerning the adviser's evaluation of research (including any mixed-use determinations) and adherence to the safe harbor; and (d) the investment adviser's compliance officer should periodically review transactions and soft dollars arrangements to determine whether the adviser's policies are being followed.

3. An investment adviser should monitor and keep accurate records reflecting the performance of brokers that it uses. Specifically, an investment adviser should: (a) periodically and systematically evaluate the execution performance of broker-dealers executing transactions; (b) monitor and record the use of clients' commission dollars; and (c) monitor and record market-impact costs of different brokers utilized – *i.e.*, whether the broker is sufficiently skilled that its execution of the trade causes minimal movement in the price of the security.
4. Advisers should also seriously consider establishing a best execution and/or soft dollar oversight committee, which would administer brokerage evaluations and allocations, an approved broker list, and research evaluations.

III. ROLE OF MUTUAL FUND DIRECTORS REGARDING ADVISER PORTFOLIO TRADING PRACTICES

A. Directors Responsibilities Generally

As directors or trustees of corporate, business trust or partnership entities, mutual fund boards are responsible for overall management of the fund. Under state and common law fund boards have fiduciary duties similar to those of corporate boards. These include the "duty of care" and "duty of loyalty." Fund boards also have obligations under the Investment Company Act of 1940 to supervise the fund's operations. These obligations include monitoring conflicts of interest that confront the fund's adviser and determining how to direct the adviser to address such conflicts so the adviser manages the fund in the best interests of the fund and investors.

B. SEC Proposed Guidance Regarding the Duties and Responsibilities of Funds Boards' with respect to Adviser Portfolio Trading

On July 31, 2008 the SEC issued proposed guidance regarding fund boards' responsibilities for overseeing fund advisers' portfolio trading practices, particularly with respect to conflicts of interest. (See Securities Exchange Act Release No. 58264 (July 31, 2008)) (the "2008 Release"). The SEC suggested a variety of adviser practices that fund boards should oversee in connection with their fund oversight responsibilities, although the SEC stated that the proposed guidance "would not impose any new or additional requirements." Even if the guidance is not adopted as proposed, it is instructive regarding the factors and processes fund boards should consider in fulfilling their overall supervisory

responsibilities. The guidance also offers some insight into the SEC's current views on soft dollars.

The SEC noted that, in order for fund boards to fulfill their fiduciary responsibilities, they need to be sufficiently familiar with the adviser's trading practices so as to satisfy themselves that the adviser is fulfilling its fiduciary obligations and acting in the best interests of the fund and its investors. The SEC said that boards do not have an obligation to monitor each trade but they do have an obligation to obtain adequate information from advisers to enable the board to complete its review of adviser trading activities. The SEC also acknowledged that, due to differences in funds' investment objectives, trading practices and procedures, some of the review criteria set forth in the 2008 Release would not be relevant for all funds.

C. **Conflicts of Interest**

The 2008 Release focuses on two areas for fund boards' responsibilities regarding both monitoring the conflicts of interest that confront the fund adviser and determining how such conflicts should be managed: (i) the duty to seek best execution and (ii) use of fund brokerage.

1. **Best Execution.**

The 2008 Release describes factors the adviser should consider in fulfilling its obligation to seek to "execute securities transactions in a manner so that the fund's total costs or proceeds for each transaction is the most favorable under the circumstances." It sets forth examples of relevant data that boards should obtain from advisers to enable boards' monitoring and evaluation of advisers' best execution responsibilities, including:

- Identity of broker-dealers to which the adviser has allocated fund trading and brokerage;
- Commission rates or spreads paid;
- Total brokerage commissions and value of securities executed that are allocated to each broker-dealer during a particular period; and
- Fund's portfolio turnover rates.

Fund directors also may want to consider the following adviser processes, depending on the circumstances:

- The process for making trading decisions and selecting execution venues and broker-dealers;
- How the adviser assesses best execution and execution quality;
- The process for negotiating commissions;
- How the adviser evaluates "execution-only" trades versus "soft-dollar" trades, and
- How the adviser evaluates its traders.

Boards that determine that the adviser's trading practices are not consistent with best interests of the fund and its shareholders should direct the adviser accordingly.

2. Use of Fund Commissions.

The 2008 Release describes conflicts of interest that can arise when advisers use commissions to acquire research and brokerage services other than execution, even where such use is consistent with the Section 28(e) safe harbor, including the following:

- Use of fund brokerage commissions to buy research it would otherwise have to pay for with "hard dollars" from its own resources;
- Trading a fund's portfolio in order to earn soft dollar credits;
- Selection of a broker-dealer based on its research services rather than the quality of execution for fund transactions; and
- Use of soft dollars that disguises the adviser's true costs thus enabling adviser to charge advisory fees that do not reflect the costs of its portfolio management services.

When boards determine that the adviser's use of fund commissions is not in the best interests of the fund and its shareholders, boards have an obligation to give direction to advisers. The proposed guidance suggests the following ways in which boards might direct advisers to change their practices:

- Refrain from using soft dollar trading for certain types of trades;
- Alter the mix of trades applying soft dollars; or
- Use soft dollar trading only or commission recapture or expense reimbursement programs.

IV. TRADE AGGREGATION AND ALLOCATION

A common problem for advisers with multiple clients is the short supply of a particular security that is desired by multiple clients, or a security that is held by multiple clients that has become unattractive and should be sold. In such circumstances, investment advisers may have to allocate purchase or sale transactions among their clients. IPOs and other limited offerings are examples of securities that are often in short supply. The situations may present a conflict of interest to the adviser, especially if it engages in the "side-by-side" management of accounts with and without performance fees: the adviser will have an incentive to favor accounts with higher fees. Allocation decisions are also needed when blocked or bunched purchases of securities are made. Blocked or bunched purchases (aggregated orders executed on behalf of two or more accounts) are typically made for large orders and generally are used to obtain better execution costs and price.

A. Standard Procedures.

In effecting such allocation decisions, advisers must treat each client in a “fair and equitable manner.” In general, no client may be favored over another client. Two allocation methods are commonly used: (1) a pro-rata allocation of the day’s transactions among the accounts with open orders for that security, all of them at the average price obtained that day; and (2) a system of allocating specific orders to specific accounts on a sequential basis in which, over a period of time, all accounts are given their share of desirable orders.

1. Typically, for accounts investing in fixed-income securities, the specific allocation method is more practical because of the greater number of issues of fixed-income securities available that have a high degree of fungibility.
2. Typically, for accounts investing in equity securities, the pro rata allocation method is more practical because of the availability of issues. Factors that may be used when allocating on a pro rata basis include: each account’s asset size; the account’s current holdings of an issuer; and the proportion that each account’s target amount of that type of security bears to the total amount desired by all accounts.
3. In determining allocations, certain investment managers adopt a *de minimis* exception. The *de minimis* exception permits smaller accounts or accounts with a small initial allocation to receive their entire allocation before larger accounts are given their pro rata amount, in order to minimize the transaction costs involved with a series of small allocations.

Consideration should also be given to the timing of trade allocation decisions: pre-trade or post trade. The adviser should maintain a written statement of the reasons for any post-trade allocation or revised allocation.

1. Allocation should generally be made at the time the order is submitted for execution.
2. Post-trade allocation may be made if all clients whose orders are allocated receive fair and equitable treatment and the allocation is consistent with the adviser’s fiduciary duties and duty of best execution. An adviser may make an exception to the pre-trade allocation provided there is a valid reason for the revised allocation. For example, a revised post-trade allocation may be appropriate where an order was not filled and pro rata allocation would result in small holdings and odd lots for clients. The adviser should maintain a written statement of the reasons for the post-trade allocation.

Advisers should disclose their allocation procedures to their clients. Advisers should also have written allocation procedures and should document any departures from the written procedures.

B. Special Procedures

The standard procedures above do not address all of the potential conflicts presented by side-by-side management. Some advisers believe that they can manage the trading conflicts only with separate trading desks for the two types of funds, with appropriate information screens. Not many advisers go to these lengths; side-by-side advisers generally use some additional procedures, tailored to the particular risks posed by the investment and trading patterns of the funds they manage.

Some advisers focus their procedures on ensuring that the appropriate suitability determinations are made. These procedures may require consistent trading activity among all funds having similar investment strategies. For example, they may:

1. mandate that, when the portfolio manager has entered into a transaction for a hedge fund or other account that the manager or his or her supervisor deems suitable for a mutual fund s/he also manages, the manager also must enter into the same transaction on behalf of the mutual fund;
2. allow a portfolio manager to enter into a transaction for one fund while not contemporaneously entering into the same transaction for other funds, but only if the portfolio manager determines and documents that the instrument or the transaction is not appropriate for the other funds. These and similar procedures are most appropriate when the investment and trading strategies for hedge funds and other accounts have significant overlap, and scarce investment or trading opportunities arise.

C. Some advisers whose funds employ short selling strategies adopt procedures that focus on trading restrictions. These procedures may:

1. prohibit a portfolio manager from maintaining different positions in the same securities on behalf of these funds and other accounts that generally follow the same principal investment strategy;
2. prohibit a portfolio manager from assuming a long position in an equity security on behalf of one account while simultaneously selling short the same securities on behalf of such a fund;
3. mandate that all trades in the same securities entered by the same portfolio manager be executed at the same time during the day;

4. establish an order of trade execution priority for short and long transactions giving general priority to long transactions over short transactions;
 5. assign trade execution priority for fund short sale orders and other account sale orders in the same securities on the basis of the time each order is received by the firm's trading desk. Such procedures will be less effective when the same portfolio manager is managing funds side-by-side, since s/he will be able to determine opportunistically the order in which the trades are entered;
 6. require a portfolio manager to obtain pre-approval from the firm's chief investment officer or a compliance officer before purchasing securities for another account that have been sold recently by a hedge fund managed by the same manager. This is the procedure that interferes the least with trading operations.
- D. Some advisers implement specific procedures to address the conflicts presented by cross-trades. The procedures may:
1. prohibit cross trades between hedge funds and any other fund or account;
 2. limit cross trades between or among funds or accounts to liquid securities for which market quotations are readily available;
 3. require that the price at which cross trades are executed be the same as the last independent trade on a recognized market.

E. Enforcement Actions

In recent years, trade allocation has received considerable attention from the SEC. Allocation cases have generally fallen into three categories.

1. Discrimination among clients occurs in situations where a limited and highly desirable investment opportunity is allocated immediately, but certain client accounts are favored (generally those held by friends or family members or those paying the adviser a performance-based fee).

See In re: Account Management Corp. et al., Inv. Adv. Act Rel. No. 1529 (Sept. 29, 1995). The SEC censured and fined the adviser for inadequately disclosing the firm's allocation policy where profitable transactions in initial public offerings were disproportionately allocated to accounts maintained for non-fee paying customers who were close friends of the portfolio managers.

2. Delayed allocation occurs where trades are allocated only after the adviser determines whether they will be profitable.

See In the Matter of MacKenzie Walker Investment Management Co., Inv. Adv. Act Rel. No. 1571 (July 16, 1996). The SEC sanctioned the adviser for allowing the portfolio manager to place orders without specifying, on the trade tickets or otherwise, the client accounts to which the trade should be allocated. The SEC found that the portfolio manager delayed allocations until the end of trading day and subsequently allocated high performing trades to the adviser's performance-fee accounts. See also In the Matter of Melhado, Flynn & Associates, Inc., George M. Motz and Jeanne McCarthy, Inv. Adv. Act Rel. No. 2593 (Feb. 26, 2007). The SEC found the adviser, its president and chairman, and its comptroller engaged in fraudulent trade allocation – i.e., “cherry picking.” During part of the period covered by the proceeding, after making trades for various clients, the adviser had unfairly allocated trades that had appreciated in value during the course of the day to the adviser's proprietary trading account and allocated purchases that had depreciated in value during the day to the accounts of advisory clients. The president also engaged in cherry-picking to favor one of the firm's advisory clients, a hedge fund affiliated with the adviser, over his other advisory clients. See also Chapter Three, Part A.I.5.

3. Usurping of client opportunity occurs where a portfolio manager improperly allocates a limited investment opportunity to his or her personal account.

See In re Ronald V. Speaker and Janus Capital Corp., Inv. Adv. Act. Rel. No. 1605 (Jan. 13, 1997). The SEC brought enforcement proceedings against a mutual fund portfolio manager who turned down a limited investment opportunity for the fund, but purchased the same investment for his personal account later the same day after learning that another broker-dealer was bidding at a higher price. Although the portfolio manager was not required to pre-clear the trade under the adviser's procedures for personal trading, the SEC also censured and fined the investment adviser for failing to discipline the portfolio manager after discovering the misappropriation.

V. TRADE ERROR CORRECTION

- A. In general, a trading error exists when a fund's adviser has taken or refrained from taking an action that results in a trade being placed, executed (or not executed) or settled (or not settled) in a manner that is inconsistent with the adviser's obligations to the fund under the applicable standard of care. The applicable standard of care may be established by law, contract, or custom and usage. The standard of care is typically one of reasonable or prudent conduct or absence of negligence. Intentional or reckless acts of misconduct are not trading errors but rather more serious violations. Errors in the investment decision-making process are also not trading errors. Examples of trading errors include:

1. Buying the security instead of selling as intended, or vice versa;
 2. Buying or selling the wrong security;
 3. Buying or selling the wrong amount of the security;
 4. Buying or selling the security for the wrong fund; or
 5. Buying or selling the security in contravention of a regulatory or fund prospectus-imposed restriction on the trade.
- B.** If a trading error is detected before a trade settles (typically on T+1), it can be easily unwound: title to the security does not formally pass to the fund until the trade settles. Many fund advisers transfer such trades to the adviser's proprietary error account and the position is promptly sold or covered in the market. When a trade error is detected post-settlement, the fund's adviser cannot transfer the trade to its error account, since this would be a principal transaction. The adviser instead must sell securities mistakenly bought and repurchase securities mistakenly sold, in both cases in the market to avoid principal transaction restrictions. The adviser must reimburse the fund for any resulting loss and allow the fund to retain any resulting gain. As a matter of trust law, the profits resulting from a trustee's negligence belong to the trust. As a matter of fiduciary principle, significant losses should be disclosed periodically to the fund board.
- C.** Generally, the fund's adviser may not "net" a fund's losses against its gains resulting from trading errors — *i.e.*, the adviser cannot reduce the amount it must reimburse a fund for a trading error loss by the amount of trading error gains. However, under certain circumstances where two trades can be considered to be part of the same transaction (*e.g.*, a foreign exchange trade in connection with a trade in a foreign security), a gain on one trade and a loss on another may be netted.
- D.** The amount of loss (or gain) resulting from a trade error is generally determined by subtracting the value of the security in question at the time of correction from its value at the time of the trade error. Calculation of losses and gains may take account of changes in interest and foreign exchange rates. Losses can be calculated, with the consent of the fund's board, to account for opportunity costs. For example, if the fund is an index fund, the amount of loss can be determined to be the change in value of the relevant benchmark index.
- E.** A case can be made that the fund and not the adviser should bear any losses from "innocent" mistakes — those that do not breach the applicable standard of care: no law makes the adviser a guarantor of the results of the trading process. Nevertheless, as a matter of best practice and good client relations, fund advisers generally reimburse funds for any losses resulting from innocent mistakes. Whether a trade error breaches the applicable standard of care is frequently a

close question requiring contextual analysis of both the particular facts of the error and the larger pattern of errors by the adviser.

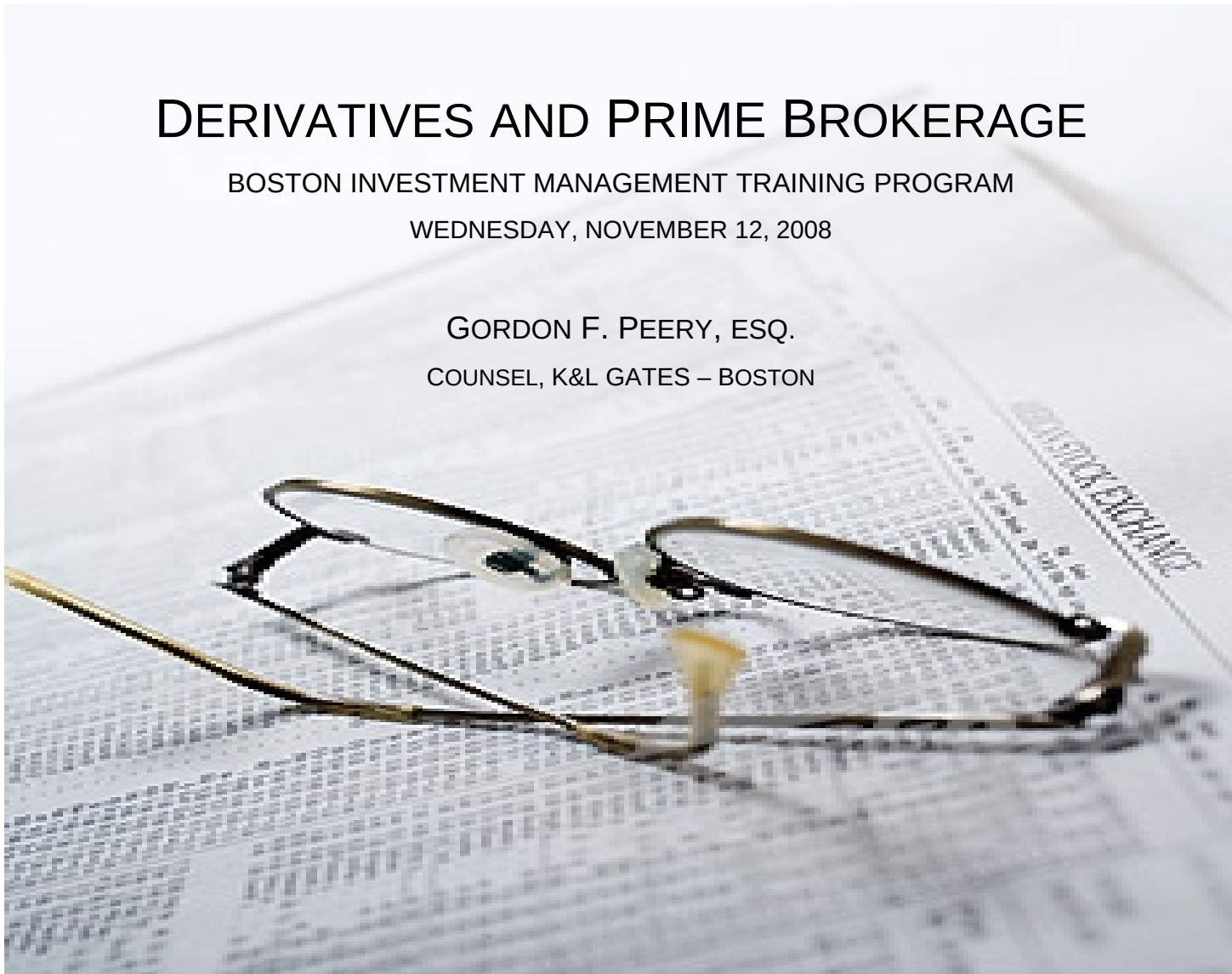
DERIVATIVES AND PRIME BROKERAGE

BOSTON INVESTMENT MANAGEMENT TRAINING PROGRAM

WEDNESDAY, NOVEMBER 12, 2008

GORDON F. PEERY, ESQ.

COUNSEL, K&L GATES – BOSTON



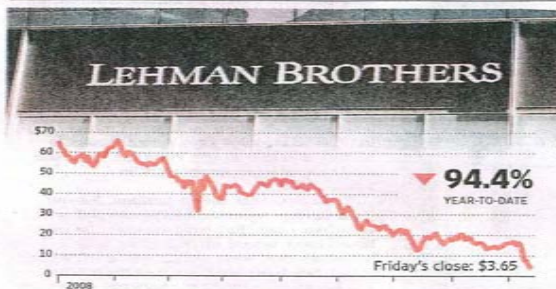
THE WALL STREET JOURNAL.

DOW JONES

MONDAY, SEPTEMBER 15, 2008 - VOL. CCLII NO. 64

★★★★ \$2.00

Last week: DJIA 11421.99 ▲ 201.03 1.8% NASDAQ 2261.27 ▲ 0.2% NIKKEI 12214.76 unch. DJ STOXX 50 2858.68 ▲ 3.8% 10-YR TREASURY ▼ 20/32, yield 3.730% OIL \$101.18 ▼ \$5.05 EURO \$1.4217 YEN 107.87



Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash

Fed Will Expand Its Lending Arsenal in a Bid to Calm Markets; Moves Cap a Momentous Weekend for American Finance

The American financial system was shaken to its core on Sunday. Lehman Brothers Holdings Inc. faced the prospect of liquidation, and Merrill Lynch & Co. agreed to be sold to Bank

By Carrick Mollenkamp,
Susanne Craig, Serena Ng
and Aaron Lucchetti

of America Corp.

The U.S. government, which bailed out Fannie Mae and Freddie Mac a week ago and orchestrated the sale of Bear Stearns Cos. to J.P. Morgan Chase & Co. in March, played much tougher with Lehman. It refused to provide a financial backstop to potential buyers.

Without such support, Barclays PLC and Bank of America, the two most interested buy-

ers, walked away. On Sunday night, Bank of America struck a deal to buy Merrill Lynch for \$29 a share, or about \$44 billion. Lehman was working on a possible bankruptcy filing that would allow most of its subsidiaries to continue operating as the firm is wound down.

Though it steered clear of a bailout, the Federal Reserve is expected to take new steps to stabilize the broader financial system. These steps, expected to be temporary, would make it easier for banks and securities firms to borrow from the central bank by using a wider range of collateral. Bankers say these financial institutions might need short-term funds as they unwind their many trading positions with Lehman.

In addition, 10 major com-

mercial and investment banks announced Sunday night that they would pool \$70 billion of their own money to create a borrowing facility. The 10 institutions, which include Citigroup Inc., Credit Suisse Group, Deutsche Bank AG, could tap the pool to help them ride out the crisis. The banks also said they are mutually committed to trying to mitigate market volatility.

A sense of foreboding gripped Wall Street as top executives feared collateral damage from a Lehman liquidation. Attention was focused on Merrill Lynch, which boasts the largest force of retail brokers, and American International Group Inc., the insurance giant. Both firms have seen their stocks get hammered on worries that they

needed capital.

"Monday will be a day of reckoning for the financial markets," said Carlos Mendez, senior managing director of ICP Capital, a boutique investment firm in New York. On Sunday, he said, "it was like a fire alarm went off and people ran in all directions."

AIG executives spent the weekend trying to raise cash, either from asset sales or a capital infusion from private-equity firms, or both. AIG executives were meeting with regulators to see if they could transfer capital from some of its subsidiaries to the holding company.

As worries spread across Wall Street that Lehman wouldn't survive, brokerage firms, hedge funds and other

traders moved to disentangle themselves from trades with Lehman. When hopes of a potential sale dimmed, a quiet Sunday on Wall Street turned into a mad rush. Executives and traders hurried to their offices or worked their phones to unwind outstanding contracts with Lehman and to gauge their overall exposure.

Merrill, whose brokerage force is known as the "thundering herd," quietly entered into discussions with Bank of America, which has retail bank branches stretching from coast to coast and has long coveted Merrill. Wall Street executives said the Federal Reserve may have been involved in orchestrating the sale, figuring that it was "better to save the relationship than to let it go."

Please turn to page A18

Ultimatum By Paulson Sparked Frantic End

One of the most tumultuous weekends in Wall Street's history began Friday, when federal officials decided to deliver a sobering message to the captains of finance: There would be no government bailout of Lehman Brothers Holdings Inc.

Officials wanted to prepare the market for the possibility that Lehman could simply fail. The best way to do that in an orderly way would be to get everyone together in a room.

Bank of America to Buy Merrill



Cri • sis /kríssiss/ (*plural* –ses /-sèez/) *n* 1 DANGEROUS OR WORRYING TIME a situation or period in which things are very uncertain, difficult, or painful, especially a time when action must be taken to avoid complete disaster or breakdown 2 CRITICAL MOMENT a time when something very important for the future happens or is decided 3 TURNING POINT IN DISEASE a point in the course of a disease when the patient suddenly begins to get worse or better [15C Via Latin < Greek *krisis* “*decisive moment*” < *krinein* “decide.”]

Overview of the Derivatives and Prime Brokerage Programs

I. Derivatives

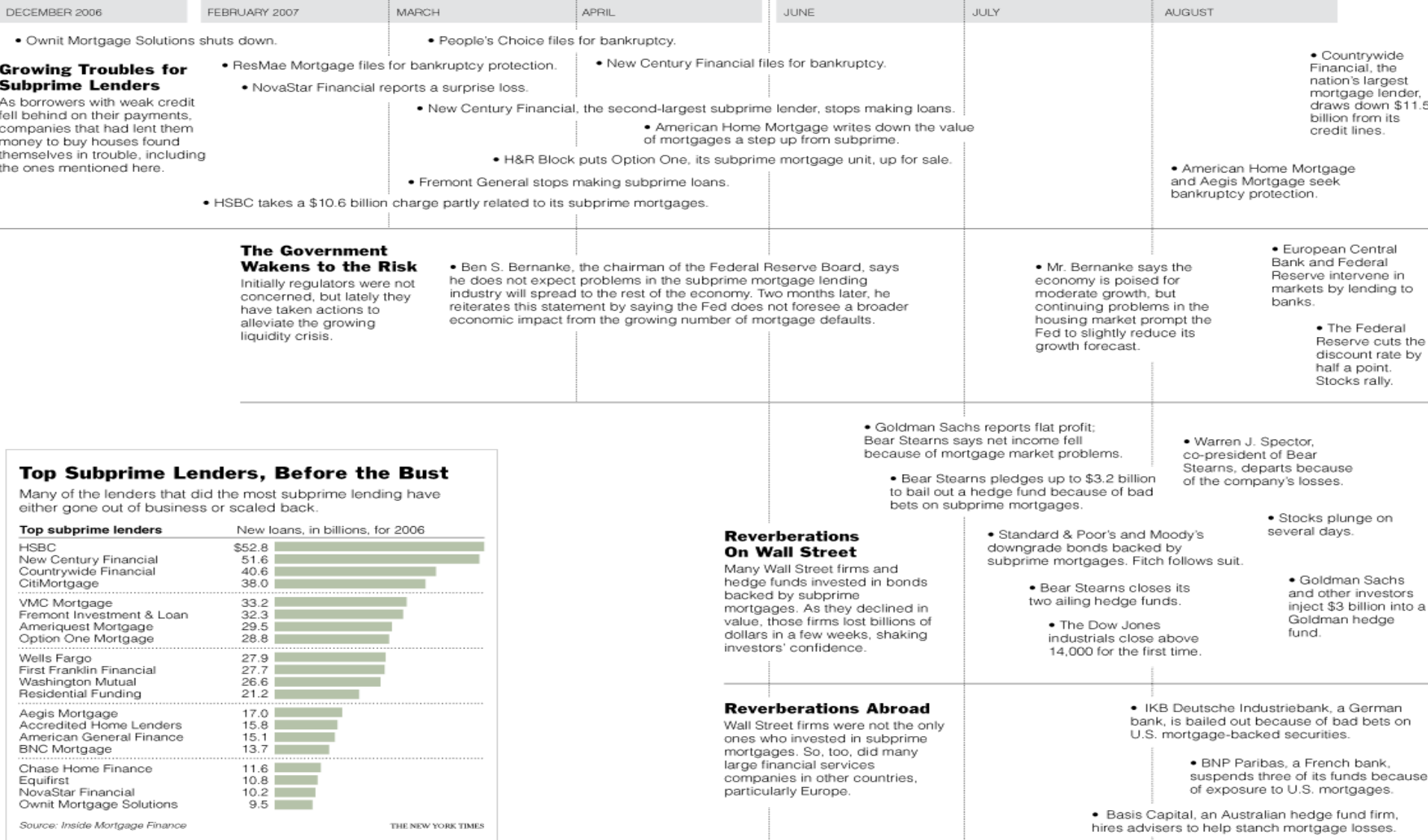
Our Derivatives Practice Thrives in 2008

- Preparation in 2007 for 2008
- Derivatives Task Force
 - Bear Stearns Sale to JPMorgan Chase & Co.
 - Lehman Liquidation
- Specific **Derivative** Problems, Fixes and Preventative Measures for 2009

II. Prime Brokerage

Prime Brokerage is Fundamentally Transforming in 2008

- An Overview of Prime Brokerage
- The Lehman Brothers Prime Brokerage Experience
- What Lehman Teaches the Market Today
 - Rehypothecation
 - Boston-based fixes to the Prime Brokerage Model
- Specific **Prime Brokerage** Problems, Fixes and Preventative Measures for 2009



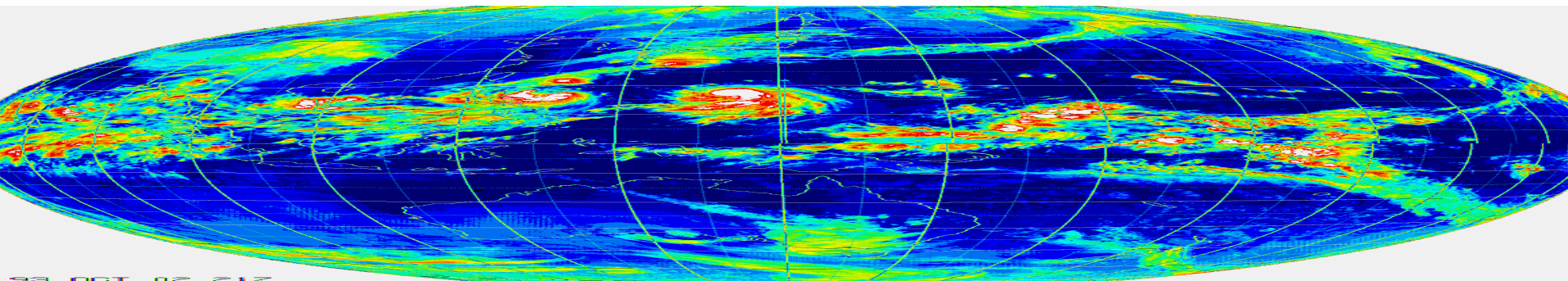
THE RESPONSE TO 2007 BY K&L GATES

- **A Global Derivatives Practice**

- Derivatives Task Force
- Includes partners and counsel-level attorneys, over 30 trained associates and several paralegals in 5 offices, from Seattle to London
 - Dealer Early Warning System
 - Alert: Insolvency Issues After Bear Stearns
 - Alert: Covered Bonds
 - Alert: Lehman Insolvency and Trade Fails

- **2008:**

- Best Practices ISDA Documentation
- New Product Development and Training for Clients

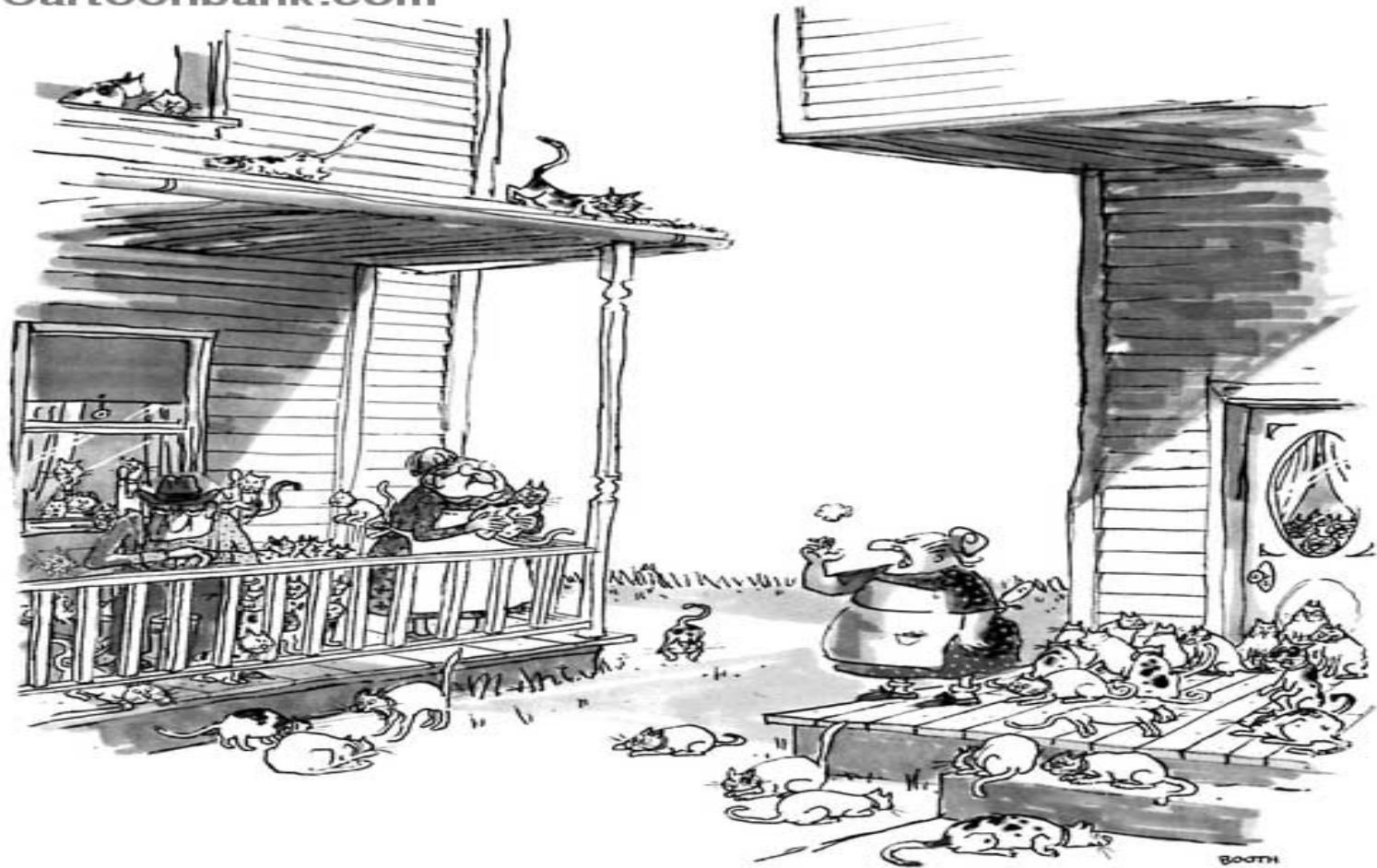


The Role of Derivatives in the 2007-08 Credit and Liquidity Crises

- The derivatives picture is not black and white:
 - The Good: FX, Interest Rate, Equity and Property Derivatives
 - The Bad: CDOs and some CDSs
 - The Ugly: CDO squared
- Systemic issues:
 - Poor documentation (pro-dealer; unexecuted, incomplete)
 - Counterparty exposure
- Regulatory implications

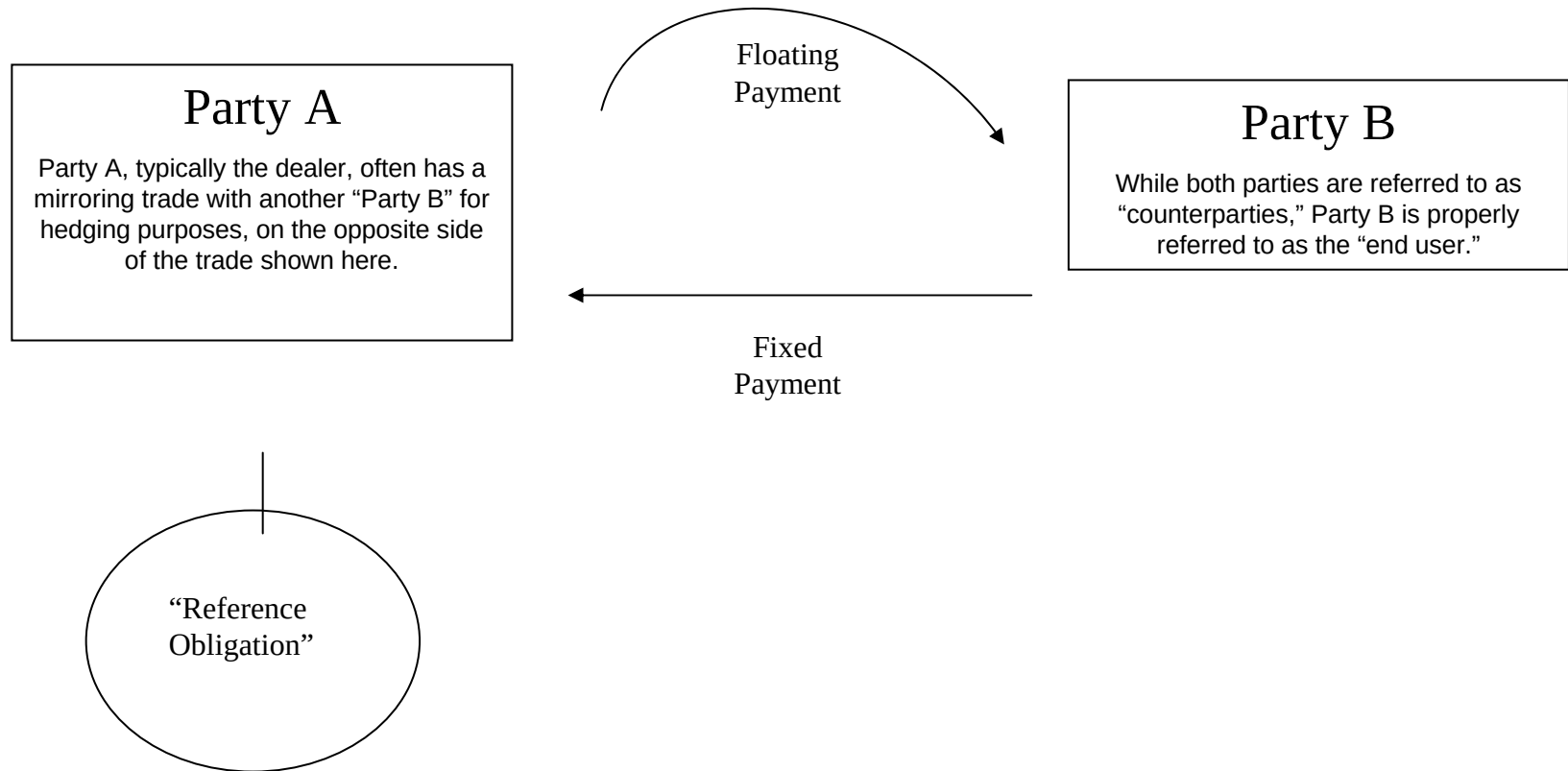
**So ... what's a derivative ?
and what's a swap
and
why do I care, really ?**

© Cartoonbank.com

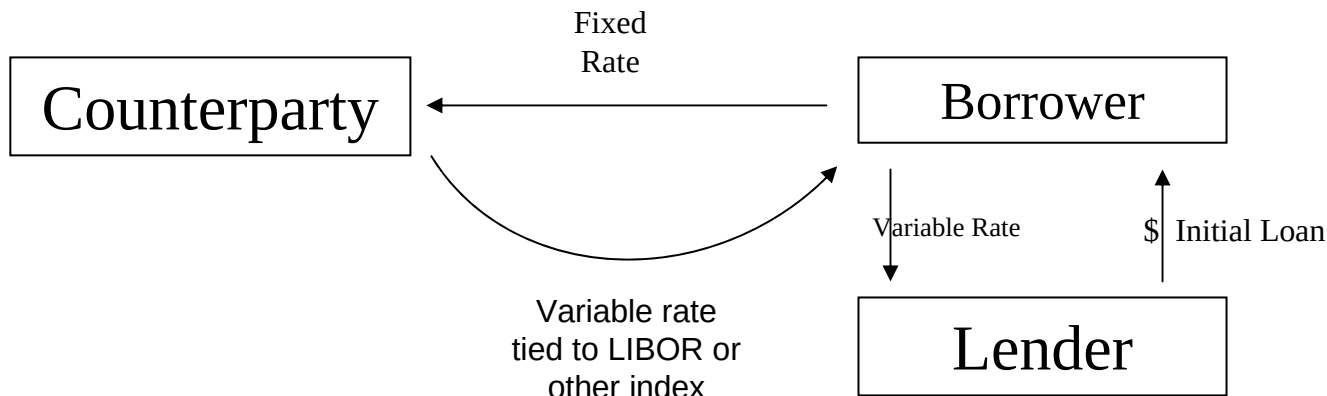


"Let's swap some cats today."

Basic Swap Structure



Interest Rate Swaps



- Borrower has a floating rate obligation
- Wants to pay fixed or hedge floating rate
- Enters into rate swap
- Counterparty assumes LIBOR risk in exchange for a fixed payment

1980 First Cross-Currency
Interest Rate Swap between
IBM and the World Bank

Nov.
2008

Equity Derivative with an Index Underlier

Obligated to pay for *increases in the index*:

(let's say the index level rises from 6000 to 6400, a rise of 6.6% The Dealer must pay the fund manager this increase, which is calculated by multiplying the percentage times the notional amount.)

Obligated to pay for *decreases in the index*:

(so, the index falls from 6400 to 6100, a drop of 4.6%, which is multiplied by the notional and then the Fund pays the "interest rate" on top of that.)

"Equity" Leg



(...the Dealer is said to short the index by acting as an equity return payer in this swap.)

"Interest Rate" Leg

(If the Fund "goes long" the index -- it's the Equity Return Receiver)



Purchase not necessary !
(this is just a "reference obligation")

Dealer and Fund agree to a hypothetical amount

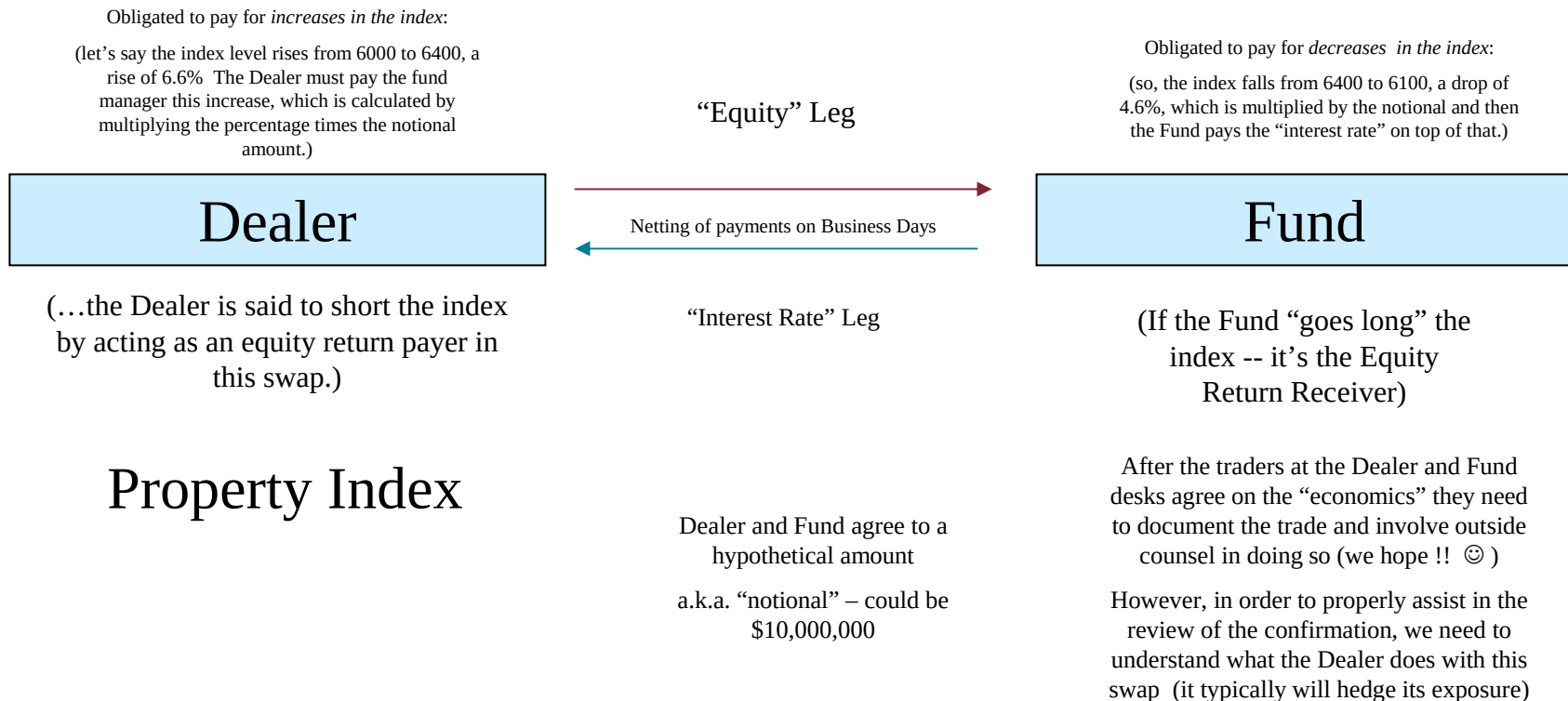
a.k.a. "notional" – could be \$10,000,000

After the traders at the Dealer and Fund desks agree on the "economics" they need to document the trade and involve outside counsel in doing so, (we hope !! ☺)

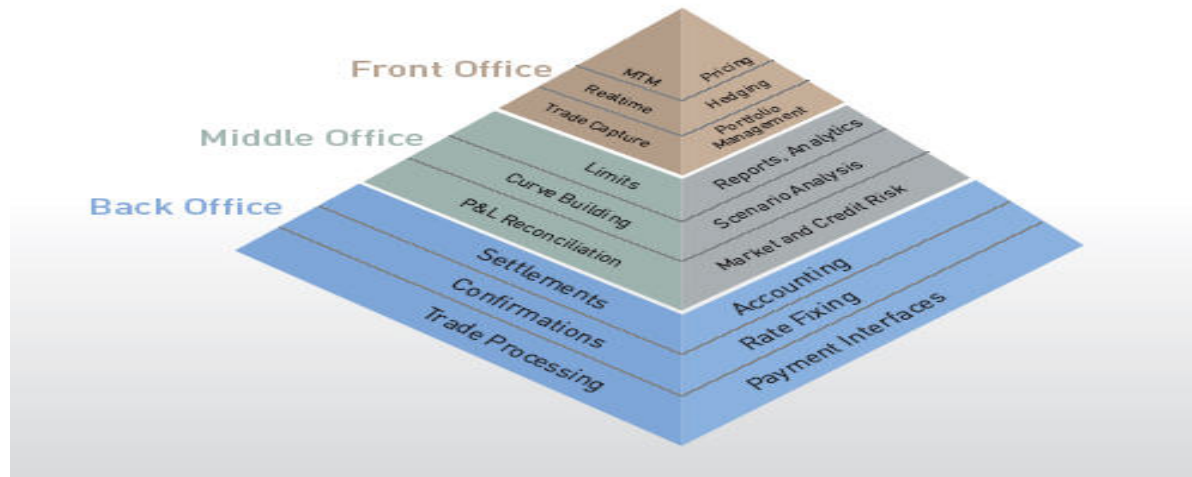
However, in order to properly assist in the review of the confirmation, we need to understand what the Dealer does with this swap (it typically will hedge its exposure)

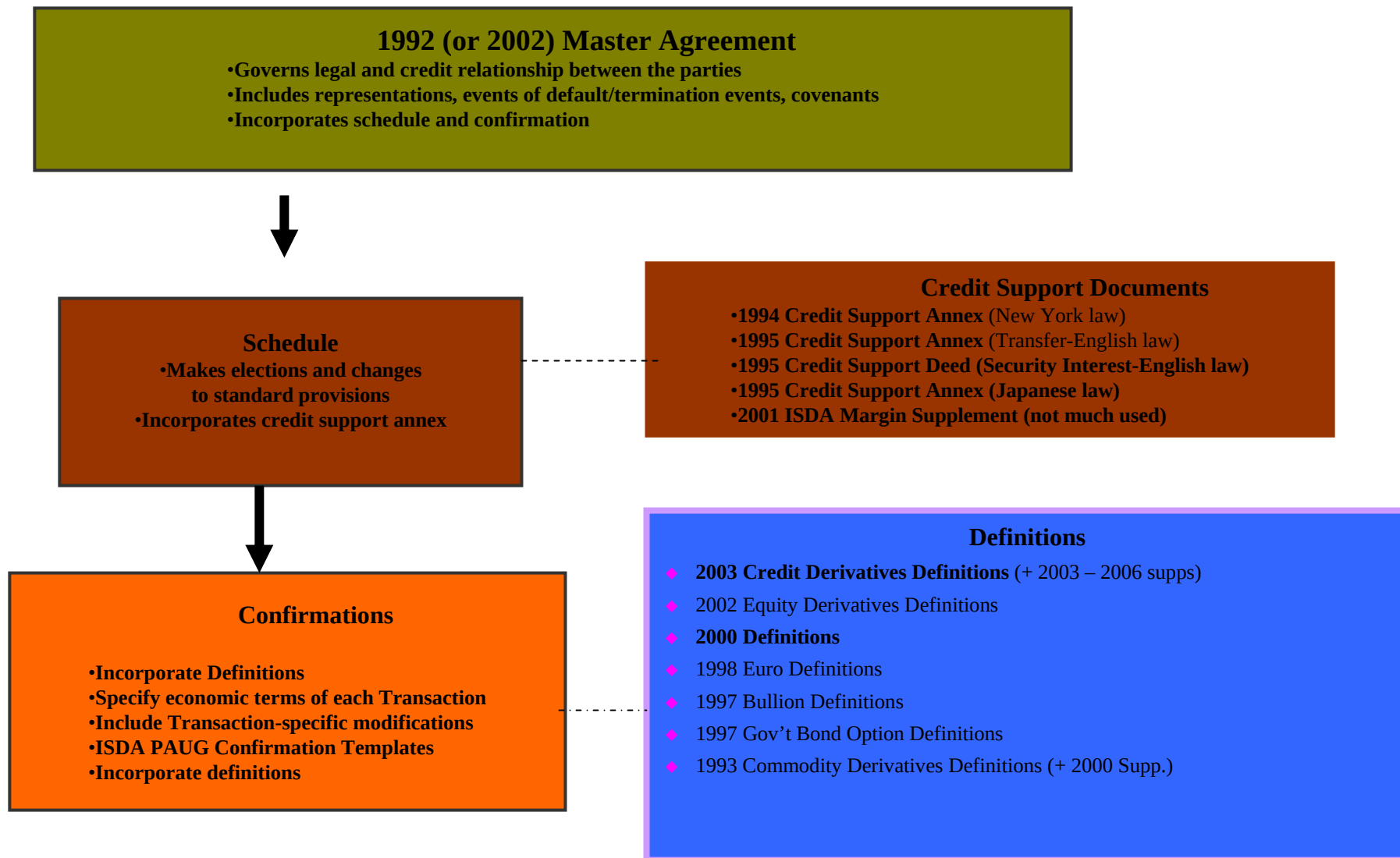
Traders agree on all the "economics" : Effective Date (the start of the term), Termination Date (term end), Valuation Date, Payment Dates, Reset Dates and, most importantly, settlement (cash/physical settlement on the "Payment Dates") ... agreement should take the form of a term sheet, then a confirmation (short preferred, long form otherwise) ... and of course the currency

A Property Derivative is Essentially a Total Return Swap on an Index



The Players in a Derivative Transaction





ISDA: Master Agreement Highlights

- **Section 5 Events of Default and Termination Events** – These are the heart of ISDA’s counterparty risk management and the most frequently modified provisions in the Schedule.
- **Section 5(a) Events of Default** are thought to be “fault-based” events and permit the non-defaulting party to terminate immediately:
 - 5(a)(i) Failure to pay/deliver (within 1-3 days)
 - 5(a)(ii-iii) Other breaches or misrepresentations
 - 5(a)(v) Default under any other derivative transaction between the parties or their affiliates
 - 5(a)(vi) Default under outstanding indebtedness above an agreed threshold
 - 5(a)(vii) Bankruptcy or insolvency proceedings
 - 5(a)(viii) Merger without assumption by surviving entity

ISDA Master Agreement Highlights

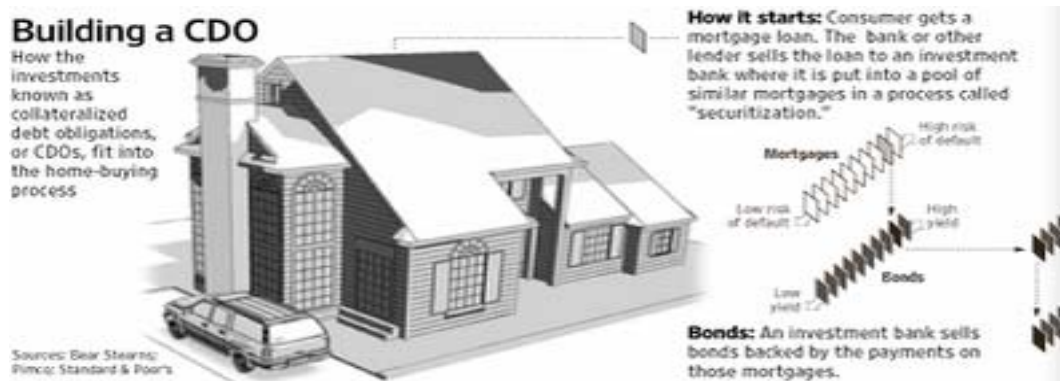
Section 5(b) Termination Events are less directly related to the “fault” of one party or the other and relate more to events beyond either of their control:

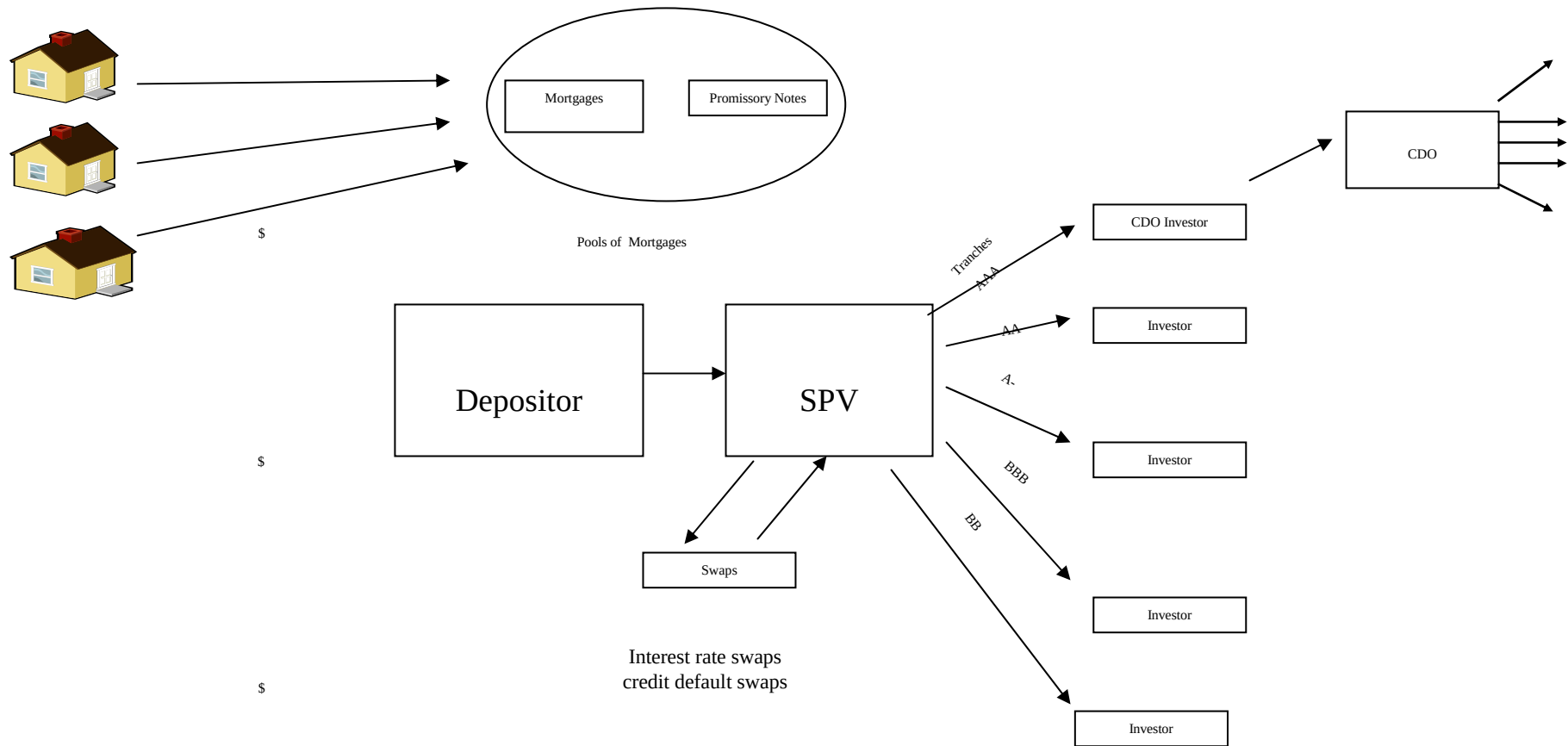
- 5(b)(i) Change in law results in illegality
- 5(b)(ii) Force majeure (2002 form only)
- 5(b)(iii) Change in tax law results in change in withholding tax
- 5(b)(v) A merger or other capital event results in an overall weaker credit (“Credit Event Upon Merger”)
- 5(b)(vi) Additional Termination Events – other negotiated events (e.g., ratings downgrade, key person events)

Top Ten Swap Documentation Issues

1. Appropriate credit parties
2. Cross default (scope, thresholds)
3. Settlement methodology
4. Additional termination events (“ATEs”)
5. Calculation agent provisions
6. Credit Support Provider/Credit Support Documents
7. Flexibility to transfer
8. Optional right to terminate
9. Collateral, collateral, collateral
10. Collateral thresholds/independent amounts/mechanics

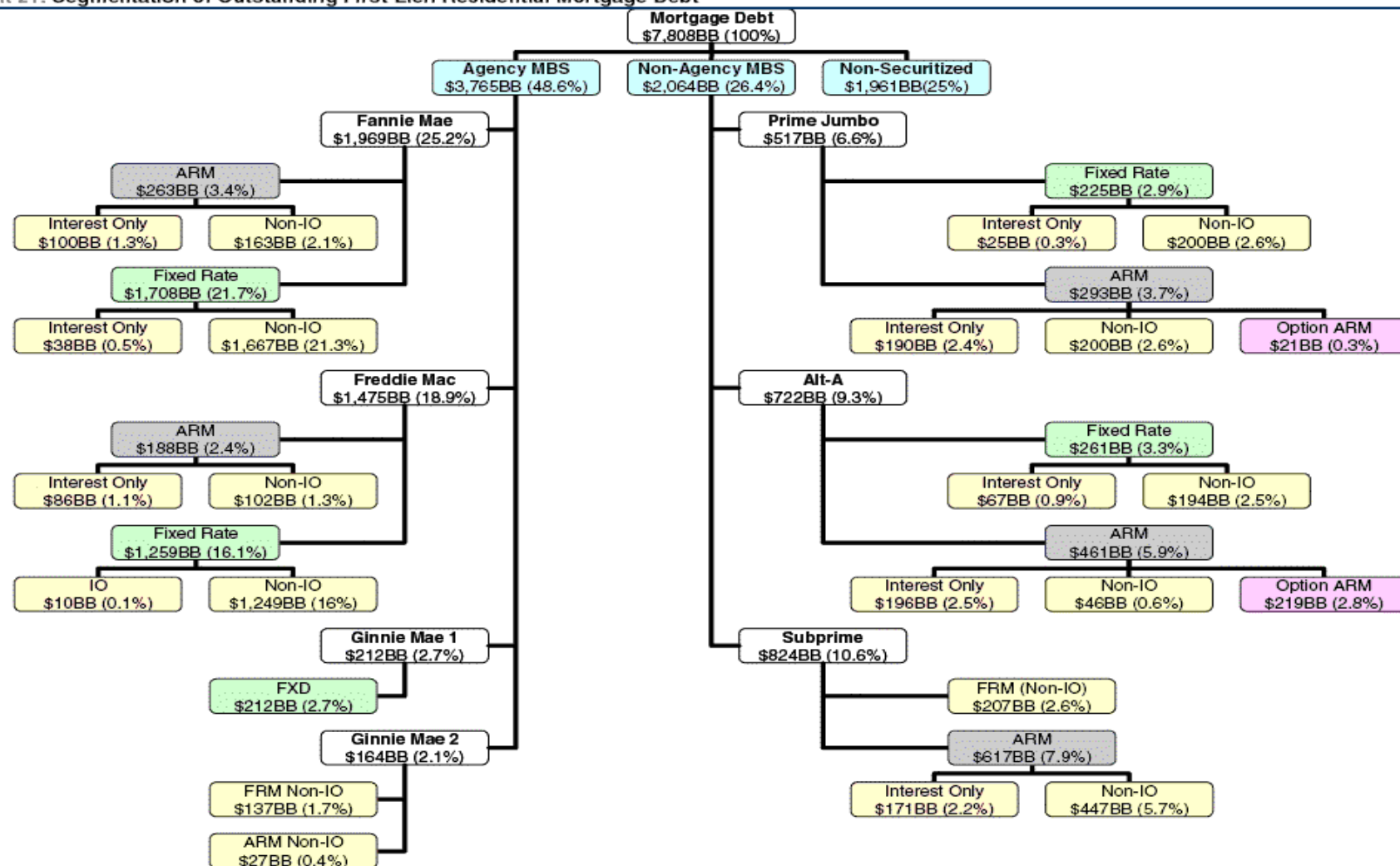
Derivatives Task Force Members Bring Unique Experience to the 2008 Team





Dealer Early Warning System

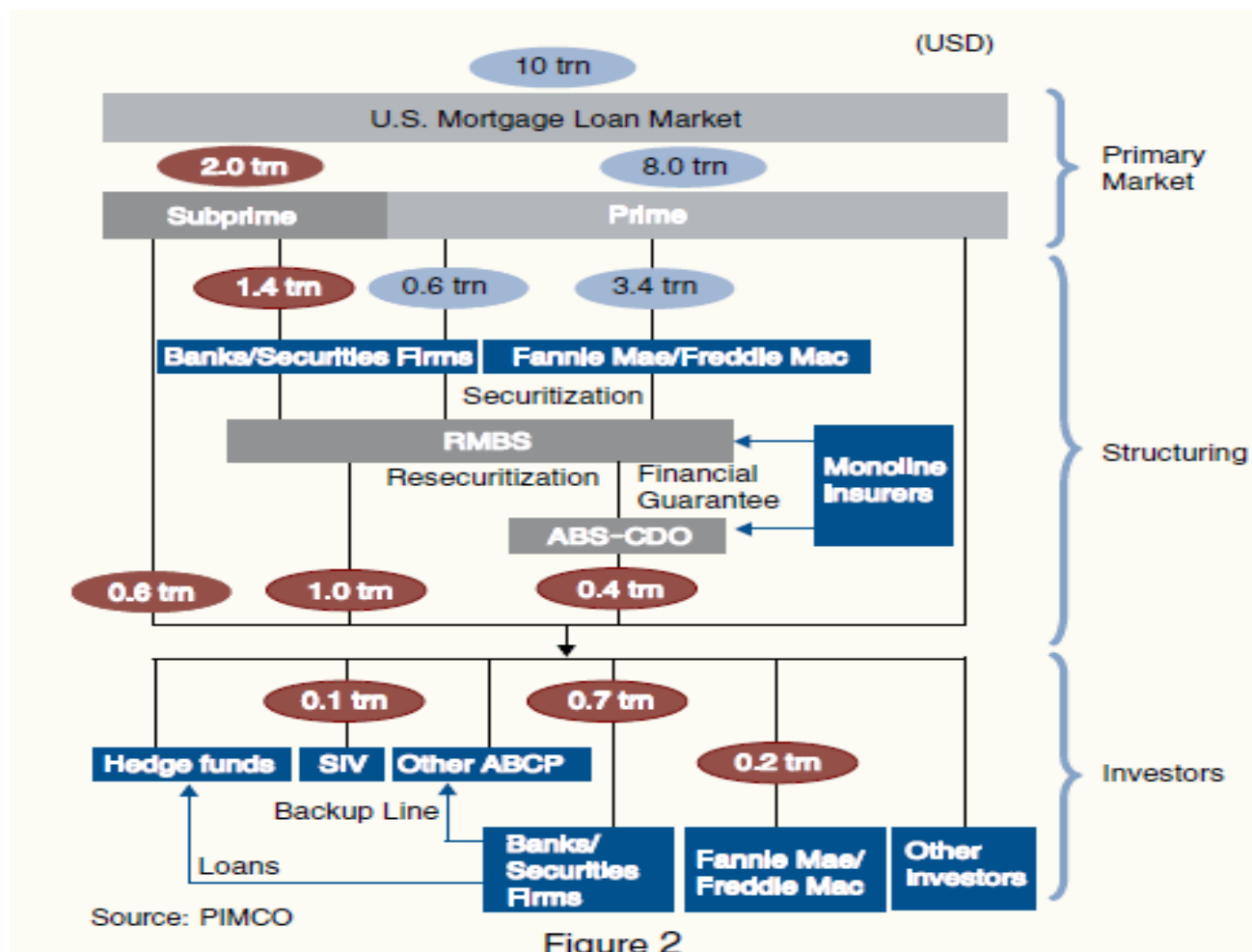
Exhibit 21: Segmentation of Outstanding First-Lien Residential Mortgage Debt



Assumptions: Securitization rate 75%; Loan Performance Reporting rate: Prime and Alt-A: 75%, Subprime: 65%

Source: Credit Suisse U.S. Mortgage Strategy

Dealer Early Warning System



"All the News
That's Fit to Print"

The New York Times

EARLY EDITION

Sunday, sun then clouds, a late shower, high 44. Sunday night, rain, low 43. Monday, sun, a shower, high 58. Details, Page 35.

V. CLVII . . . No. 54,223

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NEW YORK, SUNDAY, FEBRUARY 17, 2008

\$5 beyond the greater New York metropolitan area.

\$4.00

Arcane Market Is Next to Face Big Credit Test

Questions Arise About Insurance Securities

By GRETCHEN MORGENSON

Few Americans have heard of credit default swaps, arcane financial instruments invented by Wall Street about a decade ago. But if the economy keeps slowing, credit default swaps, like subprime mortgages, may become a household term.

Credit default swaps form a large but obscure market that will be put to its first big test as a looming economic downturn strains companies' finances. Like a homeowner's policy that insures against a flood or fire, these instruments are intended to cover losses to banks and bondholders when companies fail to pay their debts.

The market for these securities is enormous. Since 2000, it has ballooned from \$900 billion to more than \$45.5 trillion — roughly twice the size of the entire United States stock market.

No one knows how troubled the credit swaps market is, because, like the now-distressed market for subprime mortgage securities, it is unregulated. But because swaps have proliferated so rapidly, experts say that a hiccup in this market could set off a chain reaction of losses at financial institutions, making it even harder for borrowers to get loans that grease economic activity.

Other Early Warnings and Credit Default Swaps

Lessons from Bear Stearns

K&L | GATES

Financial Services Alert



April 2008

www.klgates.com**Authors:**

Robert T. Honeywell
212.536.4863
robert.honeywell@klgates.com

Anthony R. G. Nolan
212.536.4843
anthony.nolan@klgates.com

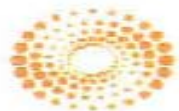
Donald W. Smith
202.778.9079
donald.smith@klgates.com

Robert A. Wittie
202.778.9066
robert.wittie@klgates.com

Key Insolvency Issues for Broker-Dealers, Custodial Banks and Counterparties to Repos, Swaps and Other Financial Contracts

The recent volatility in the credit markets has led to many inquiries on how clients should protect their holdings with brokers and custodial banks, and how they can protect their financial contracts (repos, swaps, securities lending, etc.) in the event a counterparty becomes insolvent. This outline is provided as a general summary of the main insolvency issues involved in protecting these types of assets and contracts, but is not intended as legal advice. The specific actions that a client should take to protect itself will of course depend on the provisions in their contracts, the applicable laws governing their contracts (and any amendments to those laws), and the facts of each case. The information herein should not be used or relied upon without first consulting an attorney.

Early Warnings re Lehman



REUTERS

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Platts review bars Lehman from key oil trade window

Mon Jul 7, 2008 11:54am EDT

By Annika Breidthardt and Luke Pachymuthu

SINGAPORE (Reuters) - Energy pricing agency Platts has put Lehman Brothers (LEH.N: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) under a temporary review that effectively excludes it from trading benchmark-setting oil contracts, four sources close to the matter said on Monday.

Lehman Crisis Management

LEHMAN MASTER TRACKING MATRIX

(as of November 12, 2008)

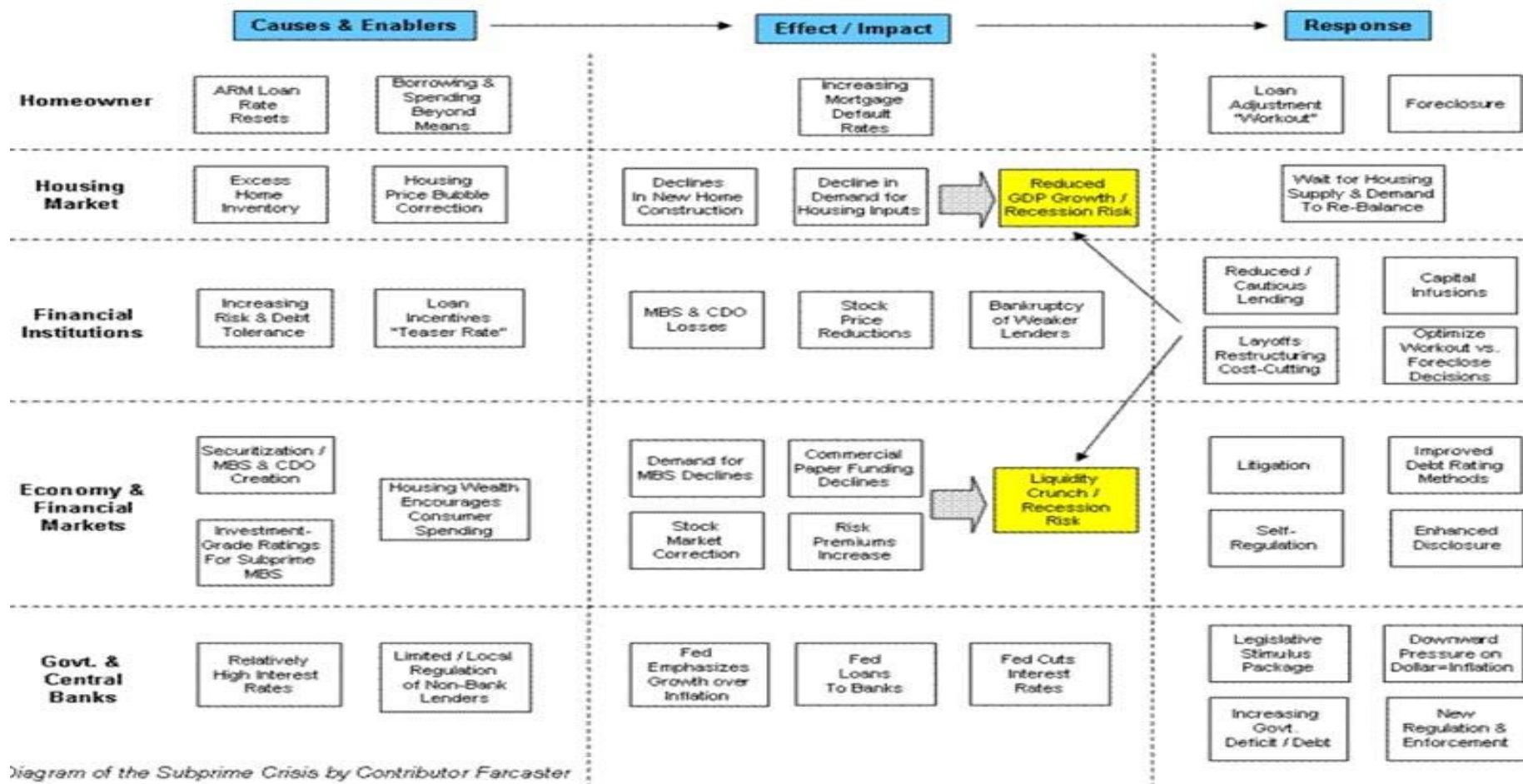
* Note – This Matrix covers open trades, existing prime brokerage relationships with Lehman Brothers, Inc. ("Lehman U.S.");

Lehman Brothers Holdings Inc. ("LBHI"); Lehman Brothers International (Europe) ("LBIE") and derivative-related undertakings with Lehman Brothers Special Financing Inc. ("LBSF")

TRANSACTIONS WITH LEHMAN OR EXPOSURE WITH RESPECT TO LB	EXCHANGE(S)	INFORMATION NEEDED FROM THE CLIENT	DOCUMENT(S)	OPTION(S)	ACTION ITEM AS OF NOV. 12, 2008	UPDATE AND NEXT STEPS
Lehman Brothers, Inc. ("Lehman U.S.")						
This column lists categories of transactions involving Lehman entities (in this case, Lehman Bros Inc. or "Lehman U.S." or other Lehman entity). [On this row, the options provided to the right pertain to trades that were placed through Lehman U.S. not as a prime broker, but as an intermediary, or agent.]	[Exchanges are important because each exchange may have rules for voiding trades that have not been settled for a certain period of time; however, even if an exchange voids a transaction, the substantive rights of the parties may very well be left intact (see, e.g., CREST); exchanges may trigger jurisdiction-related issues that may alter process and approach.]	1. Documentation such as a Trading Authorization Agreement; 2. Open trades including details; 3. Exchanges used for trades; 4. Summary of communications sent re trades 5. Was the trade bought-in? 6. If so, details of buy-in. 7. Communications with Lehman or Barclays regarding this trade, if any. 8. Determine, to the extent possible, whether Barclays or any other third party acquired the position/trade at issue.	A key, threshold question is how the client brought about the trade/position at issue. There will inevitably be a Trading Authorization Agreement or other written instrument that the Lehman broker will require (signed); this must be requested. Many trades are not documented by prime brokerage agreements. The trades may be placed through a third party vendor and may be paperless transactions, or perhaps only evidenced by an email or exchange of screens.	Possible Options: 1. Request assurance of performance. 2. Terminate Open Trades With respect to open outstanding securities and commodity transactions, there is no prohibition against exercising any contractual right to terminate transactions entered into with Lehman. Consent of the Securities Investor Protection Corporation ("SIPC") or the SIPC Trustee is not generally required. For securities and commodity transactions that may be subject to the stay, an expedited procedure has been established. Parties seeking relief should contact David Wittenburg, Esq., c/o Hughes Hubbard & Reed LLP, One Battery Park Plaza, New York, NY 10004, (Telephone) 212-837-6800, witten@hughes Hubbard.com and Josephine Wang, Esq., General Counsel, Securities Investor Protection Corporation, 805 15th Street, N.W. Suite 900, Washington, DC 20005, (Telephone) 202-371-8300, jwang@sipc.org. Any claim arising from doing out such transactions can be submitted through the SIPC claims process that will be established through Court order in the SIPC liquidation proceeding and with respect to which claimants will receive notice. These procedures apply only to the U.S. brokerage entity, not to Lehman Brothers International (Europe) over which the Trustee has no jurisdiction. (See also Appendix A) http://chapter11.epicsystems.com/ViewDocument.aspx?DocumentPk=6726b224-622c-4416-bd60-e7f4e4e9edcd	[In this column we advise our client of the options and follow through with action items with our client.]	11.03.08 – G. Peery spoke with Josephine Wang (General Counsel, Securities Investor Protection Corporation), and learned that: - the claim form on the SIPC website is <u>not</u> to be used to file claims. - the SIPC Trustee will move the U.S. LB BK court on Nov. 5, 2008 (in an application to be heard on that date) to approve a claim application in final form. Ms. Wang believes that the court will approve this application and this week a form for a claim will be approved in final form shortly after the hearing, with more detailed instructions on claims procedure and final forms on the SIPC website. - before the Nov. 5 hearing, it is a mistake to submit the current SIPC Lehman form - G. Peery/M. Prince at KLGates Boston will be reviewing SIPC Series 300 rules for application to open trade fails.

PAGE 1

The Life Cycle of the Crisis



Specific Derivative Problems; Fixes in 2008; and Preventative Measures for 2009

- Dealer Early Warning System
- March 2008: Bear Stearns
- Derivatives Task Force Work:
 - Identify Counterparty Risk
 - Prepare Matrix / Tracking System
 - Crisis Manage Trades with Lehman Brothers
 - Develop Best Practices Documentation by Negotiating Schedules, CSAs and Control Agreements with Key Terms:
 - Triggers for Additional Termination Events
 - Transfer without Consent
 - Supercollateralization
 - Novations
 - Wind-Down Transactions
 - Develop Plan Bs for Clients

Federal Tax Considerations for Mutual Funds and Hedge Funds

Joel D. Almquist

November 12, 2008

www.klgates.com

Partnerships and RICs

- Hedge funds are partnerships for income tax purposes (offshore funds are corporations)
- Mutual funds are corporations electing treatment as “regulated investment companies” (RICs) under Subchapter M of the Code
- Tax consequences of partnership investments pass through to partners; partnerships are not subject to tax
- RICs are subject to corporate tax, but receive a deduction for dividends paid provided the requirements of Subchapter M are met
- Tax character of some types of RIC income is preserved in dividends distributed to shareholders (long-term gain; tax-exempt interest)

Requirements for RIC Treatment Quasi-Pass-Through” Treatment under Subchapter M

- Domestic corporation (or entity classified as such)
- Registered under the 1940 Act (or BDC election)
- Election to be a RIC – Form 1120-RIC
- Gross Income Requirement – 90% of gross income
 - Passive income (dividends, interest, gains from sale of securities, and other income from business of investing in securities)
 - Interest in qualified publicly traded partnership (QPTP)
 - Commodities?

Requirements for RIC Treatment (continued)

- Diversification Requirements – close of each taxable year quarter (different from 1940 Act requirement)
 - 50% of assets
 - 5% of assets in a single issuer
 - 10% of a single issuer's voting securities
 - Specific instruments (including repos and government securities)
 - 25% of assets – no more than 25% of total assets in securities of any one issuer, any two controlled issuers or QPTPs
 - No disqualification for certain failures to comply
 - Exception for market fluctuations and distributions
 - 30-day cure period

Requirements for RIC Treatment (continued)

- Distribution Requirement
 - 90% of investment company taxable income
 - Includes short-term capital gain
 - Includes net foreign currency gains and losses
 - 90% of net tax-exempt income
 - Net capital gain (LTCG can either be distributed or retained subject to tax)
 - Year-end dividend rule

Tax Treatment of Shareholders

- Income Dividends
 - Qualified dividend income (individuals) – 15% maximum rate
 - Requirements
 - Dividends-received deduction (corporations)
- Capital Gain Dividends – designated within 60 days after taxable year end
 - 15% maximum rate for individuals
- Undistributed Net Capital Gain

Tax Treatment of Shareholders (continued)

- Exempt-Interest Dividends – 50% diversification requirement
- Interest-Related Dividends – foreign shareholders; recently extended
- Short-Term Capital Gain Dividends – foreign shareholders; recently extended
- Pass-through of Foreign Taxes Paid

Tax Treatment of Shareholders (continued)

- Disposition of Shares
 - Taxable gain or loss – redemption, sale, or exchange
 - 15% maximum rate for individuals
 - Disposition of shares within 90 days
 - “Wash” sales
 - Sales after short holding period

Income Tax Treatment of a RIC

- Investment Company Taxable Income - taxable income with adjustments
 - Net capital gain excluded
 - No net operating loss and certain other deductions
 - Dividends-paid deduction
 - “Spillover dividends”

Excise Tax on Undistributed Income & Gains

- 4% Tax
 - Measured by calendar year, not taxable year
 - 98% of ordinary income
 - 98% of capital gain net income
 - 100% of “prior year shortfall”

Master-Feeder and Multiple Class Arrangements

- Master-Feeder Structure
 - Non-corporate registered management company
 - Partnership classification – “check-the-box”
 - Publicly traded partnership
 - Not registered under the Securities Act of 1933
 - Private placement safe harbor
 - Ruling unnecessary

Master-Feeder and Multiple Class Arrangements (continued)

- Multiple Classes
 - Preferential dividend rule
 - Within class or between classes
 - Private letter rulings required
 - Revenue procedure 96-47 – safe harbor
 - Language similar to Rule 18f-3 under the 1940 Act
 - Rev. Proc. 99-40 - waivers and reimbursements
 - Advisory fees
 - 12b-1 fees
 - Class-specific expenses

Fund of Funds

- Reimbursement of Upper-Tier Fund of Funds' Expenses
 - General principle – corporation's payment of shareholder's expense is a constructive dividend
 - Private letter rulings – not a preferential dividend

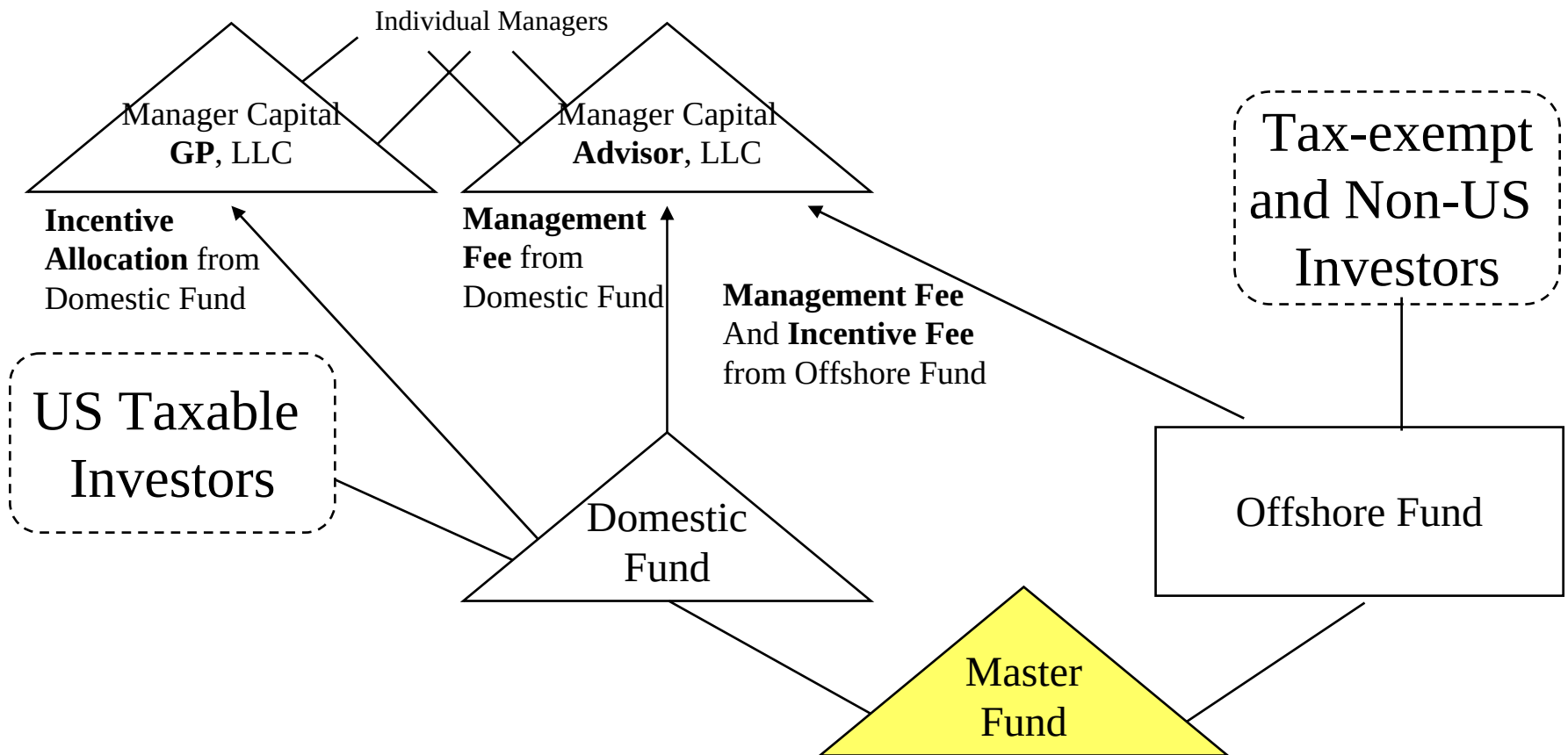
Hedge Funds -- Entity Classification: Partnership vs. Corporation

- Income earned by a partnership is subject to only one level of tax, whereas income earned by a corporation is subject to two levels of tax
 - Note: certain types of corporations, such as RICs and REITs, qualify for special tax treatment
- Domestic hedge funds are treated as a **partnership** for US tax purposes
- Offshore funds are often treated as corporations for US tax purposes
- Master funds in master-feeder structures are treated as partnerships for US tax purposes

Basic Tax Issues for Hedge Fund Key Players

- Who are the key players?
 - Fund managers (generally, our clients)
 - US taxable investors
 - US tax-exempt investors
 - Non-US investors

Basic Tax Issues for Key Players



Basic Issues for Key Players

- Fund managers
 - Let's assume they are US taxpayers
 - Managers will generally organize an LLC or LP (“Advisor”)
 - This entity will be treated as a partnership or “flow-through entity” for tax purposes
 - Generally, for state tax reasons, a separate entity is formed to serve as general partner of the domestic fund (“GP”)
 - The Advisor / GP will receive:
 - Management fees from the domestic and offshore fund (1-2%)
 - Incentive fee from the offshore fund (20% of profits)
 - The GP will receive an “incentive allocation” (or “carried interest”) from the domestic fund (20% of profits)

Basic Issues

- Because the Advisor and GP are treated as partnerships or flow-through entities for tax purposes, the character of income earned by these entities flows through to the members.
 - The fees – management fees from both funds and the incentive fee from the offshore fund – will be treated as **ordinary income**, taxable at rates of up to 35%
 - The incentive allocation represents a share of the income of the domestic fund (which is also treated as a partnership). To the extent this income consists of **capital gains** and **qualified dividend income**, this income, when allocated to individual managers, will be taxable at a maximum rate of 15%.

Basic Issues

- Deferral of Fees from Offshore Fund
 - Managers often elected to defer receipt of the incentive fee (and sometimes the management fee) from the offshore fund.
 - Ability to defer has been eliminated by the recent enactment of Code Section 457A
 - Alternative – incentive allocation at master fund

Basic Issues

- US taxable investors
 - They will invest in the domestic fund so that the character of the income earned by the fund flows through to them.
 - For individual US taxable investors, capital gains and qualified dividend income earned by the fund will be taxable at a maximum rate of 15%
 - Same issue as with fund managers

Basic Issues

- US taxable investors (continued)
 - US taxable investors should be able to deduct the management fee as a business expense if the fund is an active “trader” rather than a passive “investor”
 - Revenue Ruling 2008-39, holding that a non-corporate investor’s deductions for management fees and other expenses incurred by a fund of hedge funds will be subject to limitations as investment expense (miscellaneous itemized deductions)
 - US taxable investors, in effect, receive a full deduction for the incentive allocation to the GP, because amounts allocated to one partner cannot be allocated to the other partners.

Capital Accounts and Net Asset Value

- Capital accounts are adjusted based on increases and decreases in NAV
 - Changes in value, not necessarily taxable sales
- NAV calculated, and capital accounts adjusted, periodically (generally each month) to ensure that:
 - Investors who enter and leave at different times share appropriately in gains and losses
 - Management Fee and Incentive Allocation are calculated on correct base

Incentive Allocation

- Incentive Allocation charged annually
 - 20% of appreciation in each partner's capital account.
 - This ensures that only partners who have experienced gains since their admission are charged.
- High water mark
 - If the value of a capital account drops, the manager will not earn another incentive allocation until the value again rises above its last high point (the "high water mark").
 - Loss Recovery Account keeps track of this.
- Allocation rather than a fee
 - So that general partner/managing member can enjoy lower tax rate on long term capital gains generated by the fund.

Tax Allocations: § 704(c)

- Book allocations may differ from tax allocations.
 - When capital accounts adjusted
 - Also, when property contributed in-kind
- Basic idea: Tax gain allocated to people who were in partnership when the gain arose.

Gain and Loss “Stuffing”

- Redemptions are treated as sales.
 - Gain if redemption proceeds greater than partner’s basis.
- Partnership agreement may provide for tax gains to be allocated to withdrawing partner to the extent of the gain he would otherwise recognize on the redemption.
 - Allocation increases this partner’s basis, and thus reduces gain on redemption, so he should be indifferent.
 - This gain will not be allocated to other partners.
 - Avoids gain duplication.
 - Similar treatment for losses

Offshore Funds

- Non-US and tax-exempt investors
 - Typically invest in the offshore fund, which is treated as a corporation for US tax purposes
 - For tax-exempt investors, this ensures that they will not receive “unrelated business taxable income” or **“UBTI”**
 - For non-US investors, this ensures that they will not be subject to US tax or US tax filings

US tax-exempt investors and UBTI

- Tax-exempt investors are generally not subject to tax on passive income, such as dividends, interest, capital gains
- But taxed, just like a corporation, on UBTI
- What gives rise to UBTI?
 - If a tax-exempt investor invests in a partnership, and the partnership borrows to make its investments, the tax-exempt investor's share of income from the partnership will be UBTI (even if that income would otherwise be passive)
 - This is the primary UBTI concern for tax-exempt investors
 - UBTI also created if tax-exempt investor borrows to make its investment in the fund, but that is less of a concern for the fund
 - Tax-exempt investor engaged, directly or through a partnership, in an active business (this is less of a concern with hedge funds)

US tax-exempt investors and UBTI (cont'd)

- So an investment in the **domestic fund** can create UBTI for a tax-exempt investor if the fund is leveraged
- By contrast, if the tax-exempt investor invests in the **offshore fund**, income from the fund will not be UBTI, even if the fund utilizes leverage to make its investments
 - The offshore fund thus “blocks” the receipt of UBTI
 - Because the offshore fund is treated as a corporation for US tax purposes, it effectively transforms the fund’s income – which would be UBTI if earned directly by the tax-exempt investor – into exempt dividends and capital gains (in the case of sales and redemptions)
- Need to consider whether the offshore fund itself will be subject to US tax (which would indirectly affect the tax-exempt investor by lowering its return)

Non-US Persons and ECI

- If a non-US investor invests in the **domestic fund**, which is treated as a partnership for US tax purposes:
 - The non-US investor could be subject to US tax at rates of up to 35%, and to US tax filing requirements, on any “effectively connected income” or “ECI” earned by the fund
 - Also subject to 30% tax (or lower rate if treaty applies) on gross amount of certain US-source income (dividends, etc.)
- By contrast, if the non-US investor invests in the **offshore fund**, which is treated as a corporation for US tax purposes;
 - No direct US tax or filing requirements
 - As with tax-exempt investors, need to consider whether the offshore fund itself will be subject to US tax (the cost of which would be borne by the tax-exempt investor indirectly)

Non-US Persons and ECI

- What gives rise to ECI?
 - The conduct of an active business carried on in the United States by a non-US person, directly or through a partnership
 - Gain from US real property investments is also treated as ECI
- Generally a safe harbor protects trading in securities and commodities
 - Activities of US-based Advisor potentially create US nexus
- Lending activity is a growing concern for hedge funds
 - Buying loans on the secondary market is ok
 - As fund gets more involved in origination and direct negotiation of loans with US borrowers, it may arguably be engaged in an active financing business
- ECI can also arise if the fund invests in another pass-through entity that is engaged in an active business
 - Issue with funds of funds

Non-US Persons and US-Source Income

- Non-US persons are subject to US tax at a rate of 30% (or lower rate if treaty applies) on US-source payments of:
 - Dividends
 - Interest generally exempt; if not “portfolio interest,” then also subject to 30% tax
 - Referred to as “fixed or determinable annual or periodical” or “**FDAP**” income
- Tax generally collected through withholding by US payor
- Capital gains generally not subject to tax (except with respect to real estate as discussed above)

Legislative Developments

- Carried interest
 - GP receives right to incentive allocation because of services to be provided to fund
 - Character of fund's income flows through to GP and its members even though related to services
 - Proposed legislation would treat all allocations with respect to "investment services partnership interest" – which would include the GP's interest in a fund – as compensation income
- Offshore deferral
 - Section 457A eliminates fee deferral
- UBTI Blockers

Hedge Funds – Tax Considerations

I. Introduction.

Private investment partnerships -- also known as “hedge funds” -- have become increasingly popular as vehicles for collective investments by investors, whether individual or corporate, domestic or foreign, in securities and “derivatives” (so-called because their value “derives” from the value of an underlying asset, reference rate, or index), including options, futures contracts, foreign currency options and forward contracts, and notional principal contracts, including swaps, caps, floors, and collars. The term “private” is used to distinguish these vehicles from entities that must register as investment companies under the Investment Company Act of 1940, as amended (“**Investment Company Act**”) (*i.e.*, mutual funds), and make public offerings of their securities under the Securities Act of 1933, as amended (“**1933 Act**”). Private investment partnerships (sometimes referred to below individually as a “**fund**”) come in various shapes and sizes. The “shapes” include the following:

- A. Limited partnerships;
- B. Limited liability companies (“**LLCs**”) and, rarely, limited liability partnerships (which usually are limited to entities practicing in a profession such as law or accounting);
- C. Trusts, whether based on statute (*e.g.*, Delaware “statutory trusts” and New Hampshire “investment trusts”), part statute/part common law (*e.g.*, Massachusetts “business trusts”), or only common law (*e.g.*, New York); and
- D. Certain foreign (“offshore”) entities.

The “sizes” range from those limited to no more than 100 investors to those with unlimited investors that are “qualified purchasers” (*i.e.*, “big hitters”). These size limitations, as it were, are dictated by the federal securities laws, primarily the Investment Company Act. In addition to extensive securities law considerations (primarily how to avoid regulation thereunder), tax considerations play a major role in planning a private investment partnership.

II. Basic Tax Concepts.

A. Partnership (Pass-Through) v. Corporate (Entity-Level) Taxation.

Virtually all domestic, and many foreign, private funds seek to be classified for federal tax purposes as partnerships rather than as associations taxable as

corporations (see section 7701 and the Regulations thereunder¹). If a private fund is classified as a partnership, its partners, and not the fund itself, are subject to tax on their respective distributive shares of the private fund's items of income, gain, loss, and deduction (collectively "**partnership items**"). The character (*i.e.*, ordinary vs. capital) of the partnership items in this "pass-through" regime also passes through to a fund's partners. On the other hand, if a private fund is classified as an association or a "publicly traded partnership" (see paragraph C. below), its investors are treated for federal tax purposes as shareholders of a corporation. In that event, (1) partnership items do not pass through to the investors, (2) distributions by the fund are treated as corporate distributions to the investors, which are taxable to them as dividends to the extent of the fund's earnings and profits, and (3) the fund's taxable income is subject to U.S. federal income tax at the rates imposed on corporations.

B. Check-the-Box Regulations.

Regulation sections 301.7701-1 through -3 (the so-called "check-the-box" Regulations), generally effective January 1, 1997, provide a largely elective regime for determining when an unincorporated organization may be classified for federal tax purposes as a partnership rather than as an association taxable as a corporation. Under this regime, certain foreign business entities (listed in Treas. Reg. § 301.7701-2(b)(8)) are classified as *per se* corporations for federal tax purposes. All other unincorporated business entities (including statutory, business, and investment trusts, but not "pure" trusts) generally may choose their federal tax classification. A domestic business entity not formed under a corporation statute that has at least two members generally is classified for federal tax purposes as a partnership without having to make an affirmative election,² while a foreign business entity with at least two members, all of whom have limited liability, is classified for those purposes as an association but may elect otherwise (unless it is a *per se* corporation).

Nearly all multi-member domestic private funds will accept the default classification as a partnership, and will not elect to be classified as an

¹ All "section" references below are to the Internal Revenue Code of 1986, as amended ("Code"), unless otherwise noted, and all "Treas. Reg. §" references are to the regulations thereunder ("Regulations").

² Under the check-the-box Regulations, an unincorporated business entity with a single owner, such as a single-member LLC, either is disregarded (the default classification) or may elect to be classified as an association. An LLC with more than one member is eligible to be classified as described in the accompanying text, and references in the discussion below to "partnership" or "fund" and "partner" includes such an LLC (other than one that "checks-the-box" to be classified as an association) and a member thereof, respectively.

association, for federal tax purposes. Accordingly, in the aftermath of the check-the-box Regulations, a private fund's sponsor generally will have little trouble receiving comfort that the fund will be classified as a partnership. For that reason, it is no longer customary for a private fund sponsor to receive an opinion of counsel as to the tax classification of a fund (except occasionally with respect to "publicly traded partnership" status, discussed below), although some sponsors disclose in offering materials that, if requested to do so by any partner, they will request (and expect to receive) such an opinion. Likewise, tax classification issues no longer require a general partner of a limited partnership to maintain any minimum percentage ownership in the partnership, and as a result many LLCs have a manager that is not also a member.

C. Publicly Traded Partnerships.

1. General.

A private fund that is classified as a partnership under the check-the-box Regulations still may be treated as a corporation for federal tax purposes if it is a **"publicly traded partnership."** A publicly traded partnership is a partnership the interests in which are traded on an "established securities market" (*i.e.*, a national securities exchange that is registered under the 1934 Act or is exempt from such registration because of limited volume, certain foreign securities exchanges, a regional or local exchange, and certain interdealer quotation systems) or are "readily tradable on a secondary market (or the substantial equivalent thereof)" ("readily tradable"). Section 7704(b). Although most private funds' interests will not be traded on an established securities market, they generally may be redeemed under certain circumstances and, therefore, could be considered to be readily tradable.

2. Exceptions to Corporate Treatment.

The Regulations under section 7704 establish certain "safe harbors" from publicly traded partnership status for a private fund classified as a partnership. The most commonly used of these provides that if all the interests in a fund are issued in a transaction (or transactions) not required to be registered under the 1933 Act (*i.e.*, a **"private placement"**) and the fund does not have more than 100 partners at any time during its taxable year, the interests will not be considered readily tradable. For purposes of determining the number of partners, the beneficial owner of an interest in a partnership, grantor trust, or S corporation (a "look-through entity") that invests in a fund is treated as a partner in the fund, but only if substantially all the value of the beneficial owner's interest in the look-through entity is attributable to that entity's interest in the fund and a principal purpose for the tiered arrangement was to satisfy the 100-partner condition.

Even if a partnership fails to satisfy the private placement safe harbor, however, treatment as a corporation is not inevitable. Under section 7704(c), a publicly traded partnership (other than one that is registered under the Investment Company Act) is not treated as a corporation for federal tax purposes if 90% or more of its gross income

consists of “qualifying income.” For this purpose, qualifying income includes, among other things, “passive” income such as interest, dividends, gain from the disposition of capital assets held to produce such income, and other income that would qualify as permissible income for a regulated investment company (*i.e.*, a registered mutual fund) or a real estate investment trust.

A private fund exempt from Investment Company Act regulation pursuant to section 3(c)(1) thereof generally will satisfy the private placement safe harbor because it will have fewer than 100 partners. However, a private fund relying on section 3(c)(7) of the Investment Company Act generally will have more than 100 “qualified purchaser” partners; if it does, that fund will not qualify for the private placement safe harbor and instead must monitor the character of its income to ensure that at least 90% of it is “qualifying income.”

D. Taxation of Partners.

1. General.

Each partner in a private fund classified as a partnership is required to take into account in computing his or her federal income tax liability his or her distributive share of the fund’s partnership items for any taxable year of the fund ending with or within the partner’s taxable year, without regard to whether the partner has received or will receive a distribution of cash or other property from the fund. In addition, if a partner purchases a fund interest at a value that includes unrealized gain and that gain subsequently is realized (and, in the case of a purchase from another partner, an election under section 754 is not made (see below)), the purchasing partner’s share of taxable gain may include gain attributable to the time period prior to the partner’s purchase.

The amount of tax due, if any, with respect to a private fund’s net income and gains is determined separately for each partner. The fund is required to file an information return on Internal Revenue Service (“**IRS**”) Form 1065 following the close of each taxable year and to provide each partner with a Schedule K-1 indicating the partner’s allocable share of the fund’s partnership items reported on the Form 1065. Each partner, however, is responsible for keeping his or her own records for determining the tax basis in his or her fund interest and calculating and reporting any gain or loss resulting from a fund distribution or disposition of a fund interest.

2. Basis.

A partner’s basis in its fund interest is important in determining (a) the amount of gain it will realize on the sale or other disposition thereof, (b) the amount of non-taxable distributions (including any decrease in its share of the fund’s liabilities) that it may receive from the fund, and (c) its ability to utilize its distributive share of any tax losses of the fund. A partner’s initial tax basis in its fund interest will equal its cost therefor plus its share of the fund’s liabilities at the time of purchase. In general, a partner’s “share” of those liabilities will equal the sum of (i) the entire amount of any otherwise nonrecourse liability of the fund as to which the partner or an affiliate is the creditor (a

“partner nonrecourse liability”) and (ii) a share, based in part on profit-sharing ratios, of any nonrecourse liabilities of the fund that are not partner nonrecourse liabilities as to any partner.

A partner’s basis in its fund interest is (a) increased by (i) its allocable share of the fund’s taxable income and gain and (ii) any additional contributions by the partner to the fund and (b) decreased (but not below zero) by (i) its allocable share of the fund’s tax deductions and loss and (ii) any distributions by the fund to the partner. For this purpose, an increase in a partner’s share of a fund’s liabilities is treated as a contribution by the partner to the fund and a decrease in that share is treated as a distribution by the fund to the partner.

3. Capital Accounts.

A capital account is established on a fund’s books for each partner and should be maintained in accordance with Treas. Reg. § 1.704-1(b). Each partner’s capital account generally is (a) credited with the partner’s capital contribution, (b) increased by the partner’s distributive share of fund taxable income and gain, and (c) decreased by the partner’s distributive share of fund tax deductions and loss. A capital account also may be increased or decreased by the amount of any special allocations provided in the governing agreement that have substantial economic effect (see below). A private fund’s governing agreement often provides for establishing special pools, e.g., a pool for privately offered securities or a pool for “new issues” (defined, in general, in the recently adopted “New Issues Rule” of the National Association of Securities Dealers, Inc., as initial public offerings of equity securities) (formerly referred to as “hot issues,” which were defined more broadly and applied more restrictively in the “Free-Riding and Withholding” Interpretation (IM-2110-1) of that organization’s Board of Governors under Rule 2110 of its Conduct Rules), the ownership of which is subject to certain restrictions; for each partner a part of whose capital account balance is allocated to such a pool, a separate sub-account may be established within its capital account for its interest in the pool.

4. Allocations of Partnership Items in General.

Allocations of a fund’s partnership items are made in accordance with its governing documents (typically a partnership, limited liability company, or trust agreement for domestic private funds), unless the allocation does not have “substantial economic effect.” In general, to have substantial economic effect, an allocation must be consistent with the partners’ underlying economic arrangement.

An allocation has “economic effect” if the fund’s governing agreement provides, throughout the fund’s full term, as follows:

- a. The partners’ capital accounts will be determined and maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv);

b. Distributions on liquidation of the fund (or any partner's interest therein) will be made in accordance with the partners' positive capital account balances; and

c. A partner that has a deficit balance in its capital account following the liquidation of its fund interest is obligated to restore the amount of that deficit to the fund, generally by the end of the fund's taxable year in which the liquidation occurs (unless the fund's governing agreement provides for a "qualified income offset" (see below)).

The economic effect of an allocation is "substantial" if there is a reasonable possibility that the allocation will substantially affect the dollar amounts received by the partners from a fund, independent of tax consequences. Although the IRS will issue private letter rulings regarding whether a partnership's allocations have economic effect, it will not rule on the substantiality thereof.

A fund's governing documents typically require that ordinary income/expense items, which generally accrue or arise in the current period, be allocated among the partners based on their relative capital account balances at the beginning of the period. Each time the partners' capital account balances change (e.g., due to capital contributions or withdrawals), a new allocation period is created. This may occur monthly, quarterly, or annually (or more frequently), as provided in the governing documents.

No loss or deduction is allocated to a partner's capital account if and to the extent the allocation would create or increase a deficit balance in the account. Any such loss or deduction is allocated instead to the other partners' capital accounts to the extent of and in proportion to the respective positive balances of those accounts. If any partner unexpectedly receives any adjustment, allocation, or distribution described in certain Regulations that creates or increases a deficit balance in the partner's capital account or the account otherwise has a deficit balance, a fund generally allocates items of income and gain to the account in an amount and manner sufficient to eliminate the deficit balance as quickly as possible. This allocation is called a "qualified income offset" and is used in lieu of obligating a partner to restore a negative capital account balance.

5. Allocations of Capital Gains and Losses.

Allocations of realized and recognized gains and losses from the sale or exchange of securities and other capital assets (i.e., capital gains and losses) is more complex because at least part of the increase or decrease in value of the asset may have occurred in an allocation period or periods other than the period in which the asset is sold or exchanged. Private funds that invest in securities may use either of two methods, the "tax lot method" or the "aggregate method," to allocate these gains or losses to their partners.

The tax lot method involves tracking the economic gain or loss of each tax lot of each security, on a partner-by-partner basis, for each allocation period. The capital gain or loss from the sale of any security is then allocated to the partners in accordance with those allocations of the economic gain or loss. This concept is exceedingly complex if the private fund holds and frequently trades many securities and has frequent admissions and withdrawals of partners.

The aggregate method allows a fund to aggregate unrealized gains and losses from all securities, instead of tracking them on a lot-by-lot basis. Under this method, for example, a fund might create an “unrealized gain/loss account” for each partner and then, for each allocation period, allocate to those accounts (based on the partners’ respective capital account balances at the beginning of the period) the unrealized gains and losses from all securities the fund held during the period. Recognized capital gains and losses for a period are then allocated to the partners’ capital accounts in accordance with their relative unrealized gain/loss account balances. The aggregate method is much simpler than the tax lot method, but in some instances it may result in differences between allocations of realized gains and losses and the actual net profits and losses allocated to a partner’s capital account.

Some private funds use an industry accounting convention of specially allocating realized gains and losses, for federal income tax purposes, to a partner who withdraws completely from a fund. Under that convention, those gains (and losses) first are allocated *pro rata* to each withdrawing partner to the extent its capital account balance exceeds (or is less than) its adjusted tax basis in its fund interest and then are allocated to the remaining partners. The IRS has not publicly taken any position as to the efficacy of such an allocation method.

In accordance with section 704(c) and the Regulations thereunder, partnership items with respect to any property contributed to a fund’s capital must, solely for tax purposes, be allocated among the partners’ capital accounts so as to take account of any variation between the fund’s adjusted tax basis in the property and the property’s fair market value at the time of contribution. Accordingly, recognized gain or loss on the disposition of that property is allocated to the contributing partner’s capital account to the extent of “built-in gain or loss” and, to the extent necessary, the partners generally will receive reasonable curative or remedial allocations permitted by the applicable Regulations. A fund may, in connection with a contribution or distribution of money or other property (other than a *de minimis* amount), make adjustments to the partners’ capital accounts to reflect a revaluation of property on its books, to the extent permitted by the applicable Regulations.

6. Distributions.

A distribution by a fund to a partner generally is not taxable to the partner except to the extent the distribution consists of cash (and marketable securities, unless the fund is an “investment partnership” and the distributee is an “eligible partner,” both as defined in section 731(c)(3), or certain other conditions apply) and exceeds the partner’s

adjusted basis in its fund interest immediately before the distribution. Ordinarily, any such excess is treated as gain from a sale or exchange of the partner's interest.

7. Other Tax Issues for Individual Partners.

Individual partners in a private fund must address a number of other tax issues, for example, the application of the "at risk" rules, the "passive activity loss" rules, and the limitation on the deduction of interest. Private fund offering memoranda may contain disclosure about these topics but must always caution individual partners to consult their own tax advisers.

III. Additional Tax Considerations.

A. Tax-Exempt Partners – UBTI.

Although certain organizations, such as qualified retirement plans, generally are exempt from federal income tax, unrelated business taxable income ("UBTI") passed through partnerships to tax-exempt partners is subject to that tax. UBTI is income from regularly carrying on a trade or business that is not substantially related to the organization's exempt purpose. UBTI excludes various types of income such as dividends, interest, royalties, rents from real property (and incidental rent from personal property), and gains from the disposition of capital assets, unless the income is from "debt-financed property," which is any property that is held to produce income with respect to which there is acquisition indebtedness (such as margin debt or other borrowings). Fee income (e.g., investment banking fees) also may be considered UBTI. Because a fund's income attributable to debt-financed property (and fees) allocable to tax-exempt partners therein will (or may) constitute UBTI to them, tax-exempt investors generally refrain from investing in private funds classified as partnerships that expect to engage in activities such as leveraged trading strategies. Many private fund sponsors may instead create a separate foreign corporate fund to accept tax-exempt investors and have that fund, together with a domestic private fund, invest in a "master fund" classified as a partnership in a "master-feeder fund" structure.

B. Non-U.S. Partners – Withholding.

1. Partnerships.

A domestic private fund classified as a partnership that has non-U.S. partners must withhold tax on their distributive shares of its income (but generally not its capital gains), even if that income is not actually distributed to them, and/or distributions thereof. The amount of tax withheld depends on how the income is characterized (as to the fund and, because the fund qualifies for pass-through treatment, as to its partners) for federal income tax purposes.

If a private fund is not considered to be conducting a trade or business within the United States for those purposes (*i.e.*, it acts merely as an "investor"), it must withhold non-U.S. partners' distributive shares of dividends, certain categories of interest, and other fixed or determinable annual or periodical income (collectively "FDAP") at a flat

30% rate (unless a lower treaty rate applies). Most other income, such as “portfolio interest” (including interest on U.S. government securities) and original issue discount, and gains derived from the sale of stocks and other securities (including that derived from options transactions) held as capital assets are exempt from withholding tax, in each case subject to certain exceptions.

If a fund is treated as conducting a trade or business within the United States for federal income tax purposes (*i.e.*, it acts as a “trader” or “dealer” in securities), a portion of its income may be treated as “effectively connected” with its conduct of that trade or business (“**ECI**”) for withholding tax purposes. If the income is considered ECI to the non-U.S. partners, they are subject to U.S. federal income tax on their distributive shares thereof as if they were U.S. residents. A fund generally must withhold tax from ECI at the highest marginal rate (*i.e.*, 35% for both corporations and individuals). If a fund also has income that is considered FDAP, that income is subject to withholding as discussed above.

2. Corporations.

A domestic private fund that is treated as a corporation generally must withhold tax from all dividend distributions to its non-U.S. shareholders at the flat 30% rate (or lower treaty rate) regardless of whether the fund is deemed to be conducting a U.S. trade or business for federal income tax purposes and regardless of whether the source of the dividend is ordinary income or capital gains. The corporate form thus prevents a non-U.S. shareholder from (a) avoiding withholding on its share of the fund’s capital gains, portfolio interest, and other amounts exempt from withholding and (b) deriving ECI from fund distributions even if the fund is conducting a U.S. trade or business, provided the shareholder is not conducting a trade or business within the United States to which the investment in the fund could be attributed.

C. Fund Investments.

1. Gains and Losses from Securities Transactions.

A private fund generally deals with its investments as a “trader” or “investor” (generally, a person that buys and sells securities for its own account for purposes of short-term gain or investment, respectively) and not as a “dealer” (generally, a person that buys and sells securities to and from customers with a view to the gains from those transactions). Accordingly, the gains and losses a fund recognizes on the sale of its investments typically are capital gains and losses, which are long-term or short-term depending, in general, on the length of time it held the securities and, in some cases, the nature of the transactions.

Gains from property held for more than one year generally are eligible for favorable tax treatment. The maximum tax rate applicable to a noncorporate taxpayer’s net capital gain (the excess of net long-term capital gain over net short-term capital loss) recognized on the sale or exchange of capital assets held for more than one year is 15%.

2. Other Income.

A fund also may realize ordinary income from interest and dividends on securities. In those cases, a fund is required to include amounts as ordinary income on a current basis even if it does not actually receive payment of those amounts until a subsequent year. A fund also may realize ordinary income or loss with respect to certain of its other investments, such as limited partnership interests.

3. Derivatives.

A private fund may invest in “nonequity” options (*i.e.*, certain listed options, such as those on a “broad-based” securities index), regulated futures contracts (other than “securities futures contracts,” as defined in section 1234B(c) of the Code), and certain foreign currency contracts (with respect to which it makes a particular election) that are subject to section 1256 (collectively “**section 1256 contracts**”). Section 1256 contracts a fund holds at the end of a taxable year -- other than section 1256 contracts that are part of a “mixed straddle” (*i.e.*, a straddle, clearly identified by the fund in accordance with applicable Regulations, at least one, but not all, of the positions of which are section 1256 contracts) with respect to which it has made an election not to have the following rules apply -- must be “marked-to-market” (that is, treated as sold for their fair market value) for federal income tax purposes, with the result that unrealized gains or losses are treated as though they were realized. Sixty percent of any net gain or loss recognized on these deemed sales, and 60% of any net realized gain or loss from any actual sales of section 1256 contracts, is treated as long-term capital gain or loss, and the balance is treated as short-term capital gain or loss.

When a covered call option written (sold) by a fund expires, it realizes a short-term capital gain equal to the amount of the premium it received for writing the option. When a fund terminates its obligations under such an option by entering into a closing transaction, it realizes a short-term capital gain (or loss), depending on whether the cost of the closing transaction is less (or more) than the premium it received when it wrote the option. When a covered call option written by a fund is exercised, it is treated as having sold the underlying security, producing long-term or short-term capital gain or loss, depending on the holding period of the underlying security and whether the sum of the option price received on the exercise plus the premium received when it wrote the option is more or less than the basis of the underlying security.

Section 1092 (dealing with “straddles”) also may also affect the taxation of derivatives in which a fund may invest. That section defines a “**straddle**” as offsetting positions with respect to actively traded personal property; for these purposes, options, futures contracts, and forward currency contracts are positions in personal property. Under that section, any loss from the disposition of a position in a straddle generally may be deducted only to the extent the loss exceeds the unrealized gain on the offsetting position(s) of the straddle. In addition, these rules may require postponing recognition of loss that otherwise would be recognized under the mark-to-market rules discussed above. The Regulations under section 1092 also provide certain “wash sale” rules, which apply to transactions where a position is sold at a loss and a new offsetting

position is acquired within a prescribed period, and “short sale” rules applicable to straddles. If a fund makes certain elections, the amount, character, and timing of recognition of gains and losses from the affected straddle positions will be determined under rules that vary according to the elections made. Because only a few of the Regulations implementing the straddle rules have been promulgated, the tax consequences to a fund and its partners of straddle transactions are not entirely clear.

4. Income from Foreign Securities.

Dividends and interest a fund receives, and gains it realizes, on foreign securities may be subject to income, withholding, or other taxes imposed by foreign countries and U.S. possessions that would reduce the total return on its securities. Tax conventions between certain countries and the United States may reduce or eliminate these taxes, however, and foreign countries generally do not impose taxes on capital gains in respect of investments by foreign investors. A partner may be able to claim a foreign tax credit with respect to any foreign income taxes a fund pays that are not reclaimed, or may deduct those taxes, in determining the partner’s federal income tax liability.

Gains or losses (a) from the disposition of foreign currencies, including forward currency contracts, (b) on the disposition of each foreign-currency-denominated debt security that are attributable to fluctuations in the value of the foreign currency between the dates of acquisition and disposition of the security, and (c) that are attributable to exchange rates fluctuations between the time a fund accrues interest, dividends, or other receivables or expenses or other liabilities denominated in a foreign currency and the time it actually collects the receivables or pays the liabilities generally are treated as ordinary income or loss. These gains are sometimes referred to as “section 988” gains or losses.

5. OID Securities.

A fund may acquire zero coupon or other securities issued with original issue discount (“**OID**”) and Treasury inflation-indexed securities (initially known as Treasury inflation-protection securities) (“**TIPS**”), on which principal is adjusted based on changes in the Consumer Price Index. A fund must include in its gross income the OID that accrues on those securities, and the amount of any principal increases on TIPS, during the taxable year, even if it receives no corresponding payment on them during the year. Similarly, a fund must include in its gross income securities it receives as “interest” on payment-in-kind securities.

D. Expenses and Special Allocations.

A partnership may deduct a trade or business expense that is ordinary, necessary, and reasonable in amount. The IRS could challenge any expense a fund deducts on the ground that the expense is a capital expenditure, which must either be amortized over an extended period or indefinitely deferred. The IRS could also challenge the treatment of a fund expense on the ground that the amount of the expense is unreasonable in relation to the value of the services performed, the goods acquired, or the other benefits to the fund.

A fund usually pays out of its assets certain legal, accounting, and other expenses of its organization. Those expenses directly related to a fund's organization, such as the costs of preparing the partnership agreement, may be capitalized and amortized over a period of 180 months; however, those expenses related to the sale of interests (including brokerage and finders fees, if any, a fund pays) must be capitalized and cannot be amortized.

An individual taxpayer's "miscellaneous itemized deductions," which include certain investment expenses, are allowable only to the extent they exceed, in the aggregate, 2% of the individual's adjusted gross income. In determining his or her miscellaneous itemized deductions, an individual partner in a fund must take into account his or her distributive share of the fund's deductions. The investment management fee a fund pays to an investment adviser would be characterized as a miscellaneous itemized deduction for the fund's partners.

In addition to an investment management fee, which generally is a fixed annual amount (usually 1% to 2%) of a fund's net asset value, many private funds provide additional compensation to the investment adviser that varies based on the fund's investment performance. That compensation may take the form of a "performance" fee -- an expense that the fund pays, which thus would be characterized as a miscellaneous itemized deduction -- or an allocation (usually called a "special" or "incentive" allocation) to the investment adviser, but only if it is also a partner (referred to below as a "**Special Allocation**").

A typical Special Allocation provides that a percentage (often 20%) of the fund's net capital appreciation (*i.e.*, both realized and unrealized gain) otherwise allocable for a taxable year to each investor-partner's capital account (usually subject to what is referred to as a "high water mark," as described in the next paragraph) instead will be allocated to the adviser's capital account, though the adviser usually has discretion to make a lesser or no allocation with respect to any particular investor-partner for any period, as negotiated between them. If an investor-partner redeems all or part of its interest at any time other than the end of a taxable year, a Special Allocation will be made by treating the redemption date as the last day of a taxable year. Funds often will engage independent public accountants to confirm all calculations of the allocation.

A "high water mark" means that if an investor-partner is allocated net capital depreciation in any period followed by net capital appreciation in a subsequent period, there will be no Special Allocation to the adviser with respect to that investor-partner until the net capital depreciation has been fully recouped. Net capital depreciation that occurs subsequent to a taxable year in which the adviser receives a Special Allocation, however, does not reduce that allocation, and that depreciation is borne by all investor-partners.

A Special Allocation is designed to avoid being characterized as a fund expense -- it is intended to be characterized as an allocation of profits to the adviser's capital account -- but could be characterized as an expense item and thereby subject to treatment as a miscellaneous itemized deduction. If an investment management fee, a

Special Allocation, and/or other expenses were so characterized, an individual partner would be required to include his or her allocable share thereof in calculating allowable miscellaneous itemized deductions. This could cause an individual partner's share of taxable income from a fund to be higher than his or her share of fund profits.

A fund usually deducts an investment management fee as it accrues. The IRS, however, could challenge the deductibility of such a fee by asserting either that it (or the combination of fees to the adviser) constitutes compensation that is unreasonable in amount or that all or a portion thereof is incurred in connection with the acquisition of fund assets and therefore must be capitalized.

E. Withdrawal or Transfer of Interests.

If a partner withdraws part or all of its interest in a fund, (1) it recognizes gain only to the extent the amount of cash (and marketable securities, unless the fund is an "investment partnership" and the distributee is an "eligible partner," both as defined in section 731(c)(3), or certain other conditions apply) distributed to it exceeds its adjusted basis in its interest immediately before the distribution, (2) it does not recognize loss on a partial redemption, and (3) it recognizes loss on a complete redemption only (a) if it receives no property from the fund other than money and unrealized receivables and inventory ("**section 751 property**") of the fund and (b) to the extent its adjusted basis in its interest exceeds the sum of any money it receives and the basis in any section 751 property. Any such recognized gain or loss generally is considered capital gain or loss from the sale or exchange of the interest -- long-term capital gain or loss if the partner held the interest for more than one year -- unless the partner is deemed to be a "dealer" in securities. However, the portion of any gain or loss attributable to the partner's share of the fund's section 751 property, if any, is treated as ordinary income or loss.

If a partner sells or exchanges its interest in a fund, it realizes gain or loss equal to the difference between the amount realized from the sale or exchange (including any reduction in its share of the fund's liabilities) and its adjusted basis in its interest. That gain or loss is treated as described in the preceding paragraph. In addition, as noted above, a fund may use an industry accounting convention that allocates realized gains and losses first to a withdrawing partner to the extent its capital account balance exceeds (or is less than) its adjusted tax basis in its fund interest and then to the remaining partners. The IRS has not publicly taken any position as to the efficacy of such an allocation method.

F. Tax Elections, Returns, and Audits.

A fund may make various elections for federal income tax purposes that could result in certain partnership items being treated differently for tax and accounting purposes. Elections permitted under the Code that may affect the determination of a fund's income, the deductibility of expenses, accounting methods, and the like must be made by the fund and not by the partners, and these elections is binding in most cases on all the partners.

Section 754 permits a partnership to elect to adjust the basis of partnership property on the sale or exchange of an interest in the partnership or on a partner's death and on certain distributions of property by the partnership to a partner. If a fund made such an election, a transferee of an interest therein would be treated, for purposes of computing gain, as though it had acquired a direct interest in the fund's assets, and the fund would be treated for those purposes, on certain distributions to partners, as though it had obtained a new cost basis in its assets. If a 754 election is not made, a transferee of a fund interest may be subject to tax on a portion of the income from the disposition of fund assets that, as to it, constitutes a return of capital if the purchase price of its interest exceeds its share of the fund's adjusted basis in its investments.

A fund must file an annual partnership information return with the IRS reporting the results of its operations. After the end of each taxable year -- generally the calendar year, though a different taxable year may be available under certain circumstances (e.g., the taxable year of partners having a majority interest in partnership profits and capital) -- a fund must distribute to its partners federal income tax information reasonably necessary to enable each partner to report its distributive share of the fund's partnership items. Each partner must treat partnership items reported on a fund's returns consistently on the partner's own returns, unless the partner files a statement with the IRS disclosing the inconsistency.

Under most partnership agreements, the general partner is designated as the "tax matters partner" and, in that capacity, will have considerable authority to make decisions affecting the tax treatment and procedural rights of all the partners. For example, a fund's tax matters partner may have the right on behalf of all partners to extend the statute of limitations with respect to the fund's partnership items and to select the forum for litigating any tax disputes, including a forum that might require the partners to pay an assessed tax deficiency before the litigation is resolved. All partners of a fund generally are bound by the outcome of final administrative adjustments agreed to by its tax matters partner relating to the fund resulting from an audit by the IRS, as well as by the outcome of judicial review of disputed adjustments.

IV. Foreign Funds.

Many sponsors also organize foreign private funds the interests in which generally are sold to non-U.S. persons and/or U.S. tax-exempt investors. Investing through foreign private funds raises a number of complicated tax issues for foreign partners.

A. Federal Taxation of Foreign Funds.

Under the check-the-box Regulations, certain foreign business entities are classified for federal tax purposes as *per se* corporations, while any other foreign business entity with at least two members, all of whom have limited liability, is classified for those purposes as an association taxable as a corporation but may elect otherwise. Most foreign private funds have no members with personal liability and are content to be

classified as corporations for federal tax purposes, but some foreign funds will elect partnership classification.

1. Corporations.

A foreign private fund that is classified as a corporation for federal tax purposes is subject to 30% (or lower treaty rate) withholding tax on any FDAP it receives, which is withheld at the source. ECI such a fund receives is subject to federal corporate income tax, which generally will not be withheld at the source provided the corporation files the proper documentation with the payor. Such a fund will also be subject to a branch profits tax on profits resulting from ECI.

2. Partnerships.

Before the issuance of extremely detailed, comprehensive, and complex Regulations under section 1441 that became effective in 2001 (after twice being delayed), a foreign fund that elected partnership classification generally was not obligated to withhold tax on a foreign partner's distributive share of FDAP (unless the fund entered into a special withholding agreement with the IRS), because tax on that income normally was required to be withheld by the person that paid the income to the fund. Such a fund still is responsible for withholding tax from its foreign partners' distributive shares of ECI. See "Withholding Requirements for Foreign Partnerships," below.

B. Federal Taxation of Foreign Fund Partners.

The taxation of non-U.S. partners in a foreign private fund classified as a partnership for federal tax purposes generally is the same as the taxation of non-U.S. partners in a domestic partnership. Non-U.S. investors in a foreign private fund classified as a corporation for those purposes, however, generally are not subject to tax on distributions from the fund (because the income already has been subject to withholding or income tax at the fund level).

C. Conducting a Trade or Business.

In general, pursuant to section 864(b), a foreign fund will not be considered to be conducting a trade or business within the United States merely by investing in the stocks or securities of U.S. issuers or by trading in such stocks or securities in the United States for its own account. In addition, a foreign fund may retain the services of U.S. investment advisers and brokers and may grant them discretion to engage in securities transactions without causing the fund to be deemed to be conducting such a trade or business. A fund that is considered a "dealer" in stocks or securities of U.S. issuers, however, is considered to be conducting a trade or business within the United States. The determination of whether a fund's activities rise to the level of dealer activities depends on the facts and circumstances of each case.

Prior to the repeal of the statutory basis for the so-called "Ten Commandments" pursuant to the Taxpayer Relief Act of 1997, a foreign fund that traded in stocks or

securities of U.S. issuers for its own account was considered to be conducting a trade or business within the United States if it maintained its principal office in the United States. The Regulations under section 864 set forth a “safe harbor” list of ten administrative functions (“**Ten Commandments**”) that, if conducted substantially outside the United States, would tend to cause a fund to be treated as if its principal office were outside the United States. Although it is no longer necessary to comply with this safe harbor to avoid being treated as conducting a U.S. trade or business, many foreign funds continue to maintain their books and records and perform certain other administrative functions offshore for privacy reasons and to avoid taxation in a small number of states that, in effect, have not adopted the repeal.

D. Withholding Requirements for Foreign Partnerships.

Income a foreign partnership receives is treated as received by its partners. Thus, a foreign partnership is responsible for collecting the necessary withholding-related forms or appropriate substitutes therefor.

1. Forms.

a. Form W-8IMY - a certificate of foreign intermediary status. An entity that files this form is stating that it is merely a flow-through entity and not the beneficial owner of the income it receives.

b. Form W-8BEN - a certificate of foreign beneficial ownership. An individual or foreign entity that files this form is claiming to be the beneficial owner of the income it receives and to be foreign and therefore subject to a 30% rate (or lower treaty rate) of withholding.

c. Form W-9 - the form used to corroborate a claim of U.S. citizenship or resident alien status.

Following is a quick reference chart to the required forms:

<u>Taxpayer</u>	<u>Form(s)</u>
Foreign partnership	Form W-8IMY (filed on its own behalf)
Investors in foreign partnership	Forms W-9 & W-8BEN (collected by the foreign partnership). The foreign partnership obtains a Form W-9 from each U.S. investor and a Form W-8BEN from each foreign beneficial owner, <i>i.e.</i> , foreign corporation or individual. However, if that owner is another foreign partnership, a Form W-8IMY is required from that partnership and Forms W8-BEN and W-9 from each of its U.S. and foreign investors, respectively.

2. Qualified Intermediary Partnership.

A foreign partnership may choose to become a qualified intermediary partnership by entering into a Qualified Intermediary Withholding Agreement with the IRS, pursuant to Revenue Procedure 2000-12.

Only entities located in jurisdictions with IRS-approved know your customer (“KYC”) rules are eligible to enter into Qualified Intermediary Withholding Agreements with the IRS. Both the Cayman Islands and Bermuda, tax friendly jurisdictions for foreign private funds, have KYC rules that the IRS has approved.

E. State Law.

Most states have amended their tax laws to be consistent with the federal repeal of the statutory basis for the Ten Commandments. Nevertheless, it is important to check state tax law consequences in any state in which a foreign private fund might be considered to be engaged in a trade or business by virtue of its investment activities conducted therein (or by virtue of activities conducted by its investment adviser that is domiciled therein).

F. Passive Foreign Investment Companies.

1. General.

Some foreign private funds (other than *per se* corporations) may “check-the-box” to be classified as partnerships for federal tax purposes. Many of those funds, however, will accept the default federal tax classification as corporations, usually because of

desires to avoid the withholding responsibilities that foreign partnerships have and sometimes, in the case of funds that use leverage in their investing activities, to permit tax-exempt U.S. investors to invest therein without having UBTI concerns. Under certain circumstances, a foreign private fund that is classified as a corporation will be deemed to be a passive foreign investment company (“**PFIC**”). A PFIC is any foreign corporation (with certain exceptions) that, in general, meets either of the following tests: (1) at least 75% of its gross income for the taxable year is passive (which generally includes dividends, interest, rents, capital gains, and other types of income defined in section 954(c)) or (2) an average of at least 50% of its assets produce, or are held for the production of, such passive income.

2. Tax on U.S. Shareholders.

If a foreign private fund is a PFIC, its U.S. shareholders generally will be subject to tax, as well as interest charges, on any “excess distributions” from the fund. That term includes actual distributions from the PFIC during a taxable year that exceed 125% of the average amount of distributions therefrom during the prior three taxable years and all gain from disposition of the PFIC’s stock (including deemed gain in some exchanges that might otherwise be tax-free). Excess distributions are treated as earned ratably over the shareholder’s entire holding period, and the part of the distribution allocated to each taxable year other than the current year is taxed at the highest rate applicable to ordinary income in that year, and interest is due on the tax so determined to be due each such year.

A U.S. shareholder of a PFIC can avoid this treatment by (a) electing to treat the PFIC as a “qualified electing fund” (“**QEF**”), in which case the shareholder would be required to include in income each year its *pro rata* share of the QEF’s annual ordinary earnings and net capital gain even if the QEF did not distribute those earnings and gain to the shareholder, or (b) electing to “mark to market” its PFIC stock (if that stock is “marketable”) by including in ordinary income each taxable year the excess, if any, of the stock’s fair market value over the shareholder’s adjusted basis therein as of the end of that year. However, in most instances it will be very difficult, if not impossible, to make a QEF election because some of the information required to make the election may not be easily obtainable, and the stock in a PFIC that is a foreign private fund generally will not be “marketable.”

FEDERAL TAX ASPECTS

I. REQUIREMENTS FOR REGULATED INVESTMENT COMPANY TREATMENT

A regulated investment company (“**RIC**”) -- whether open-end or closed-end, and including an exchange-traded fund (“**ETF**”) -- receives special treatment under Part I of Subchapter M of Chapter 1 of the Internal Revenue Code of 1986, as amended (“**Code**”)¹: it can completely eliminate corporate tax liability (and thus achieve so-called “**pass-through**” treatment). To qualify for that treatment, a fund must satisfy some very specific requirements outlined below. Because each fund in a series investment company is treated as a separate corporation for federal tax purposes, those requirements apply to each such fund separately (except for the registration requirement in A. below, which the investment company satisfies). Thus, a RIC (*i.e.*, a regulated investment company) is not necessarily the same as a registered investment company.

- A. Domestic Corporation Registered under the 1940 Act.** To qualify as a RIC, a fund must be a domestic corporation. This requirement is satisfied if the fund (1) is organized under a federal or state corporation statute (Maryland being the most popular state because of favorable provisions of its corporate law) or (2) is a Delaware statutory trust, Massachusetts business trust, or other entity that, for federal tax purposes, either (a) elects to be classified as a corporation under the so-called “check-the-box” Regulations (Treas. Reg. § 301.7701-3(c)) or (b) is a “publicly traded partnership” that is treated as a corporation (see section 7704). A fund (or the company of which it is a series) must be (x) registered as a management company under the Investment Company Act of 1940, as amended (“**1940 Act**”), or (y) have in effect an election thereunder to be treated as a business development company, on every day of its taxable year. See section 851(a)(1)(A). Thus, a fund should file Form N-8A with the Securities and Exchange Commission (“**SEC**”) when it is organized and not wait until it commences operations.
- B. Election to Be a RIC.** A fund must elect to be a RIC for its current taxable year or must have made that election in a previous taxable year. See section 851(b)(1). The election is made simply by filing a federal income tax return on Form 1120-RIC.
- C. Gross Income Requirement.** A fund must derive at least 90% of its gross income each taxable year from (1) dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of securities or

¹ “Section” references are to the Code, unless otherwise noted, and “Treas. Reg. §” references are to the final, temporary, and proposed regulations under the Code (“**Regulations**”).

foreign currencies, or other income (including gains from options, futures, or forward contracts) derived with respect to its business of investing in securities or those currencies, and (2) net income from an interest in a “qualified publicly traded partnership” (“**QPTP**”). See section 851(b)(2). (A QPTP is defined as a publicly traded partnership -- generally, a partnership the interests in which are “traded on an established securities market” or are “readily tradable on a secondary market (or the substantial equivalent thereof)” -- other than a partnership at least 90% of the gross income of which consists of dividends, interest, and other qualifying income described in (1) above.)

Income from Commodities. Income from direct investments in commodities and from certain types of derivative contracts regarding commodities, such as certain swaps on commodity indices, is not qualifying income for the purpose of this requirement because the contracts are not securities. See Rev. Rul. 2006-1, 2006-2 I.R.B. 261, modified by Rev. Rul. 2006-31, 2006-25 I.R.B. 1133. Shortly after publication of the first of those revenue rulings, however, the Internal Revenue Service (“**Service**”) ruled privately that the following do constitute qualifying income: (1) income and gain from certain “structured notes that create a commodity exposure” (so-called “commodities-linked notes”) and (2) income from a wholly owned foreign subsidiary that invests in commodities and financial derivatives. The Service so ruled as recently as private letter ruling (“**PLR**”) 200842014 (July 17, 2008, released Oct. 17, 2008).²

D. Diversification Requirements

1. 50% of Assets

At the close of each quarter of a fund’s taxable year, at least 50% of the value of its total assets must be invested in cash, cash items, government securities, securities of other RICs, and (subject to the 5% and 10% restrictions noted in a) and b) below) other securities. See section 851(b)(3)(A). Compare the diversification requirement in section 5(b)(1) of the 1940 Act (at least 75% of assets must be so diversified at all times).

² Although, under section 6110(k)(3), a PLR may not be cited as precedent, tax practitioners look to PLRs as generally indicative of the Service’s views on the proper interpretation of the Code and the regulations thereunder. Cf. *Rowan Companies, Inc. v. United States*, 452 U.S. 247, 261 n. 17 (1981); *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962); *Buckeye Power, Inc. v. United States*, 38 Fed. Cl. 283, 285 (Claims Ct. 1997); also see Treas. Reg. § 1.6662-4(d)(3)(iii) (providing that PLRs issued after October 31, 1976, are authority for purposes of determining whether there is or was substantial authority for the tax treatment of an item under section 6662(d)(2)(B)(i), in connection with the imposition of the accuracy-related penalty under section 6662 to a substantial understatement of income tax).

The other 50% of a fund's assets may be invested in anything, subject to the 25% diversification requirement described in 2. below, although that may not satisfy the 1940 Act diversification requirement.

- a) *5% of assets in a single issuer.* If more than 5% of the value of a fund's total assets is invested in the securities of a single issuer, all of those securities (not merely the excess over 5%) do not qualify for the purpose of the 50%-of-assets requirement.
- b) *10% of a single issuer's voting securities.* If a fund owns more than 10% of the voting securities of a single issuer -- equity securities of QPTPs are considered voting securities for these purposes -- none of those securities qualifies for that purpose.
- c) *Treatment of Specific Instruments*
 - (1) Certificates of Deposit. The Service has ruled that short-term CDs are cash items, not securities (though the SEC has classified them as securities).
 - (2) Bankers' Acceptances. The Service has ruled that these are not cash items for a real estate investment trust (which is governed by similar rules in Part II of Subchapter M); presumably, the same treatment applies to RICs.
 - (3) Repurchase Agreements. Pursuant to Rev. Proc. 2004-28, 2004-1 C.B. 984, a fund may treat a position in a repo that is "collateralized fully" with government securities as such securities (*i.e.*, "good" assets) for diversification purposes. Previously, a repo was treated for those purposes as a secured loan (*i.e.*, a single security issued by the counterparty ("borrower")), not a purchase and resale of the underlying securities; and a repo will continue to be so treated if it fails to satisfy the revenue procedure's requirements. Moreover, the revenue procedure does not apply for purposes of the diversification requirement under section 817 that applies to separate accounts that invest in variable insurance products.
 - (4) Overnight loans of federal funds are not cash, but securities.
 - (5) Government Securities. There is no definition of "government securities" in the Code or the Regulations.

However, for purposes of the diversification requirements, the Code adopts the definitions in the 1940 Act for any term not defined in the Code. See section 851(c)(6). Section 2(a)(16) of the 1940 Act defines a “government security” as any security issued or guaranteed as to principal or interest by the United States or by a person controlled or supervised by, and acting as an instrumentality of, the U.S. government pursuant to authority granted by Congress. Thus, for example, Government National Mortgage Association (a/k/a “Ginnie Mae”), Federal National Mortgage Association (a/k/a “Fannie Mae”), and Federal Home Loan Mortgage Association (a/k/a “Freddie Mac”) mortgage-backed and mortgage participation certificates are government securities. See Rev. Rul. 92-89, 1992-2 C.B. 154, for a short list of other government securities; also see Rev. Rul. 2003-84, 2003-32 I.R.B. 289 (refunded municipal bonds, with respect to which government securities are placed in escrow to fund future payments on the bonds, are government securities for purposes of the diversification requirements). Options, futures, and options on futures on government securities also appear to be government securities.

2. **25% of Assets**

At the close of each quarter of a fund’s taxable year, not more than 25% of the value of its total assets may be invested in (a) securities (other than government securities or securities of other RICs) of any one issuer, (b) securities (excluding other RICs’ securities) of two or more issuers the fund controls that are determined to be engaged in the same, similar, or related trades or businesses, or (c) securities of QPTPs. See section 851(b)(3)(B).

3. **No Disqualification for Certain Failures to Comply (Section 851(d))**

- a) *Market Fluctuation Exception.* If a fund fails to meet a diversification requirement due solely to market fluctuations, distributions, or redemptions rather than wholly or partly because of an acquisition, the fund will not be disqualified if it had satisfied both diversification requirements at the close of the first quarter of the first taxable year for which it elected to be a RIC.

Example - A fund acquired a position in an issuer's securities valued at less than 25% of the fund's total assets. If that position subsequently exceeded 25% of those assets at a quarter-end because those securities increased in value more rapidly than the fund's other assets or because the fund had to liquidate other securities to make a cash distribution, the failure to satisfy the 25% diversification requirement would not disqualify the fund. But if it then acquired (including through a transfer in connection with a reorganization) as little as one additional share of that issuer's securities (even if its cost plus the cost of the original shares still was less than 25% of the fund's total asset value), the fund would no longer be able to rely on this exception.

- b) *30-Day Cure Period.* If a fund's failure to satisfy a diversification requirement at the close of any quarter is wholly or partly (see example above) the result of an acquisition (including, in the case of a closed-end fund, a redemption or repurchase of its own securities!), the fund has 30 days after the close of the quarter in which to cure the failure.

E. **Distribution Requirement**

A fund that satisfies all the above requirements qualifies to be a RIC. To qualify for the pass-through treatment of Subchapter M, however, a RIC also must distribute to its shareholders for each taxable year at least 90% of the sum of its **"investment company taxable income"** -- which generally consists of net investment income, the excess of net short-term capital gain over net long-term capital loss (**"short-term capital gain"**), and net gains or losses from certain foreign currency transactions, all determined without regard to the dividends-paid deduction (see III. below) -- plus its net interest income excludable from gross income under section 103(a). See section 852(a)(1).³ There is no requirement to distribute any **"net capital gain"** (i.e., the excess of net long-term capital gain over net short-term capital loss). For these and other purposes (see, e.g., II.A.-F. and III. below), dividends and other distributions that (1) a RIC declares in the last quarter of any calendar year, (2) are payable to shareholders of record on a date in that quarter, and (3) are actually paid during the following January are deemed to have been paid by the RIC and received by the shareholders on December 31 of that year (**"Year-end Dividend Rule"**). See section 852(b)(7).

³ Technically, to qualify for that treatment a RIC's dividends-paid deduction (see III. below) must be at least 90% of that sum, and not all distributions qualify for that deduction. See, e.g., the preferential dividend rule described in V.B.1. below.

II. TAX TREATMENT OF SHAREHOLDERS

- A. **Income Dividends.** A RIC's distributions to its shareholders from its investment company taxable income (including short-term capital gain) are taxed to them, unless they are exempt from federal income tax, as ordinary income. See section 301(c)(1). A portion of those dividends, however, may be eligible for a 15% maximum federal income tax rate that applies to dividends individuals receive through 2010 (enacted by the Jobs and Growth Tax Relief Reconciliation Act of 2003, and extended from an expiration date of 2008 by the Tax Increase Prevention and Reconciliation Act of 2005, passed in 2006 (collectively, "**2003 Act**")). See section 1(h)(11).⁴ The eligible portion ("**qualified dividend income**") may not exceed the aggregate dividends a RIC receives from most domestic corporations and certain foreign corporations (subject to its satisfying certain holding period and other restrictions with respect to the stock on which the dividends are paid), unless that aggregate is at least 95% of its gross income (as specially computed), in which case the entire dividend qualifies. In addition, the availability of the 15% rate is subject to the shareholders' satisfying the same restrictions with respect to the RIC shares on which the dividends are paid. A portion of a RIC's dividends also may be eligible for the dividends-received deduction allowed to corporations -- the eligible portion may not exceed the aggregate dividends the RIC receives from domestic corporations subject to federal income tax (excluding real estate investment trusts) and excludes dividends from foreign corporations -- subject to similar restrictions. See section 854(b). However, dividends a corporate shareholder deducts pursuant to the dividends-received deduction are subject indirectly to the federal alternative minimum tax.
- B. **Net Capital Gain.** A RIC's distributions to its shareholders from its net capital gain, when properly designated as such, are treated by them as long-term capital gain. See section 852(b)(3)(B). That designation, as well as other dividend designations for tax purposes, normally is made in the RIC's annual report to its shareholders. Similar treatment is provided for undistributed net capital gain. See section 852(b)(3)(D). As a result of the 2003 Act, any distributions a RIC makes of net capital gain it recognizes on sales or exchanges of capital assets through the end of its last taxable year beginning before January 1, 2011, will be subject to a 15% maximum federal income tax rate for individual shareholders. See section 1(h)(11). Note that this treatment is determined by how long the RIC held the investments the sale of which generated the gain, not by how long a shareholder held the RIC's shares.

⁴ Technically, for purposes of the taxation of dividends that individuals receive, qualified dividend income (see the next sentence in the accompanying text) is included in net capital gain, which, as explained in paragraph B. below, is subject to the 15% maximum rate.

- C. **Exempt-Interest Dividends.** If at least 50% of the value of a RIC's total assets at the close of each quarter of its taxable year consists of obligations the interest on which is excludable from gross income under section 103(a) -- the Service takes the position that this requirement cannot be satisfied by including shares in other RICs that satisfy it -- then the RIC's distributions of the excess of that interest income over certain amounts disallowed as deductions, when properly designated by the RIC ("**exempt-interest dividends**"), may be excluded from gross income by its shareholders. See section 852(b)(5).
- D. **Interest-Related Dividends.** The income dividends a RIC pays to a non-U.S. shareholder generally are subject to a 30% (or lower treaty rate) federal withholding tax ("**withholding tax**"). However, withholding tax does not apply to a RIC's distributions of amounts it properly designates as interest-related dividends with respect to a taxable year beginning before January 1, 2010 -- the Emergency Economic Stabilization Act of 2008, which became law on October 3, 2008, extended the sunset date under prior law from taxable years beginning before January 1, 2008 -- paid to a shareholder who files a statement (presumably a Form W-8BEN) that the beneficial owner of the RIC's shares is a non-U.S. person, with certain exceptions (an "**eligible foreign shareholder**"). The amount a RIC designates for a taxable year may not exceed its "qualified net interest income," which is its "qualified interest income" less allocable deductions, for that year. Qualified interest income consists of the following amounts a RIC derives from U.S. sources: Original issue discount on an obligation payable within 183 days of its original issue, interest on obligations in registered form (with certain exceptions), interest on deposits, and any interest-related dividend from another RIC. See sections 871(k), 881(e), 1441(c)(12), and 1442(a). Question -- how did calendar-year RICs (or those with taxable years that ended in 2008 before October 3) handle withholding on interest-related dividends paid to eligible foreign shareholders in that part of 2008?
- E. **Short-Term Capital Gain Dividends.** Although capital gains a non-U.S. person recognizes generally are exempt from withholding tax, a RIC's short-term capital gain is included in its investment company taxable income, with the result that a distribution thereof is taxed as an ordinary dividend (see I.E. and II.A. above) and, therefore, subject to withholding tax when distributed to non-U.S. shareholders. A RIC's distributions to eligible foreign shareholders, however, of amounts it properly designates as short-term capital gain dividends (essentially, its short-term capital gain, subject to certain adjustments) with respect to a taxable year beginning before January 1, 2010 (see paragraph D. above), are exempt from withholding tax. See the sections cited in paragraph D. above.
- F. **Foreign Taxes.** Under certain circumstances, a RIC also may pass-through to its shareholders any foreign withholding, income, and similar taxes it pays, with respect to which the shareholders may be able to claim a foreign tax credit or

deduction on their own income tax returns. See section 853. Generally, this pass-through treatment will be available only to funds that invest primarily in foreign securities.

G. Disposition of Shares

1. **Taxable Gain or Loss.** When a shareholder redeems an open-end RIC's shares or sells a closed-end fund's or ETF's shares on an exchange, the shareholder will recognize taxable gain or loss, measured by the difference between the redemption/sale proceeds and the shareholder's adjusted basis in the redeemed/sold shares, which normally includes any sales charge paid on them. An exchange of RIC shares for shares of another RIC (usually permitted within fund complexes without payment of sales charges) -- not to be confused with conversion of shares from one class of a RIC to shares of another class of the same RIC -- normally will have similar tax consequences. Any capital gain an individual shareholder recognizes on a redemption or exchange through the end of 2010 of shares that have been held for more than one year will qualify for the 15% maximum federal income tax rate enacted by the 2003 Act (which maximum generally was 20% before that act). The 2003 Act did not change the tax rate on short-term capital gain (essentially, net gain from the sale or exchange of capital assets held for one year or less), which continues to be taxed at the ordinary income rate.
2. **Disposition of Certain Shares.** If a shareholder disposes of a RIC's shares ("original shares") within 90 days after purchase thereof and subsequently reacquires shares of that RIC or acquires shares of another RIC on which a sales charge normally is imposed ("replacement shares"), in either case without paying the sales charge (or paying a reduced charge) due to an exchange privilege or a reinstatement privilege, then (a) any gain on the disposition of the original shares will be increased, or the loss thereon decreased, by the amount of the sales charge paid when those shares were acquired (in effect, excluding that amount from the basis in the original shares) and (b) that amount will increase the adjusted basis in the replacement shares that were subsequently acquired. See section 852(f).
3. **"Wash" Sales.** If a shareholder purchases shares of a RIC (whether pursuant to a reinstatement privilege or otherwise) within 30 days before or after redeeming other shares of that RIC (regardless of class) at a loss, all or part of that loss will not be deductible and instead will increase the basis in the newly purchased shares.

4. **Sales after Short Holding Period.** If a shareholder disposes of RIC shares at a loss within six months after purchasing them, (a) the loss will be disallowed to the extent of any exempt-interest dividends received on the shares and (b) any loss that is not disallowed will be treated as long-term, rather than short-term, capital loss to the extent of any capital gain distributions received thereon. See section 852(b)(4). (The reference to six months here -- previously the maximum holding period to which short-term capital gain treatment applied -- is not a typo; the rule described in this paragraph just wasn't changed when that holding period was extended to a year.)

III. **INCOME TAX TREATMENT OF A RIC**

A RIC is taxed on its investment company taxable income (see I.E. above), which generally is taxable income determined in the same manner as a normal corporation, with three significant differences: (1) net capital gain is excluded (and is taxed separately, unless the gain is distributed to the RIC's shareholders); (2) the net operating loss deduction and certain other deductions available to normal corporations are not allowed; and (3) most importantly, the RIC is allowed a deduction for dividends it pays to its shareholders (unless the dividend is preferential (see V.B.1. below)). See section 852(b)(2). The dividends-paid deduction for a taxable year applies not only to dividends paid during that year but also to dividends distributed in accordance with the Year-end Dividend Rule and to so-called "spillover" or "spillback" dividends, which are dividends declared before the time prescribed for filing the RIC's tax return (including extensions) for that year and distributed within the following taxable year not later than the date of the first regular dividend payment made after the declaration. Thus, if a RIC makes qualifying distributions to its shareholders of all its net income and net realized gains, it avoids the "double taxation" that applies to normal corporations and their shareholders and instead receives pass-through treatment. Note that although shareholders are deemed to have received distributions subject to the Year-end Dividend Rule on December 31 of the year in which they are declared, spillover dividends are taxable to shareholders in their taxable year in which they actually receive the dividends.

IV. **EXCISE TAX**

A RIC will be subject to a nondeductible 4% federal excise tax to the extent it fails to distribute by the end of any calendar year (not its taxable year) at least the sum of (1) 98% of its ordinary (not including tax-exempt) income for that year, (2) 98% of its capital gain net income for the one-year period ending on October 31 of that year, plus (3) 100% of certain other amounts (known as the "prior year shortfall"). See section 4982(a). For these purposes, distributions for a calendar year include the deductible dividends paid (or, pursuant to the Year-end Dividend Rule, deemed paid) by the RIC during that year and amounts on which the RIC pays tax for any taxable year ending in that calendar year (see section 4982(c)(1)) but do not include spillover dividends.

V. MASTER-FEEDER AND MULTIPLE CLASS ARRANGEMENTS

A. Master-Feeder Structure

1. **Partnership Classification.** A master fund is a Delaware statutory trust, a Massachusetts business trust, a New York common law trust (used in the Signature Financial Group's "Hub and Spoke"SM model), or other non-corporate entity that is registered as a management company under the 1940 Act. It is critical that the master fund be classified for federal tax purposes as a partnership, which is not a taxpaying entity, because the "double taxation" resulting from classification as a corporation would far outweigh any benefits otherwise available from the master-feeder structure. Partnership classification can be assured by complying with the "check-the-box" Regulations (Treas. Reg. § 301.7701-3(c)), which is relatively easy to accomplish.
2. **Publicly Traded Partnership.** Partnership classification is not enough, however, because a publicly traded partnership generally is treated as a corporation for federal tax purposes and thus leads to double taxation. To avoid classification as a publicly traded partnership, the offering of interests in the master fund must not be registered under the Securities Act of 1933, as amended (to take advantage of the "private placement safe harbor" provided in the Regulations under section 7704).
3. **No PLR.** Although at one time it was necessary to obtain a PLR for a new master-feeder structure, especially one involving a "conversion" of an existing fund complex (*i.e.*, transfers of assets from existing RICs to new master funds), that is no longer required.

B. Multiple Classes

1. **Preferential Dividend Rule.** No dividends-paid deduction (and, hence, no pass-through treatment) is available for a distribution unless it is *pro rata*, with no preference to any share as compared with other shares of the same class, and with no preference to one class as compared with another class except to the extent the former is entitled (without reference to waivers of their rights by shareholders) to that preference. See section 562(c). The Service has refused to recognize multiple-class structures of the type adopted by RICs (*i.e.*, those based largely on differences in 12b-1 fees, shareholder services, and sales charges) as creating separate "classes" for these purposes.
2. **Revenue Procedure 96-47.** For more than six years in the early 1990s, the Service issued hundreds of PLRs in which it ruled that 12b-1 fees are

shareholder expenses (!) for purposes of the preferential dividend rule. The number of those PLRs was so high because that theory unfortunately could not be relied on in legal opinions, and PLRs cannot be used or cited as precedent (see note 2), so establishing virtually every new multiple-class structure meant having to obtain a PLR from the Service. Thankfully, the Service eventually issued Rev. Proc. 96-47, 1996-2 C.B. 338, which created a “safe harbor” on which multi-class RICs could rely. In much the same manner that the adoption of Rule 18f-3 under the 1940 Act (from which much of the language in the revenue procedure is taken) eliminated the need to file applications for exemptive orders with the SEC, the revenue procedure largely eliminated the need to obtain PLRs in this area, for it established a standard on which opinions could be based. If a RIC satisfies the requirements of the revenue procedure, which should not be difficult for most multi-class RICs, “variations in distributions to shareholders of different Qualified Groups [the Service still refuses to call them ‘classes’] [that] exist solely as a result of the allocation of expenses in accordance with” those requirements will not result in preferential dividends.

3. **Waivers and Reimbursements - Revenue Procedure 99-40.** The thorniest problem left in the wake of Rev. Proc. 96-47 involved waivers of fees and reimbursement of expenses. Until Rev. Proc. 99-40, 1999-2 C.B. 565, was issued, the Service’s ruling policy permitted no reimbursement of expenses and allowed waivers in only three situations:

- a) *Advisory fees.* An adviser could waive all or any part of its advisory fee (but no other fund-wide expense, such as custodial fees), as long as the waiver was proportionate to all shares of all classes of the RIC.
- b) *12b-1 fees.* A distributor or a related entity could waive all or part of a 12b-1 fee, on a class-by-class basis.
- c) *Class-specific expenses.* An adviser or related entity that charged a fee for an expense allocated to a particular class could waive all or part of that fee “only if the revised fee more accurately reflects the relative costs of providing to each [class] the service for which the fee was charged.”

The Service recognized the inadequacy of this policy, so in Announcement 96-95 (which accompanied Rev. Proc. 96-47) it requested comments on waiver/reimbursement issues. The result, more than three years later -- delayed in part by difficulties in satisfying the Treasury Department’s conflict-of-interest requirements -- is set forth in Rev. Proc.

99-40: the benefit of a waiver or reimbursement of all or part of a fee or expense must be allocated in accordance with the method pursuant to which the fee or expense itself was allocated. Thus, in the case of advisory fees (other than a performance fee) and other fees and expenses related to management of a RIC's assets (specifically including custodial and tax return preparation fees) -- which must be allocated among the RIC's classes on the basis of their relative net asset values -- the benefit of a waiver or reimbursement thereof must be allocated among those classes on the same basis. On the other hand, the benefit of a waiver or reimbursement of a 12b-1 fee or class-specific expense imposed on or incurred with respect to a particular class must be allocated only to that class.

VI. FUND OF FUNDS

In a 1990 PLR, the Service ruled that reimbursements of expenses by underlying RICs to upper-tier "fund of funds" did not result in preferential dividends. The Service reached this conclusion notwithstanding the general principle of federal income taxation that the payment by a corporation of a shareholder's expenses is a constructive dividend to that shareholder, which in the fund context would result in a preferential dividend paid by an underlying RIC to its shareholder, the fund of funds. When a request for a similar PLR was submitted a few years later, however, the Service took over 1½ years to finally grant the request (which it did in July 1996), giving very strong indications from time to time during the pendency of the request that it was disinclined to do so. Since then, the Service has issued many favorable PLRs on this structure.

DIVIDENDS AND OTHER DISTRIBUTIONS**I. GOVERNING LAW**

Three separate laws may regulate the payment of dividends and other distributions by a registered investment company: Section 19 of the Investment Company Act of 1940, as amended (“**1940 Act**”); Part I of Subchapter M of Chapter 1 (sections 851 - 855) (“**Subchapter M**”) and section 4982 of the Internal Revenue Code of 1986, as amended (“**Code**”); and, in some cases, the corporate law of the state in which the investment company is organized.

II. INCOME DIVIDENDS**A. Section 19(a) of the 1940 Act**

1. This section makes it unlawful for a registered investment company to pay any dividend, or to make any distribution in the nature of a dividend, wholly or partly from any source other than --
 - a) the company’s accumulated undistributed net income, “determined in accordance with good accounting practice” and not including profits or losses realized on the sale of securities or other properties, or
 - b) the investment company’s net income so determined for the current or preceding fiscal year,unless the payment is accompanied by a written statement that adequately discloses the sources of the payment. The term “good accounting practice” is not defined.
2. Securities and Exchange Commission (“**SEC**”) rules require that every statement made pursuant to section 19(a) be on a separate sheet of paper, *i.e.*, it cannot be buried in the annual report, although the SEC has granted no-action relief in certain circumstances.
3. The statement must clearly indicate what portion of the payment per share is made from the following sources:
 - a) Net income for the current or preceding fiscal year, or accumulated undistributed net income, not including in either case profits or losses from the sale of securities or other properties;

- b) Accumulated undistributed net profits from the sale of securities or other properties (except that an open-end company may treat as a separate source its net profits from those sales during its current fiscal year); or
- c) Paid-in surplus or other capital source.

See Rule 19a-1(a) under the 1940 Act.

- 4. On June 13, 2007, the Investment Company Institute submitted to the SEC recommendations regarding amendments to Rule 19a-1. Among these recommendations is a proposal to permit investment companies to satisfy their disclosure obligations under the rule by including the relevant information on their own, or an affiliate's Internet website and in periodic shareholder communications.

B. Internal Revenue Code¹

- 1. Pass-Through Tax Treatment. Subchapter M provides pass-through tax treatment to investment companies and series thereof -- each of which is referred to under the federal tax law as a "regulated investment company" ("RIC") -- that meet certain requirements. (More specifically, in determining its own taxable income and net capital gain, an investment company may deduct distributions it pays to its shareholders.) These requirements include the following:
 - a) the RIC must distribute annually at least 90% of its investment company taxable income and 90% of its net tax-exempt income; and
 - b) the RIC must not distribute "preferential dividends" to any of its shareholders.
- 2. Investment Company Taxable Income ("ICTI"). ICTI is defined to include net investment income, the excess of net short-term capital gain over net long-term capital loss, and net gains and losses from certain foreign currency transactions. ICTI differs from a regular corporation's taxable income primarily in that it excludes net capital gain (*i.e.*, the excess of net long-term capital gain over net short-term capital loss) and provides a dividends-paid deduction for dividends a RIC pays to its shareholders that are not "preferential dividends" (see paragraph 4. below)

¹ For more detail regarding the federal income tax treatment of dividends and other distributions, see Federal Tax Aspects at Item 13.

3. Exempt-Interest Dividends

- a) If, at the close of each quarter of its taxable year, a RIC holds at least 50% of its assets in securities the interest on which is excludable from gross income under section 103 of the Code (but not shares of other RICs that satisfy that requirement), dividends it pays to its investors from exempt sources (“**exempt-interest dividends**”) are tax-exempt in their hands as well.
- b) Distributions of exempt-interest dividends may affect shareholders’ capital loss calculations. If a shareholder receives an exempt-interest dividend from a RIC and redeems or exchanges some or all of its shares in the RIC within six months after purchase, any loss on the redeemed or exchanged shares is disallowed to the extent of the amount of the exempt-interest dividend received on the shares.

4. Preferential Dividends

- a) If any part of a distribution is deemed preferential, the entire distribution fails to qualify for the dividends-paid deduction. As a result, a RIC that pays a preferential dividend is likely to fail to qualify for pass-through tax treatment under Subchapter M.
- b) RICs must take care that programs involving fee payments or other benefits for some investors and not others are not considered preferential dividends.

5. Spillover Dividends

- a) A RIC may in some cases pay a dividend in one taxable year and count it as having been paid in the preceding taxable year for purposes of determining its tax liability for the earlier year.
- b) These so-called “spillover dividends” must be declared before the time prescribed for filing the RIC’s tax return (including extensions) for the taxable year to which the dividend is intended to relate; and they must be distributed within the following year and not later than the date of the first regular dividend payment made after the declaration.
- c) Spillover dividends can apply to ordinary income, capital gain, and exempt-interest dividends. While they are useful for insuring that a RIC has complied with the 90% distribution requirement

essential to its status as a pass-through entity, they are not counted for purposes of determining the RIC's distributions needed to comply with the 4% excise tax described below.

- d) For investors, spillover dividends are taxable in the year in which they are actually received.
- e) Although not technically a spillover dividend, a dividend declared in October, November, or December to shareholders of record in one of those months, and actually paid in the following January, is treated by both the RIC and the shareholders as having been paid on December 31 for all purposes under the Code, including the excise tax.

C. Excise Tax

- 1. Section 4982 of the Code imposes a nondeductible 4% excise tax on a RIC unless it distributes (without regard to spillover dividends) by the end of each calendar year at least the sum of (a) 98% of its ordinary (taxable) income for that year plus (b) 98% of its capital gain net income (both short- and long-term) for the one-year period ending October 31 of that year plus (c) 100% of any "prior year shortfall."
- 2. Note that the measuring period for this tax is not the RIC's taxable (fiscal) year.

III. CAPITAL GAIN DISTRIBUTIONS

A. Section 19(b) of the 1940 Act

- 1. Section 19(b) and Rule 19b-1 thereunder permit registered investment companies that qualify for pass-through treatment under the Code (*i.e.*, RICs) to declare up to three, and with SEC permission four, **capital gain distributions** (as defined below) in a year:
 - a) They permit one capital gain distribution of any amount; and the rule permits a second, supplemental "spillover" distribution with respect to the same taxable year that does not exceed 10% of the aggregate amount distributed for that taxable year;
 - b) In response to the imposition of the federal excise tax described above, Rule 19b-1(f) permits investment companies to make one additional (third) capital gain distribution with respect to each taxable year, made in whole or in part for the purpose of not incurring the excise tax; and

- c) Any investment company that proposes to make an additional capital gain distribution in a particular taxable year because of unforeseen circumstances may apply to the SEC for permission. The request is deemed granted unless the SEC denies it within 15 days after receipt.

B. Internal Revenue Code

1. The long-term or short-term character of capital gain a RIC distributes to its shareholders is determined by how long the RIC held the investment the sale of which generated the gain, not by how long the shareholder held the RIC's shares. That character is retained when the RIC distributes the gain to its shareholders.
2. RIC distributions of net capital gain ("**capital gain distributions**") may be treated as long-term capital gain by its shareholders only if the company sends shareholders a written notice, mailed not more than 60 days after close of the taxable year, designating the amount of the net capital gain. Investment companies normally satisfy this notice requirement by making the required designation in their annual reports to shareholders.
3. Capital gain distributions may affect shareholders' capital loss calculations. If a shareholder receives a capital gain distribution from a RIC and redeems or exchanges some or all of its shares in the RIC within six months after purchase, any loss on the redeemed or exchanged shares is a long-term loss to the extent of the amount of the capital gain distribution received on the shares.
4. Also see the discussions of Spillover Dividends and Excise Tax, above.

IV. STATE LAW

A. Corporations

The corporation law of the state in which an investment company is organized may impose limitations on or procedures regarding distributions.

1. In Maryland, for example, the Corporations and Associations Article of the Maryland Code requires that the board of directors authorize any distribution. In addition, no distribution may be made if, as a result, the corporation would not be able to pay its indebtedness as it becomes due in the usual course of business. If it is established that a director did not exercise due care in voting for a dividend, directors may be individually liable if it appears the corporation cannot pay its debts.

2. Directors may establish the record date for any distribution. The record date may not be prior to the close of business on the day the directors fix the record date.
3. Additional requirements may be contained in the corporation's charter or by-laws.

B. Business/Statutory Trusts

Massachusetts business trusts are largely free of statutory requirements, and many of the requirements of the Delaware Statutory Trust Act (originally, the Delaware Business Trust Act) may be overridden by provisions in the trust instrument. Nevertheless, a trust's declaration of trust (or trust instrument) or by-laws, or both, may contain restrictions or conditions on the payment of distributions and/or the establishment of record dates.

HEDGE FUND BASICS

Nicholas S. Hodge
Rebecca O'Brien Radford

www.klgates.com

AGENDA

- I. History of Hedge Funds/What is a Hedge Fund?
- II. Hedge Fund Investment Strategies
- III. Hedge Fund Structures
- IV. Hedge Fund Regulatory Exemptions
- V. Hedge Fund Documentation

I. History of Hedge Funds/What is a Hedge Fund?

- A privately-offered pooled investment vehicle that generally permits investments and redemptions periodically
- Limited to high net worth individuals and institutions
- Not registered as an investment company
- Professionally managed by a manager that shares in the gains of the investment vehicle based on its investment performance

II. Hedge Funds Investment Strategies

- Long Only
- Long/Short
- Equity Market Neutral
- Fixed Income
- Global Macro
- Convertible Arbitrage
- Relative Value Arbitrage
- Fixed Income Arbitrage
- Distressed Securities
- Special Situations
- Merger Arbitrage
- Event Driven

III. Hedge Fund Structures

A. Fund Organization

Onshore Funds

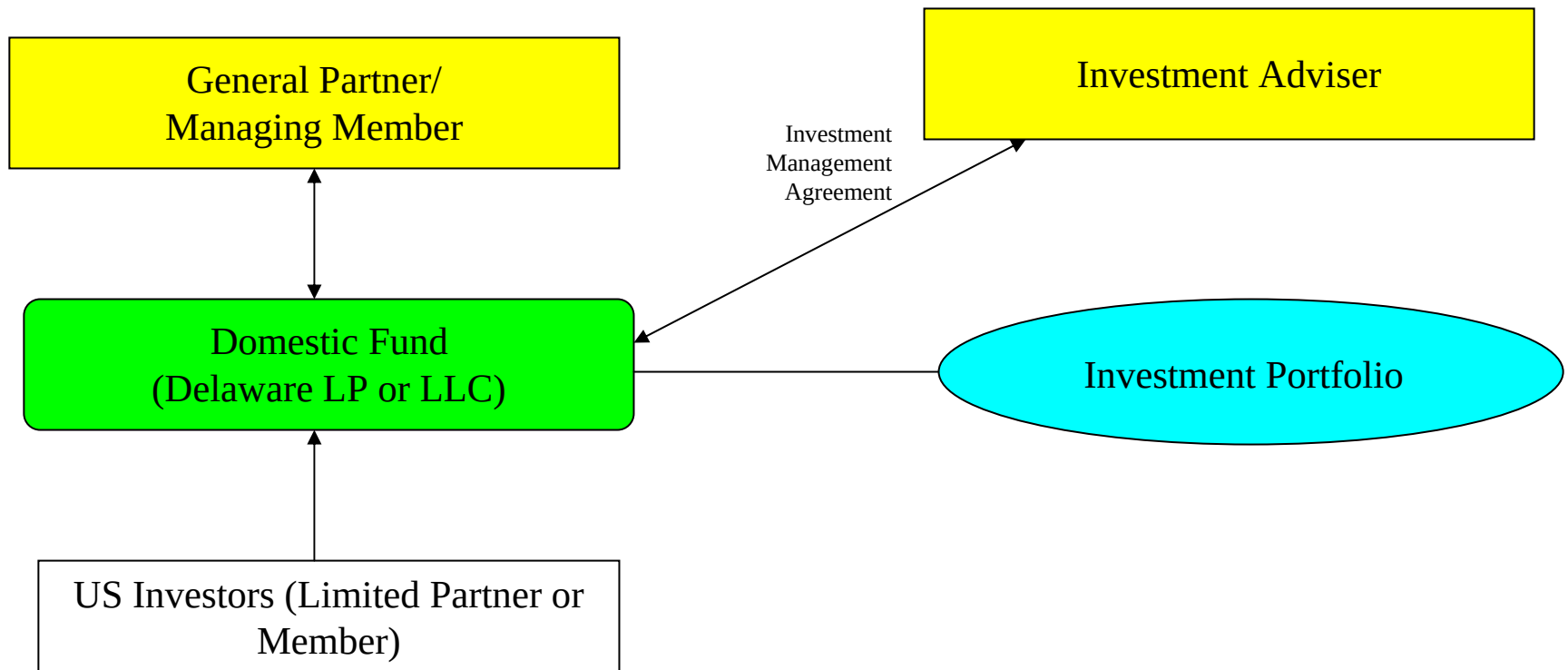
Offshore Funds

B. Issues for Non-US Investors

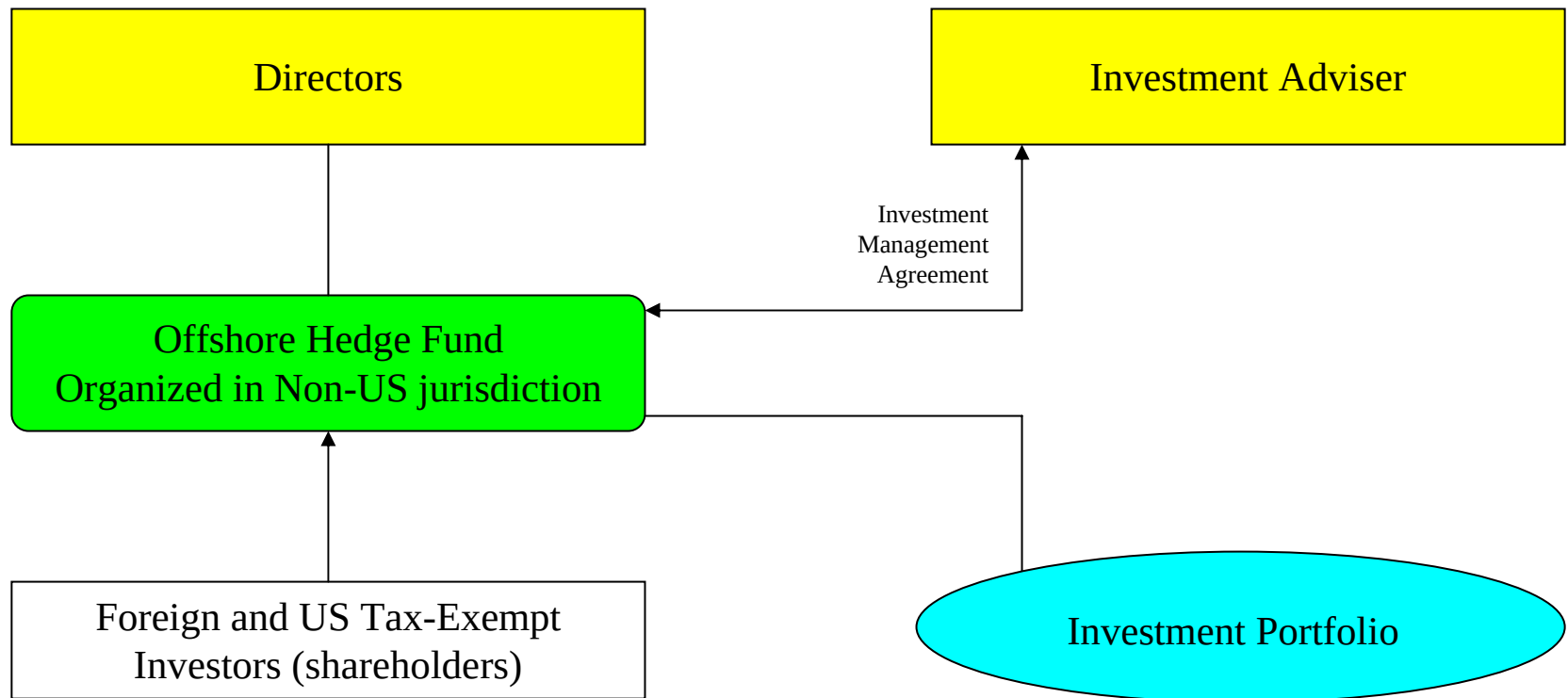
C. Issues for Tax-Exempt Investors

D. Issues for US Taxable Investors

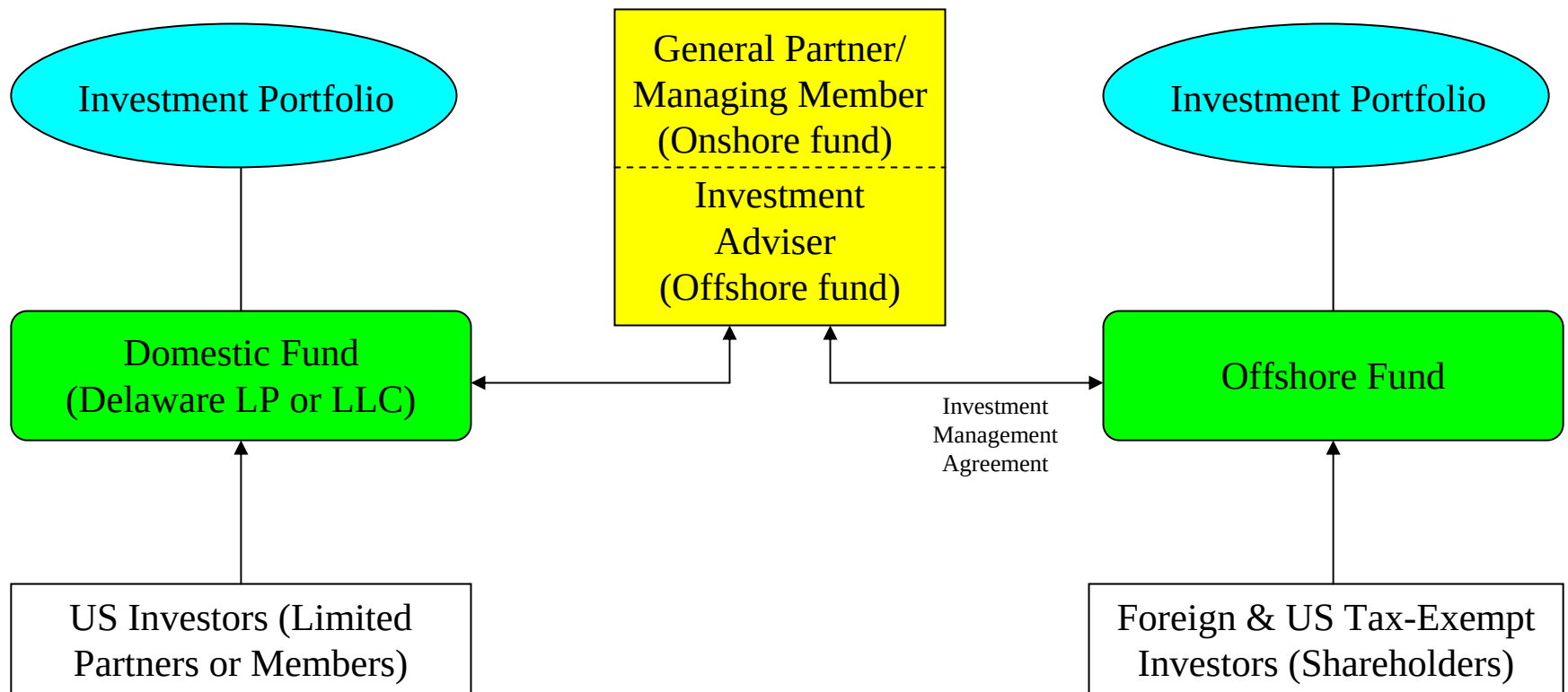
Basic Structure of a US Hedge Fund



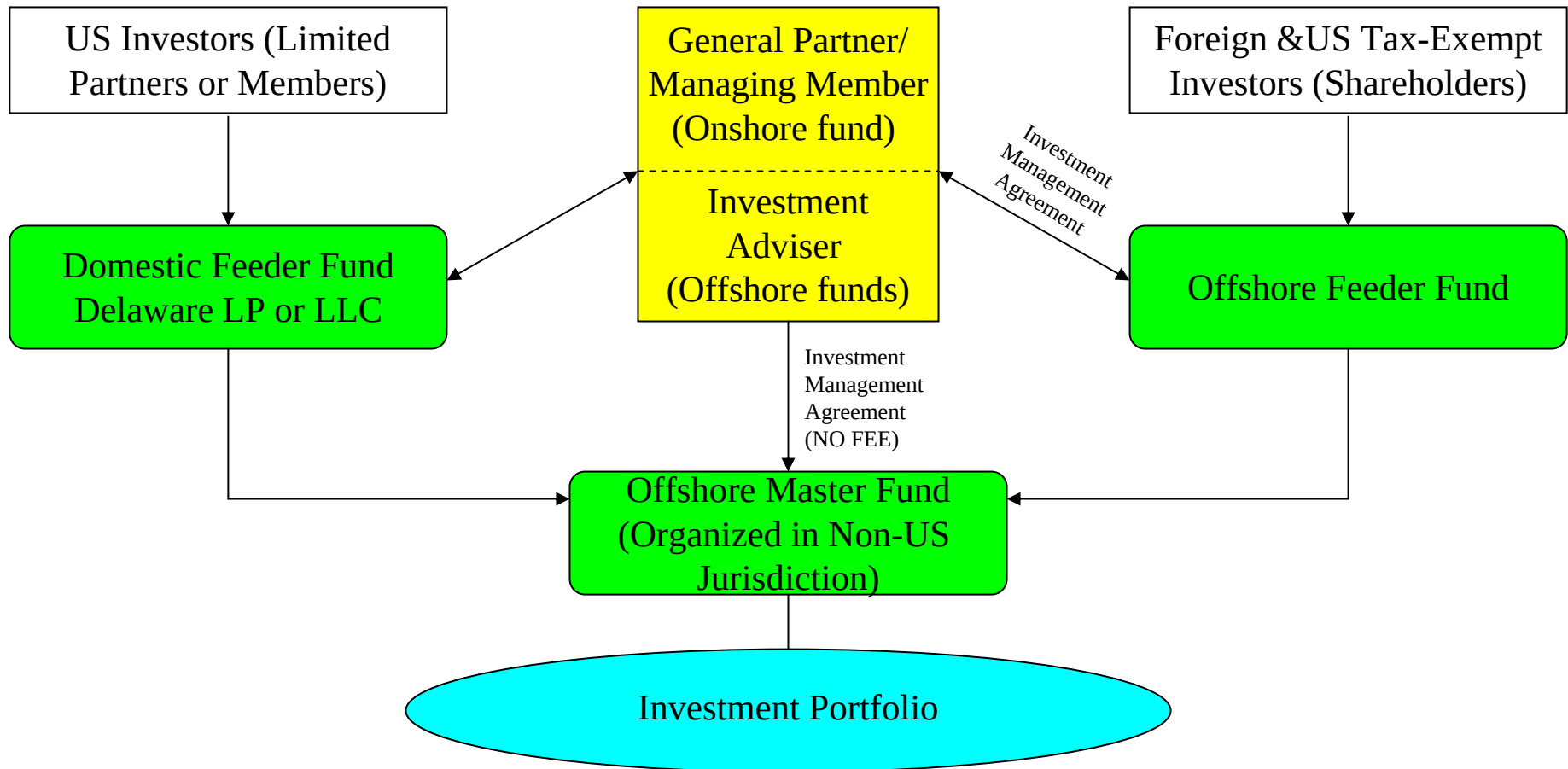
Basic Structure of an Offshore Hedge Fund



Structure of Parallel Hedge Funds



Master-Feeder Structure of Hedge Funds



IV: Hedge Fund Regulatory Exemptions: *Overview of Applicable Laws, Rules, and Regulations*

- Investment Company Act of 1940 (“1940 Act”)
 - Hedge funds operate under an exception from the definition of Investment Company: Section 3(c)(1) or 3(c)(7)
- Securities Act of 1933 (“Securities Act”)
 - Regulates the offering of a fund’s securities and also certain trading activity
- Investment Advisers Act of 1940 (“Advisers Act”)
 - Regulates the fund’s manager
 - Disclosure Obligations – Delivery of Part II of Form ADV
- Securities Exchange Act of 1934 (“Exchange Act”)
 - Relevant to trading activities and could require certain filings with the SEC if the fund has 500 or more investors
- Commodity Exchange Act (“CEA”)
 - Governs trading for futures, contracts, and commodity options

Regulations, Continued

- ERISA (Employee Retirement Income Security Act of 1974)
- Anti-money Laundering (USA Patriot Act)
 - Proposed regulations that would require a written AML program
- Anti-fraud provisions of the federal and state securities law
- Internal Revenue Code of 1986, as amended (“Code”)
- State securities and corporate law
- Foreign laws
- Banking laws

V. Hedge Fund Documentation

- **A. Basic Documents – Onshore Hedge Fund**
- Private Placement Memorandum (Offering Memorandum)
- Limited Partnership Agreement or Limited Liability Company Operating Agreement
- Subscription Agreement
- Offering Questionnaire

B. Basic Documents – Offshore Hedge Fund

- Charter Documents (*e.g.*, Memorandum and Articles of Incorporation)
- Private Placement Memorandum
- Subscription Agreement
- Investment Adviser Agreement
- Offering Questionnaire



Conflicts of Interest, Distribution and Compliance Issues Associated with Hedge Funds, presented by Nicholas Hodge

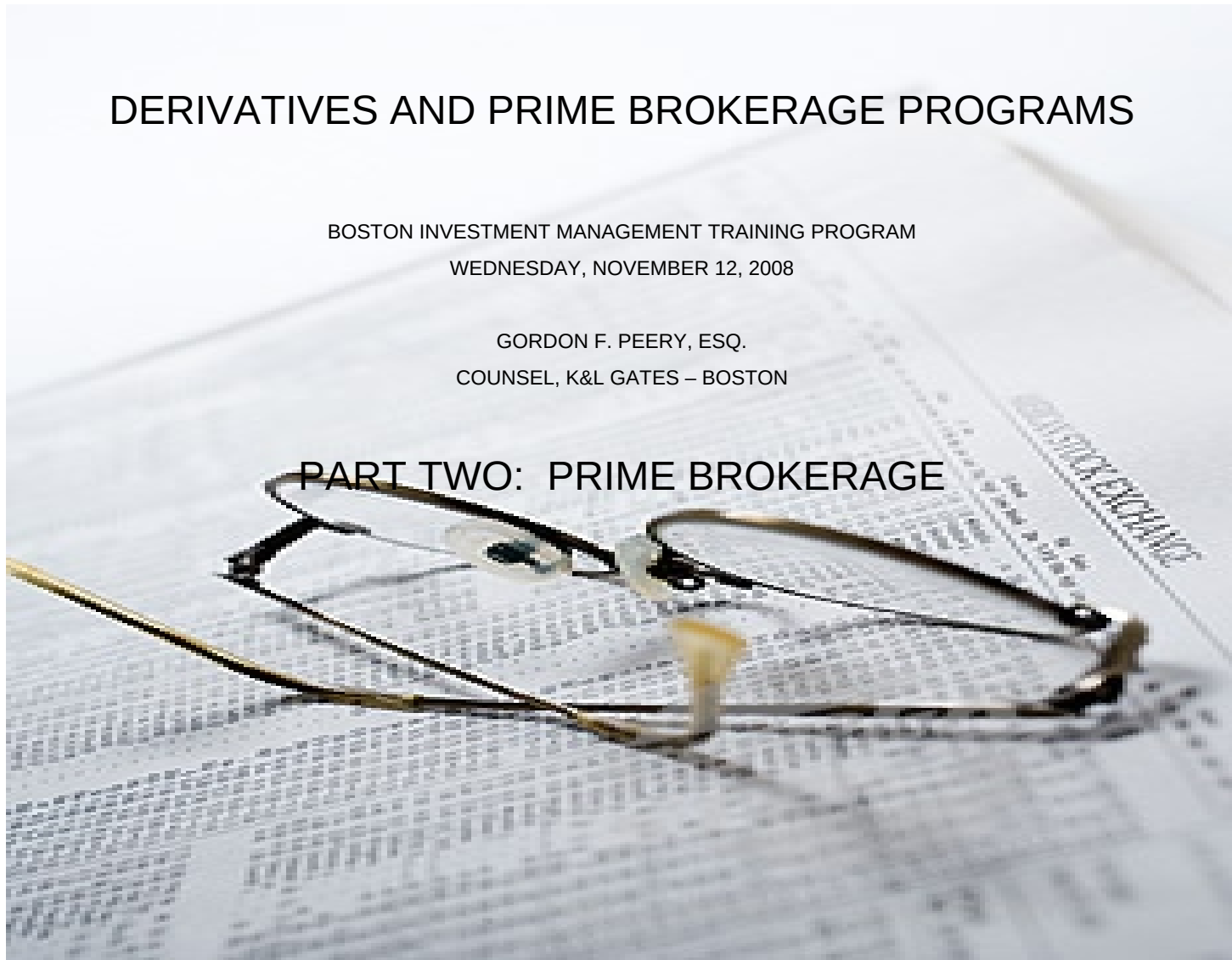
Please note there are no corresponding materials for this section.

DERIVATIVES AND PRIME BROKERAGE PROGRAMS

BOSTON INVESTMENT MANAGEMENT TRAINING PROGRAM
WEDNESDAY, NOVEMBER 12, 2008

GORDON F. PEERY, ESQ.
COUNSEL, K&L GATES – BOSTON

PART TWO: PRIME BROKERAGE



The Prime Brokerage Agenda

- Motivations
- Prime Brokerage Services
- The Law Governing Prime Brokerage
- Introducing the Players
- Introducing the Documentation
- The (critical) Margin Agreement, and its Key Terms
- What Lehman and Bear Teach Us

Prime Broker

- Large Investment Bank
- Wants fees/spread

Client

- Usually a fund
- Needs Leverage

Prime Brokerage Services

- Prime brokers offer a wide range of brokerage, financing and related services
- Primary Services (approximately in order of importance and frequency):
 - Custody of cash and securities
 - Clearance and settlement of trades
 - Financing
 - long side financing (margin loans)
 - short side financing (short positions or securities loans)
 - Securities lending (both borrowing and lending)
 - Swap transactions
 - Custom reporting
 - Capital introduction
 - Risk management

Prime Brokerage Agreement

Self-Regulatory Organization Rules

SEC REGULATIONS

(e.g., the no-action letter of the SEC dated January 25, 1994)

State Law

Federal Law

The Law Governing the Prime Brokerage / Client Relationship

Introducing the Players: The Prime Broker and its Affiliates

Morgan Stanley

CUSTOMER PRIME BROKER ACCOUNT AGREEMENT

Ladies and Gentlemen:

In consideration of Morgan Stanley from time to time accepting an account or receiving, holding or delivering any property of the undersigned, or entering into any Contract with the undersigned, the undersigned agrees with Morgan Stanley to the following:

- "Morgan Stanley" and the "Morgan Stanley Entities" mean, individually or collectively, as appropriate, Morgan Stanley & Co. Incorporated, MS Securities Services Inc., Morgan Stanley & Co. International plc, Prime Dealer Services Corp., Morgan Stanley Securities Limited, Morgan Stanley Japan Limited, Morgan Stanley Asia Limited, Morgan Stanley GMBH, Morgan Stanley Market Products Inc., Morgan Stanley Capital Group Inc., Morgan Stanley Capital Services Inc., Morgan Stanley DW Inc., Morgan Stanley, MSDW Asia Securities Products LLC, MSDW Equity Finance Services (Cayman) Ltd., Morgan Stanley Financial Products Ltd., MSDW Markets Inc. and their respective successors, parents, subsidiaries, affiliates, divisions, officers, directors, and employees.

Morgan Stanley**DOCUMENTATION CHECKLIST***Prime Brokerage Core Documents*

- ☐ NEW ACCOUNT INFORMATION FORM
- ☐ CUSTOMER PRIME BROKER ACCOUNT AGREEMENT ("MARGIN AGREEMENT")
- ☐ CASH & SECURITIES TRANSFER AGREEMENT
- ☐ RESOLUTIONS
- ☐ INVESTMENT ADVISOR'S REPRESENTATION LETTER
- ☐ MASTER SECURITIES LOAN AGREEMENT
- ☐ ARRANGED CASH AGREEMENT LETTER
- ☐ TAX FORMS

Listed Derivatives

- ☐ [INSTITUTIONAL OPTION AGREEMENT FORM]

Additional Product Documents

- ☐ [OVERSEAS SECURITIES LENDER'S AGREEMENT]
- ☐ [HONG KONG SHORTING APPLICATION]
- ☐ [ISDA MASTER AGREEMENT/SCHEDULE/CREDIT SUPPORT ANNEX]
- ☐ BRIDGE AGREEMENT
- ☐ AUTOMATED TRANSACTIONS SUPPLEMENT]

The Margin Agreement:
What the Prime Broker Needs: Control Over Other Brokerage Activities

5. **MORGAN STANLEY AS PRIME BROKER.** In connection with any transactions where Morgan Stanley acts as the undersigned's prime broker:
- (a) **The undersigned maintains brokerage accounts with a number of other brokers ("Executing Brokers") and, from time to time, will place orders to be executed by one or more Executing Brokers. The undersigned agrees to give Morgan Stanley notice of the names of all Executing Brokers with whom the undersigned intends to place orders (which Executing Brokers must be acceptable to Morgan Stanley). Morgan Stanley is authorized to enter into a Prime Brokerage Agreement with all current or future Executing Brokers, to set up an account for the undersigned's benefit at any Executing Broker and to provide or obtain any information necessary to establish or maintain a prime brokerage relationship. The undersigned acknowledges that no order need be accepted by Morgan Stanley as prime broker from any Executing Broker with which Morgan Stanley has not entered into a "Prime Brokerage Agreement" with respect to the undersigned's account at Morgan Stanley. Further, Morgan Stanley reserves the right at any time to place a limit on the size of transactions executed by any Executing Broker which are to be settled and cleared by Morgan Stanley as a prime broker. The undersigned will use its best efforts to assure that such Executing Brokers comply with the terms set forth in the Prime Brokerage Agreement. The undersigned acknowledges that as between Morgan Stanley and any Executing Broker, the Executing Broker will be acting as an agent of the undersigned, not as Morgan Stanley's agent, for the purpose of carrying out the undersigned's directions with respect to the purchase, sale and settlement of securities.**

The Margin Agreement: What the Prime Broker Needs: Control Over Other Brokerage Activities

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Specific Negotiation Topics

- broad discretion
- unlimited use of agents or affiliates
- ability to unilaterally amend the agreement
- perfected security interest
- generous indemnification provisions for the broker only
- no liability for technical problems
- broad default provisions and even broader powers upon an event of default

Negotiation Tactics

- Standard prime brokerage agreements are extremely one-sided in favor of the broker
- Prime brokers have immense leverage and are providing a service upon request, so it is unreasonable to expect fully balanced final agreement
- Nevertheless, some matters may be negotiated – the key is to *pick your battles*. Battles to pick in November 2008:
 - Location of Collateral
 - Segregated Accounts
 - Withdrawal of Collateral
 - Use of Custodian:
 - Daily Sweeps
 - Tri-Party Control Agreement
- Pursue Substitute Prime Brokerage Arrangements (e.g., solutions from Boston)

What Bear Stearns and Lehman Teach Us in November 2008

K&L | GATES

Financial Services Alert



April 2008

www.klgates.com

Authors:

Robert T. Honeywell
212.536.4863
robert.honeywell@klgates.com

Anthony R. G. Nolan
212.536.4843
anthony.nolan@klgates.com

Donald W. Smith
202.778.9079
donald.smith@klgates.com

Robert A. Wittie
202.778.9066
robert.wittie@klgates.com

Key Insolvency Issues for Broker-Dealers, Custodial Banks and Counterparties to Repos, Swaps and Other Financial Contracts

The recent volatility in the credit markets has led to many inquiries on how clients should protect their holdings with brokers and custodial banks, and how they can protect their financial contracts (repos, swaps, securities lending, etc.) in the event a counterparty becomes insolvent. This outline is provided as a general summary of the main insolvency issues involved in protecting these types of assets and contracts, but is not intended as legal advice. The specific actions that a client should take to protect itself will of course depend on the provisions in their contracts, the applicable laws governing their contracts (and any amendments to those laws), and the facts of each case. The information herein should not be used or relied upon without first consulting an attorney.

October 2008

www.klgates.com

Author:

Gordon F. Peery
+1.617.261.3269
gordon.peery@klgates.com

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.

The Lifecycle of Lehman Trade Fails

Prior to September 15, 2008, portfolio managers (“PMs”) placed thousands of trades with Lehman Brothers Inc. (“LBI”) in New York City. These trades, many of which were subsequently transferred for settlement to LBI affiliates throughout the world, eventually failed to settle last month (and are referenced in settlement parlance as “trade fails”) as a result of the worldwide collapse of Lehman Brothers and the landmark civil proceedings that followed on at least three continents. The circuitous routes taken by these trades prior to settlement failure and the legal and business implications along the way demonstrate the complexity of the global system of modern finance and the need to pay careful attention to protecting one’s rights.

This Alert follows the path of two hypothetical trades placed with LBI for settlement in early September 2008 and introduces the legal analysis that is necessary to simultaneously protect portfolio managers and minimize fund exposure.

DERIVATIVES AND PRIME BROKERAGE PROGRAMS

BOSTON INVESTMENT MANAGEMENT TRAINING PROGRAM

WEDNESDAY, NOVEMBER 12, 2008

GORDON F. PEERY, ESQ.

COUNSEL, K&L GATES – BOSTON



Separately Managed Accounts and Investment Adviser Advertising: Reporting Performance in a Complex Regulatory Environment

Michael S. Caccese
K&L Gates LLP
One Lincoln Street, Boston, MA 02111
(617) 261-3133
michael.caccese@klgates.com

www.klgates.com

Investment Adviser Advertisement

- Specific Guidance
 - Section 206 (general antifraud provision of Advisers Act)
 - Rule 206(4)-1 (SEC advertising rule)
 - No-Action Letters
 - Enforced through SEC inspections and enforcement actions
 - Disclosure rules not calculation rules

What Is An Advertisement

- “Any written communication addressed to more than one person” that offers investment advisory services related to securities
- Includes communications designed to maintain existing clients or solicit new clients
- Includes electronic and broadcast advertisements

What Is Not Investment Adviser Advertisement?

- If the name of mutual fund included, then most likely is mutual fund advertisement subject to mutual fund and NASD advertisement requirement.
- Oral communications
- Customized RFP responses, letters or e-mails (not sent to more than one person)
- Account statements
- May still violate Section 206 antifraud provision

SEC Advertisements

- Applicable to Registered and Unregistered Advisers
- General Antifraud Rule
 - “Unlawful to engage in any act, practice or course of conduct which is fraudulent, deceptive or manipulative.”

SEC Advertisements

- Specific prohibitions applicable to Registered Advisers:
 - Testimonials
 - Third Party Reports
 - Partial Client Lists
 - Ratings
 - Past Recommendations
 - Charts/Formulas
 - Free Services

SEC Advertisements

- General Prohibitions:
 - Anti-Fraud Provision Depends On
 - Form
 - Content
 - Inferences
 - Client Sophistication

SEC Performance Advertising

Guiding Principals:

- Investment performance is false or misleading if:
 - it implies, or a reader would infer
 - something about the adviser's competence or about future investment results
 - that would not be true had the advertisement included all material facts
- Comply with investment performance presentation guidelines
 - *Clover Capital* series on No-Action Letters

Clover Capital Requirements

Model & Actual Performance

- Not disclosing the effect of material market or economic conditions
- Not presenting net-of-fees performance, except under certain circumstances
 - Advisory fees
 - Other expenses that a client would have paid or actually paid
- Not disclosing whether and to what extent the results reflect reinvestment of dividends and other earnings

Clover Capital Requirements

Model & Actual Performance

- Claiming the potential for profit without disclosing the possibility for loss
- Comparing results to an index without disclosing material factors relevant to the comparison
- Failing to disclose material conditions, objectives or investment strategies used to obtain the performance

Clover Capital Requirements

Model Performance

- Failing to disclose:
 - The inherent limitations in model results
 - Material changes in the model versus actual performance
 - Differences between the model and adviser's actual strategy
 - Adviser's client results were materially different from model results

Investment Performance Presentations

Actual Performance Results

- Must include performance of all accounts managed to same style or strategy unless disclose that the:
 - Results relate only to a select group of clients
 - Basis on which the selection was made, and
 - Effect of this practice on the results portrayed.

Clover Capital Requirement Exceptions

Exceptions to Net of Fees

- Gross of fees performance
 - Performance presented NET of advisory and custodial fees in one-on-one presentations
 - Must always be shown after transaction costs

Clover Capital Requirements Exceptions

“One-on-One” Presentations

- Private Meeting
- Ability to ask questions and negotiate advisory fees
- Must disclose:
 - Advisory fees are described in the adviser’s Form ADV
 - A representative example showing the effect advisory fees, compounded over years, could have on the value of a portfolio

Clover Capital Requirements Exceptions

Net Versus Gross of Fees Presentation

- Model advisory fees
- Side-by-side gross and net
- Multi-manager accounts
- Model-wrap fees

Investment Adviser Advertisements

Article Reprints

- Permitted, if comply with Advertisement Rules
- Can't be false or misleading
 - Redact problematical statements
- Use legends to
 - Correct inaccuracies
 - Update information
 - Fill in gaps (provide net performance if article discusses only gross)

Investment Adviser Advertisements

Recordkeeping

- Client communications and distribution lists
 - Copies of all written communication
 - No record of who sent to if sent to more than 10 recipients
- Advertisements and Recommendations
 - All advertisements sent to more than 10 recipients
 - Document basis of all recommendations

Investment Adviser Advertisements

Recordkeeping

- Records to support performance calculations
 - “necessary to form the basis for or demonstrate the calculation of the performance”
 - Internal account statements and worksheets
 - Prepared contemporaneously
 - Third party records to substantiate claims
- Retention periods
- Necessary to support performance:
 - In articles
 - From prior firm

Investment Adviser Advertisements

Applicable to Hedge Funds and other Private Funds:

- Unregistered advisers:
 - “Holding out” prohibition
 - Cannot advertise (even with client prescreening)
- Registered advisers:
 - Can advertise but must pre-screen for qualification
 - Restriction on both offer and sale of Fund

SEC ADVERTISEMENTS

Applicable to Hedge Funds and other Private Funds:

- Internet Advertisement:
 - Pre-screening for qualification
 - Adviser ultimately responsible
 - Subscription fee no longer required

Fund-of-Funds Performance Presentation

New Private Fund:

- Creating “marketing record”
 - Market Record
 - Substantially similar managed funds
 - Disclose assumptions
 - Supporting record
 - One-three Years usage
 - No linkage

Fund-of-Funds Performance Presentation

Existing Private Fund:

- Due Diligence of performance calculation methodology of underlying Funds
- Need comfort in valuations
 - Require performance audit
- Estimated performance concerns
 - Clearly disclose estimate and limitation
 - Promptly update
 - Wait for year-end audit because of 5% holdback

ADVERTISING HEDGE FUNDS AND SEPARATE ACCOUNTS**I. ADVERTISING HEDGE FUNDS AND SEPARATE ACCOUNTS****A. Regulatory Framework.**

1. Section 206(4) of the Advisers Act makes it unlawful for investment advisers, directly or indirectly, “to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.” The SEC has imposed a standard of conduct for investment adviser advertisements that is stricter than that for other vendors of products or services, on the theory that advisory clients may be unsophisticated in investment matters.

2. Rule 206(4)-1 under the Advisers Act defines “advertisement” to include:

“any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers: (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.”

Electronic Communication. The SEC has made clear that electronic communications (e.g., Internet postings) give rise to the same registration, antifraud and record keeping obligations as paper-based communications.

3. Specific Prohibitions.

Rule 206(4)-1(a) under the Advisers Act lists four specific advertising practices prohibited by this general anti-fraud provision:

- a. Testimonials.

No advertisement can be made that contains any direct or indirect reference to a testimonial of any kind regarding the advice or any other services the adviser may offer. A testimonial generally includes statements of a client’s experience or an endorsement by a client. Testimonials are deemed to be misleading because they may give the inference that the experience of the individual giving the testimonial is typical of the experience of all the adviser’s clients.

(1) Third-Party Reports.

The SEC staff takes the position that *bona fide*, unbiased third-party reports generally are not prohibited by the rule, provided they do not imply or cause a reader to draw an inference concerning:

- (a) the experience of advisory clients;
- (b) the possibility of a prospective client's having an investment experience similar to that of prior clients; or
- (c) the adviser's competence when there are additional facts that, if disclosed, would imply different results than those suggested in the third party reports.
- (d) Partial Client Lists.

The SEC staff has also taken the position that a partial client list that does no more than identify certain clients of an adviser cannot be viewed either as a statement of a client's experience with, or an endorsement of, the investment adviser, and therefore is not a prohibited testimonial. In order to avoid violating the general anti-fraud advertising prohibitions of the Rule, the SEC staff has suggested that advisers (1) do not use performance-based data to determine which clients to include on the listing, (2) disclose the criteria used to compile the list, and (3) provide disclosure that it is not known whether the clients listed approve or disapprove of the investment adviser or its services.

b. Past Specific Recommendations.

No reference may be made, either directly or indirectly, to past specific recommendations unless the investment adviser furnishes a list of all recommendations made by the investment adviser during the preceding year, as well as other disclosure. A reference to profitable recommendations that ignores unprofitable recommendations or investment advice is prohibited. The list of recommendations must include:

- (1) the name of each security recommended;

- (2) the date and nature (*e.g.*, buy, sell, hold) of each recommendation;
- (3) the market price at the time;
- (4) the price at which the recommendation was to be acted upon; and
- (5) the market price of each security as of the most recent practicable date.

The SEC staff has permitted the use of a selected group of recommendations so long as it is based on objective, non-performance-based criteria, accompanied by appropriate disclosures and maintenance of records as described in items 1 through 5 above.

The list must also include disclosure that “it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list.”

The SEC staff takes the position that, for purposes of the “past specific recommendations rule” and for reporting portfolio holdings, the listing or description of portfolio holdings is not considered an “advertisement” when specifically requested by the client/potential client.

c. Charts or Formulas.

No claim can be made in an advertisement that a graph, chart, formula or other device being offered can be used to determine which securities to buy or sell or to assist persons in making those decisions, unless the limitations and difficulties regarding the use of the device are prominently disclosed.

d. Free Reports or Services.

An advertisement cannot claim that any type of advisory services will be provided free of charge if there are any conditions or obligations connected with such service.

4. General Anti-Fraud Provision – Rule 206(4)-1(a)(5).

Rule 206(4)-1(a)(5) under the Advisers Act contains a general provision that prohibits an investment adviser from using any advertisement that

contains an untrue statement of material fact or is otherwise false or misleading. Whether any advertisement is false and/or misleading will depend generally upon the facts and circumstances surrounding its use, including: (1) the form as well as the content of the advertisement; (2) the implications or inferences arising out of the advertisement in its total context; and (3) the sophistication of the client or prospective client.

Note: All advertisements by investment advisers, registered or unregistered, must comply with the general anti-fraud provisions of Rule 206(4)-1(a)(5).

a. Use of Actual or Model Performance Results.

The SEC staff at one time took the position that the use of model or actual performance results in an advertisement was *per se* fraudulent under Section 206(4) and Rule 206(4)-1(a)(5). However, in 1986 the SEC staff modified its position, stating that whether the use of model or actual performance results is misleading under the Advisers Act depends on the facts and circumstances of the advertisement. The SEC staff stated that, as a general matter, the use of model or actual results would be misleading if those results implied something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts. The SEC staff also took the opportunity to set forth its views regarding certain uses of model or actual performance results that the staff would consider misleading.

- (1) The SEC staff stated that both model and actual performance results would be misleading if they:
 - (a) fail to disclose the effect of material market or economic conditions on the results portrayed;
 - (b) include model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client paid or would have paid (the "net of fees" requirement);
 - (c) fail to disclose the extent to which the results portrayed reflect the reinvestment of dividends and other earnings;

- (d) suggest or make claims about the potential for profit without also disclosing the possibility of loss;
 - (e) compare model or actual results to an index without disclosing all material facts relevant to the comparison (*e.g.*, an advertisement that compares model results to an index without disclosing that the volatility of the index is materially different from that of the model portfolio); and
 - (f) fail to disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed (*e.g.*, the model portfolio contains equity securities that are managed with a view toward capital appreciation).
- (2) The SEC staff stated that model performance results would be misleading if they fail to disclose:
- (a) prominently the limitations inherent in model results, particularly the fact that such results do not represent actual trading and that they may not reflect the impact that material economic and market factors might have had on the adviser's decision-making if the adviser were actually managing the client's money;
 - (b) if applicable, that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period portrayed in the advertisement and, if so, the effect of any such change on the results portrayed;
 - (c) if applicable, that any of the securities contained in, or the investment strategies followed with respect to, the model portfolio do not relate, or only partially relate, to the type of advisory services currently offered by the adviser (*e.g.*, the model includes some types of securities that the adviser no longer recommends for its clients); and
 - (d) if applicable, that the adviser's clients had investment results materially different from the results portrayed in the model.

The SEC staff stated that *actual performance results* would be misleading if they fail to disclose prominently, if applicable, that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material.

b. Exceptions to the "Net of Fees" Requirement.

One of the SEC staff's more difficult requirements is that model or actual performance results be presented after the deduction of advisory fees, brokerage or the other commissions and any other expenses that a client would have paid or actually paid (*i.e.*, "net of fees"). The SEC staff is concerned that disclosure that fees would affect the results presented is not sufficient to overcome the compounding effect on performance results that occurs unless fees are actually deducted. Moreover, the SEC staff believes that clients should not be forced to calculate the compounding effect if fees are not actually deducted. The SEC staff has, however, provided limited relief from the net of fee requirement in three situations:

(1) Custodian Fees.

The SEC staff has allowed advisers to provide model or actual results that are presented without deducting custodian fees paid to a bank or other organization for safekeeping client funds and securities. The SEC staff reasoned that custodians are often selected by clients and frequently are paid directly by clients.

(2) One-on-One Presentations.

The SEC staff has allowed investment advisers to present model or actual performance results on a gross basis in a one-on-one presentation to wealthy individuals, consultants, pension funds, or other sophisticated clients. The staff's position is expressly conditioned on the adviser providing to the client or consultant, in writing, at the time of the presentation:

- (a) Disclosure that the performance results do not reflect the deduction of investment advisory fees;

- (b) Disclosure that the client's return will be reduced by the advisory fees and other expenses it may occur as a client;
 - (c) Disclosure that the adviser's advisory fees are described in Part II of the adviser's Form ADV; and
 - (d) A representative example (in the form of table, chart, graph, or narrative) showing the effect of compounded advisory fees, over a period of years, on the value of a client's portfolio.
- c. Composite Accounts.

The SEC staff has allowed advisers to present performance results based on a composite of accounts (including mutual fund and non-mutual fund accounts) if net of fees and gross of fees performance results are provided with equal prominence for ease of comparability. Notably, in addressing composites, the SEC staff has not required that the gross of fees results be provided only to wealthy or institutional clients in one-on-one presentations, when accompanied with net of fees performance.

B. Use of Prior Performance in Advertising.

1. General Standard.

a. Predecessor Entities.

The SEC staff takes the position that an investment adviser advertisement that includes prior performance results of accounts managed by a predecessor entity would not in and of itself be misleading under Rule 206(4)-1(a)(5) under the Advisers Act if:

- (1) the person or persons who manage accounts at the adviser were also those primarily responsible for achieving the prior performance results;
- (2) the accounts managed at the predecessor entity are so similar to the accounts currently under management that the performance results would provide relevant information to prospective clients;
- (3) all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such

account does not result in materially higher performance and the reason for the exclusion is disclosed;

- (4) the advertisement is consistent with staff interpretations with respect to the advertisement of performance results;
- (5) the advertisement includes all relevant disclosures, including that the performance results were from accounts managed at another entity; and
- (6) the investment adviser has the SEC-required records supporting the performance from the predecessor entity.

b. Portability.

Although addressed in the context of an adviser to a registered investment company, the SEC staff has taken the position that Section 206(4) of the Advisers Act would not prohibit an investment company from providing in its prospectus performance information for a portfolio manager's previous accounts if (1) the performance is not presented in a misleading manner and does not obscure or impede understanding of information that is required to be in the prospectus, and (2) the portfolio manager was solely responsible for the performance of the previous account. The logic of this position should extend to investment adviser advertisements that do not involve registered investment companies.

C. Global Investment Performance Standards ("GIPS")

1. The Global Investment Performance Standards ("GIPS" or "Standards") are performance presentation standards that are created, sponsored and interpreted by the CFA Institute ("CFAI," which was formerly known as the Association for Investment Management and Research or "AIMR"). The objectives of the Standards are to: (i) establish a global standard for the calculation and presentation of investment performance in a fair, comparable format with full disclosure, (ii) ensure the accuracy and consistency of performance data for reporting, recordkeeping, marketing and presentations; (iii) promote competition among investment firms without barring entry of new investment firms; and (iv) foster industry self-regulation on a global basis. Although firms must always adhere to the fundamental principles of fair representation and full disclosure, the Standards primarily address the presentation of performance to prospective clients. Presentations to existing clients do not have to adhere to the GIPS standards since "[p]erformance reporting to existing clients is something that should be agreed upon between the firm and the client."

The Standards are comprised of eight sections that reflect what the CFAI perceives to be the basic components involved in presenting performance: fundamentals of compliance; input data; calculation methodology; composite construction; disclosures; presentation and reporting; real estate; and private equity. Within each section, the Standards are divided into required provisions and recommended provisions. Each firm that claims compliance with the Standards must adhere to the required provisions and is “strongly encouraged” to adhere to the recommended provisions under the Standards. Failure to adhere to the recommended provisions will not in any way bar a firm’s claim of GIPS compliance.

2. Compliance with GIPS is voluntary. However, once a firm claims compliance, it must comply at all times on a firmwide basis. GIPS are ethical standards, not legally required, enforced or interpreted. Laws and regulations override GIPS when in conflict. However, if the Standards impose a higher standard than law and regulation, the Standards control. CFAI’s enforcement of the Standards is limited to individuals that are members of CFAI and involved in the preparation or presentation of historical performance by a firm claiming GIPS compliance. CFAI does not have any authority over a firm that does not claim compliance with the Standards. Firms that choose to claim compliance with GIPS are expressly required to comply with all “updates, reports, guidance statements, interpretations or clarifications published by the CFA Institute and the Investment Performance Council”

The SEC takes an active role in enforcing the Standards. As part of its investment adviser inspection program, the SEC Staff will determine whether a firm’s claim of compliance with GIPS is accurate. The SEC Staff will examine in detail all aspects of a firm’s compliance with the Standards, including firm definition, discretion definition, composite creation and maintenance, calculation methodology, recordkeeping, and presentations. The SEC’s jurisdiction with respect to the Standards is based on whether a firm claims compliance with GIPS. The SEC cannot impose the Standards on any firm that does not claim compliance with the Standards.

3. For details of GIPS, see the attached article “Advertising by Investment Advisers.”

ADVERTISING BY INVESTMENT ADVISERS

Michael S. Caccese and Christina H. Lim¹

This article was originally published as *Investment Adviser Regulation, A Step-by-Step Guide to Compliance and the Law*, Chapter 7, Practical Considerations for Performance Advertising by Advisers, Second Edition, Nov. 2006

§ 6.1 Introduction

§ 6.2 Rule 206(4)-1

§ 6.2.1 Definition of Advertisement

§ 6.2.2 Testimonials

[A] Partial Client Lists

[B] Ratings

[C] Article Reprints

§ 6.2.3 Past Specific Recommendations

[A] Performance-Based Recommendations

[1] Partial List of Recommendations

[2] Article Reprints

[B] Non-Performance Based Recommendations

§ 6.2.4 Charts and Formulas

§ 6.2.5 Free Reports or Services

§ 6.2.6 Anti-Fraud Catchall Provision

§ 6.3 Performance Advertising

§ 6.3.1 General Requirements

§ 6.3.2 Model Performance

§ 6.3.3 Hypothetical Backtested Performance

§ 6.3.4 Gross-of-Fee and Net-of-Fee Performance

[A] Net-of-Fee Performance

[B] Gross-of-Fee Performance

[i] One-on-One Presentations

[ii] Consultants

[iii] Side-by-Side Gross and Net of Fee Performance

§ 6.3.5 Model Fees

¹ Michael S. Caccese is a partner in the Boston office of Kirkpatrick & Lockhart Nicholson Graham LLP. He works extensively with investment firms on compliance issues, including all of the GIPS and AIMR standards. He was previously the General Counsel to CFA Institute and was responsible for overseeing the development of the AIMR-PPS, GIPS and other standards governing the investment management profession and investment firms. He can be reached at 617.261.3133 and mcaccese@klng.com. Christina H. Lim is an associate with Kirkpatrick & Lockhart Nicholson Graham LLP in the Boston office and may be reached at 617.261.3243 and clim@klng.com.

- § 6.3.6 Portability
- § 6.3.7 Recordkeeping

§ 6.4 Global Investment Performance Standards (GIPS®)

- § 6.4.1 General Background
 - [A] Overview of the Standards
 - [B] Interpretation of the Standards
 - [C] Enforcement of the Standards
- § 6.4.2 Fundamentals of Compliance
 - [A] Definition of the Firm
 - [1] General Guidelines
 - [2] Redefinition of the Firm
 - [3] Total Firm Assets
 - [4] Sub-Advisors
 - [B] GIPS Policies and Procedures
 - [C] Claim of Compliance
 - [D] Firm Fundamental Responsibilities
- § 6.4.3 Input Data
- § 6.4.4 Calculation Methodology
- § 6.4.5 Constructing Composites
 - [A] Carve-Outs
- § 6.4.6 Disclosures
- § 6.4.7 Presentation and Reporting
 - [A] Performance Record Portability
 - [B] Supplemental Information
- § 6.4.8 Advertising Guidelines
- § 6.4.9 Verification

§ 6.1 Introduction

Deficiencies in presenting investment adviser performance continues to be one of the top five problem areas identified by the Securities and Exchange Commission (“SEC” or “Commission”) for investment advisers.² As investment advisers continue to expand their efforts in asset gathering, adviser advertisements are becoming more prominent and important to the success of investment firms. Although neither the Investment Advisers Act of 1940, as amended (the “Advisers Act”) nor the rules thereunder require advisers to submit or file advertisements with the SEC prior to use, advisers should expect a request by the SEC staff during any SEC examination for any and all advertising materials distributed by the adviser during the examination period and all necessary documentation that supports the calculation of the advertised performance. As a matter of policy, the SEC staff will not review advertisements on a pre-use basis to determine whether they comport with the advertising rules under the Advisers Act.³ Therefore, advisers must decipher the regulatory scheme governing adviser advertising themselves by piecing together the SEC and its staff’s positions as set forth in sometimes conflicting SEC staff no-action letters, speeches by the SEC’s staff, and SEC enforcement actions against investment advisers.

§ 6.2 Rule 206(4)-1

Section 206(4) of the Advisers Act and Rule 206(4)-1 thereunder govern the advertisements of investment advisers. Section 206 applies to all advisers, whether registered or unregistered, whereas Rule 206(4)-1 only applies to those advisers that are registered or required to be registered with the Commission.⁴ Section 206(4) of the Advisers Act makes it unlawful for any investment adviser, whether registered or unregistered, to directly or indirectly engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.⁵ Rule 206(4)-1 promulgated thereunder speaks specifically to four advertising practices, but also contains a “catchall” provision for any additional practices deemed to be false and misleading. Specifically, the Rule deems it to be a “fraudulent, deceptive, or manipulative act, practice, or

² Lori A. Richards, “Fiduciary Duty: Return to First Principles,” Speech before the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006). One of the five most common deficiencies discovered through examinations by the Office of Compliance Inspections and Examinations in 2005 included deficiencies in performance calculations including overstating performance results, comparing results to inappropriate benchmarks, failing to disclose material information regarding the calculation methods behind performance returns, and advertising returns in a misleading manner.

³ See, e.g., Trainer, Wortham & Co. et al., SEC No-Action Letter (pub. avail. Dec. 6, 2004) (“[T]he staff does not review specific advertisements as a matter of policy.”); Clover Capital Management, Inc., SEC No-Action Letter (pub. avail. Oct. 28, 1986) (“Because of the factual nature of the determination, the staff, as a matter of policy, does not review any specific advertisements.”); James B. Peeke & Company, Incorporated, SEC No-Action Letter (pub. avail. Sept. 13, 1982).

⁴ Section 206 was amended in September 1960 to subject all advisers, whether registered or unregistered, to Section 206 and grant the SEC the power, through rules and regulations, to “define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative” within the meaning of Section 206(4). Prior to this amendment, the SEC did not have the power to define the specific activities that were deemed to be fraudulent or deceptive within the meaning of Section 206 of the Advisers Act. See Investment Advisers Notice of Proposed Rule Making, SEC Release No. IA-113 (Apr. 4, 1961).

⁵ Section 206 of the Advisers Act.

course of business” for any registered adviser to, directly or indirectly, publish, circulate or distribute an advertisement that:

- makes any direct or indirect references to a testimonial concerning the adviser or its advice, analysis, report or other service it has rendered;⁶
- makes any direct or indirect references to the adviser’s past specific recommendations that were or would have been profitable, unless the advertisement sets out or offers to provide a list of all recommendations made within the immediately preceding period of not less than 1 year, accompanied by certain disclosures;⁷
- makes any direct or indirect representation that a graph, chart, formula or other device: (a) can in and of itself determine which securities to buy or sell or when to buy or sell securities; or (b) can assist an individual in making such determinations, without prominently disclosing the limitations thereof and the difficulties regarding its use;⁸
- states that any report, analysis or other service is for free, unless such materials or services are entirely free and without any direct or indirect condition;⁹ or
- that contains any untrue statement of a material fact, or is otherwise false or misleading.¹⁰

Rule 206(4)-1 was originally adopted in 1961 under the consideration that “advisers are professionals and should adhere to a stricter standard of conduct than that applicable to merchants, securities are ‘intricate merchandise’, and clients or prospective clients of investment advisers are frequently unskilled and unsophisticated in investment matters.”¹¹ The SEC staff continues to impose a standard of conduct for investment adviser advertisements that is stricter than that for other vendors of products or services. Each investment adviser is accountable for all of the information that is included in an advertising piece that it creates and/or distributes. If information is obtained from external sources, those sources are required to be identified, the information must be truthful and supportable, and if it includes any performance, the investment adviser must have documentation supporting the calculation of that performance.¹²

§ 6.2.1 Definition of Advertisement

⁶ Rule 206(4)-1(a)(1).

⁷ Rule 206(4)-1(a)(2).

⁸ Rule 206(4)-1(a)(3).

⁹ Rule 206(4)-1(a)(4).

¹⁰ Rule 206(4)-1(a)(5).

¹¹ Advertisements by Investment Advisers, SEC Release No. IA-121 (Nov. 1, 1961) (adopting release to Rule 206(4)-1).

¹² See discussion *infra*, § 6.3.7 Recordkeeping.

Whether any material, either in written or in oral form, is subject to Rule 206(4)-1 depends upon whether it constitutes as an “advertisement” within the meaning of Rule 206(4)-1(b) under the Advisers Act. Rule 206(4)-1(b) defines an “advertisement” to include:

- any notice, circular, letter or other written communication addressed to more than one person, or
- any notice or announcement in any publication or by radio or television

which offers any:

- analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or
- graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or
- other investment advisory service with regard to securities.

In general, “whether any particular communication – or series of communications – constitutes an advertisement under rule 206(4)-1(b) under the [Advisers] Act depends upon all of the facts and circumstances.”¹³ Although Rule 206(4)-1 does not set forth a specific list of communications that are considered advertisements under the Rule, the SEC has applied a broad view of what constitutes an advertisement, which generally includes materials designed to maintain existing clients or solicit new clients¹⁴ including form letters, presentation booklets, requests for proposals, a brochure delivered pursuant to Rule 204-3 under the Advisers Act, radio and television broadcasts, magazine or newspaper pieces, and certain electronic communications such as internet postings.¹⁵ Some examples of communications that are generally *not* considered advertisements within the meaning of Rule 206(4)-1 include oral communications other than those in radio or television broadcasts,¹⁶ and written communications that do no more than respond to an unsolicited request by a client, prospective client or consultant for specific information about the adviser.¹⁷ In addition, the SEC staff has clarified that documents that

¹³ Investment Counsel Association of America, Inc., SEC No-Action Letter (pub. avail. Mar. 1, 2004).

¹⁴ Munder Capital Management, SEC No-Action Letter (pub. avail. May 17, 1996) (“Materials designed to maintain existing clients or solicit new clients for the adviser are considered to be advertisements within Rule 206(4)-1.”).

¹⁵ See also SEC v. Yun Soo Oh Park a/k/a Tokyo Joe and Tokyo Joe’s Societe Anonyme Corp., N.D. IL, Case No. 00C 0049 (complaint filed Jan. 5, 2000).

¹⁶ Investment Counsel Association of America, Inc., SEC No-Action Letter (pub. avail. Mar. 1, 2004).

¹⁷ *Id.* An adviser that induces an existing or prospective client, or a consultant to request the adviser to provide information on its past specific recommendations or distributes an advertisement indicating that the adviser may provide past specific recommendations upon request is deemed to have solicited such a request. See *id.* The SEC staff clarified that a response to an unsolicited client request would not be deemed to be an advertisement under Rule 206(4)-1 even if the information was provided to one consultant who submits the request on behalf of several clients, or several consultants, so long as the information was provided “in response to a specific, unsolicited request” for information. See *id.*

relate specifically to investment companies (*e.g.*, prospectuses, advertisements or sales literature) will not be treated as materials “designed to maintain existing clients or solicit new clients for the adviser unless the documents are directed to such persons or refer to advisory services that are offered to such persons.”¹⁸ Written communications to existing advisory clients about the performance of their accounts are also generally not considered advertisements under Rule 206(4)-1.¹⁹ However, if the purpose of the communication is to offer advisory services or maintain the existing client, the communication will likely be deemed to be an advertisement under Rule 206(4)-1.²⁰

§ 6.2.2 Testimonials

Rule 206(4)-1(a)(1) under the Advisers Act prohibits an adviser from referring, directly or indirectly, to a testimonial of any kind regarding the adviser, its advice or any other services the adviser offers.²¹ The prohibition against testimonials is premised on the concern that the testimonial may give the misleading impression that the experience of the individual giving the testimonial is typical of the experience of all of the adviser’s clients.²² In adopting the prohibition, the SEC characterized advertisements containing testimonials as innately misleading since advisers will always present testimonials in an unbalanced manner by publishing only those that are favorable to the adviser and/or its activities.²³ Although Rule 206(4)-1(a)(1) does not define the term “testimonial,” the SEC staff has interpreted the term through a number of no-action letters. A testimonial generally includes statements of an experience with, or endorsement of an adviser made by any former, existing or prospective client, and is not restricted to statements about the adviser’s performance.²⁴ For instance, in *Gallagher and Associates, Ltd.*, the SEC staff refused to grant a no-action position with respect to client endorsements that were restricted to the adviser’s character.²⁵

¹⁸ Munder Capital Management, SEC No-Action Letter (pub. avail. May 17, 1996).

¹⁹ Investment Counsel Association of America, Inc., SEC No-Action Letter (pub. avail. Mar. 1, 2004).

²⁰ *Id.* For instance, if an adviser distributes a communication to an existing client that discusses the profitability of past specific recommendations that were not held or recently held by the existing client, this would suggest that the purpose of the communication was to promote the adviser’s services and may therefore constitute an advertisement that contains past specific recommendations in contravention of Rule 206(4)-1(a)(2). *See id.*

²¹ Rule 206(4)-1(a)(1) under the Advisers Act.

²² *See* CIGNA Securities, Inc., SEC No-Action Letter (pub. avail. Sept. 10, 1991) (stating that written statements from satisfied financial planning clients are testimonials prohibited by Rule 206(4)-1(A)(1); New York Investors Group, Inc., SEC No-Action Letter (pub. avail. Sept. 7, 1982).

²³ Advertisements by Investment Advisers, SEC Release No. IA-121 (Nov. 1, 1961). The SEC added that “[t]his is true even when the testimonials are unsolicited and are printed in full.” *Id.*

²⁴ *See* DALBAR, Inc., SEC No-Action Letter (pub. avail. Mar. 24, 1998) (“Although the term ‘testimonial’ is not defined in Rule 206(4)-1, we consistently have interpreted that term to include a statement of a client’s experience with, or endorsement of, an investment adviser.”).

²⁵ *Gallagher and Associates, Ltd.*, SEC No-Action Letter (pub. avail. July 10, 1995). The proposed endorsements were restricted to statements about the adviser’s religious affiliation or moral character, his community service, trustworthiness and ethical character, diligence and attention to details, ability to listen and be sensitive to client needs, knowledge of investing, insurance and tax strategies (but without referencing performance), and prudence and judgment. *See id.*

[A] Partial Client Lists

In *Denver Investment Advisors, Inc.*, the SEC staff's first no-action letter to address client lists as testimonials under Rule 206(4)-1(a)(1), an adviser sought permission to provide consultants with partial client lists assembled using objective criteria (e.g., account size, geographic location, client classification) on an unsolicited basis, except with respect to updates to consultants who originally received the information pursuant to their request.²⁶ The SEC staff declined to take the position that the client lists were not testimonials under Rule 206(4)-1(a)(1), but stated that it would not recommend enforcement action to the Commission if the adviser included a partial client list in its advertisements so long as: (i) the adviser did not use performance-based criteria in determining which clients to include in the list; (ii) each client list contained a disclaimer that it was not known whether the listed clients approved or disapproved of the adviser or the advisory services provided; and (iii) each client list included a statement disclosing the objective criteria used to determine which clients to include in the list.²⁷

Approximately four years later, in *Cambiar Investors, Inc.*, the SEC staff pronounced that a partial client list that does no more than identify certain clients of the adviser (i.e., neither emphasizes comments or activities favorable to the adviser nor ignores those that are unfavorable) is not a statement of a client's experience with or endorsement of the adviser and is therefore not a testimonial under Rule 206(4)-1(a)(1).²⁸ The SEC staff clarified:

Our position is not conditioned on the adviser's use of nonperformance-related criteria to select clients that appear on the partial list or the presence of any particular disclosure or disclaimer. Our position also is not conditioned on who receives the advertisement (consultant or client) or whether the recipient requested the information. In our view, these factors are not relevant to determining whether the content of an advertisement constitutes a statement of a client's experience with, or endorsement of, a particular investment adviser.²⁹

Although an advertisement that does no more than identify select advisory clients is not a testimonial within the meaning of Rule 206(4)-1(a)(1), the SEC staff emphasized that such advertisements are nonetheless subject to the general prohibition against false or misleading advertisements under Rule 206(4)-1(a)(5).³⁰ For instance, in an action against Reservoir Capital Management, Inc., the SEC admonished the adviser for providing prospective clients with a "representative" client list which contained eight institutional investors.³¹ Since institutional clients comprised no more than 15% of the adviser's assets under management and at least 2 of

²⁶ *Denver Investment Advisors, Inc.*, SEC No-Action Letter (pub. avail. July 30, 1993).

²⁷ *Id.*

²⁸ *Cambiar Investors, Inc.*, SEC No-Action Letter (pub. avail. Aug. 28, 1997).

²⁹ *Id.* But see *Franklin Management, Inc.*, SEC No-Action Letter, at n. 14 (pub. avail. Dec. 10, 1998) (stating that the SEC staff agreed not to recommend enforcement action against *Cambiar Investors, Inc.* so long as the selection criteria for the partial client list were objective and unrelated to the performance of clients' accounts, and the advertisement contained disclosure and the disclaimer set forth in *Denver Investment Advisors, Inc.*).

³⁰ *Cambiar Investors, Inc.* SEC No-Action Letter (pub. avail. Aug. 28, 1997).

³¹ *In re Reservoir Capital Management, Inc. and Roann Costin*, SEC Release No. IA-1717 (Apr. 24, 1998).

the 8 investors were not clients of the adviser, the SEC found that the adviser violated Section 206(4) and Rule 206(4)-1(a)(5) thereunder.

The SEC staff has indicated that a partial client list that is *not* distributed in the manner described in *Denver Investment Advisors, Inc.* is not necessarily false or misleading under Section 206(4) and Rule 206(4)-1(a)(5). However, the SEC staff stated that “an adviser’s deviation from one or more of the [Denver Investment Advisors, Inc.] representations could be relevant, but would not necessarily be determinative” in the analysis of whether the advertisement containing a partial client list is false or misleading.³² In addition, the SEC staff stated that a list that includes only advisory clients who were selected on the basis of performance and the selection bias was not adequately disclosed may be potentially misleading in violation of Rule 206(4)-1(a)(5).³³

[B] Ratings

Third party ratings that are based solely on performance, regardless of whether an adviser compensates the third party to verify and rank its performance, do not constitute as testimonials under Rule 206(4)-1.³⁴ However, a third party rating that contains an implicit statement of a client’s experience with an adviser is a testimonial within the meaning of Rule 206(4)-1(a)(1).³⁵ In *Investment Advisers Association*, the SEC staff clarified that the term “testimonial” includes a third-party rating that “relies primarily” on client evaluations of an adviser, but does not include a third-party rating where client responses about the adviser are considered but deemed to be an insignificant factor in formulating the rating.³⁶ When determining whether a third-party rating constitutes a testimonial, the adviser should consider (1) the criteria used by the third party in formulating its rating, and (2) the significance of client evaluations in the rating’s formulation.³⁷ In making these considerations, the SEC staff indicated that an adviser may need to contact the third party to make this determination.³⁸

In a no-action letter issued to DALBAR, Inc., the SEC staff stated that a rating that solicits client views about their experience with an adviser is a testimonial under the Rule since the rating “is an implicit statement of clients’ experiences with an adviser . . . and because the rating purports to convey the experience of a hypothetical average, or typical client with an adviser.”³⁹ Nonetheless, the SEC staff believed that the advertising of such ratings would not raise the dangers that Rule 206(4)-1(a)(1) was designed to prevent so long as:

³² Cambiar Investors, Inc., SEC No-Action Letter (pub. avail. Aug. 28, 1997).

³³ *Id.* at n. 8.

³⁴ See *Stalker Advisory Services*, SEC No-Action Letter (pub. avail. Feb. 14, 1994). See discussion *infra* § 6.2.2[C] Article Reprints.

³⁵ *Investment Adviser Association*, SEC No-Action Letter (pub. avail. Dec. 2, 2005).

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ DALBAR, Inc., SEC No-Action Letter (pub. avail. Mar. 24, 1998).

- (1) the rating does not emphasize favorable client responses or ignore unfavorable client responses;
- (2) the rating represents all, or a statistically valid sample, of the responses of the adviser's clients;
- (3) the questionnaire sent to clients was not prepared to produce any pre-determined results that could benefit any adviser;
- (4) the questionnaire is structured to make it equally easy for a client to provide a negative or positive response; and
- (5) the research firm does not perform any subjective analysis of the survey results, but instead assigns numerical ratings after averaging the client responses for each adviser.

In taking this position, the SEC staff relied upon the factors above and DALBAR, Inc.'s representations that: (i) participating advisers have met certain eligibility criteria reasonably designed to ensure that a participating adviser has an established and significant history and record free from regulatory sanctions; (ii) the research firm is not affiliated with any participating adviser; (iii) the research firm surveys all or a statistically valid sample of a participating adviser's clients; (iv) all participating advisers are charged a uniform fee, paid in advance; (v) the research firm does not issue ratings to an adviser unless the ratings are statistically valid with respect to that adviser; and (vi) any survey results published by the research firm contains information that clearly identifies the percentage of survey participants who have received such designation and the total number of survey participants.

Even if a third-party rating does not constitute as a "testimonial" within the meaning of the Rule 206(4)-1, the advertisement is still subject to Rule 206(4)-1(a)(5), the general "catchall" fraud provision under the advertising rule. In order to determine whether an advertisement containing a third-party rating is false or misleading under Rule 206(4)-1(a)(5), the SEC staff has provided the following eight factors that should be considered:

- (1) whether the advertisement discloses the criteria on which the rating was based;
- (2) whether an adviser advertising any favorable rating without disclosing facts that the adviser knows would call into question the validity of the rating or the appropriateness of advertising the rating (*e.g.*, the adviser has received numerous complaints relating to the rating category or in areas not included in the survey);
- (3) whether the adviser advertises a favorable rating without disclosing any unfavorable ratings;
- (4) whether the advertisement states or implies that the adviser was a top-rated adviser in a category when it was not rated first in that category;
- (5) whether, in disclosing an adviser's rating, the advertisement clearly and prominently discloses the category for which the rating was calculated or

determined, the number of advisers surveyed in that category, and the percentage of advisers that received that rating;

- (6) whether the advertisement discloses that the rating may not be representative of any one client's experience because the rating reflects an average of all, or a sample of all, of the experiences of the adviser's clients;
- (7) whether the advertisement discloses that the rating is not indicative of future performance; and
- (8) whether the advertisement discloses prominently who created and conducted the survey, and that the adviser paid a fee to participate in the survey.⁴⁰

[C] Article Reprints

An article drafted by an unbiased third party that discusses an adviser's performance is not a testimonial within the meaning of Rule 206(4)-1(a)(1) unless it includes a statement of a customer's experience or endorsement.⁴¹ However, the advertisements of such reprints will continue to be subject to Rule 206(4)-1(a)(5). The SEC staff has indicated that an advertisement that reprints articles by an independent financial publication may be prohibited pursuant to Rule 206(4)-1(a)(5) if the reprint, together with the advertisement, implied something about or caused a reader to make an inference regarding: (i) the experience of the adviser's clients; (ii) the possibility of a prospective client having a similar investment experience to that of prior clients; or (iii) the adviser's competence, when there are additional facts that if disclosed would imply different results.⁴²

§ 6.2.3 Past Specific Recommendations

[A] Performance-Based Recommendations

In adopting Rule 206(4)-1, the SEC emphasized its belief that advertisements that refer only to profitable recommendations and ignore unprofitable ones are "inherently misleading and deceptive" in absence of a list containing all recommendations made within the immediately preceding period of at least one year.⁴³ In the adopting release to Rule 206(4)-1, the Commission stated that the underlying concern of the Rule was the act of misleading prospective clients regarding the adviser's investment performance by emphasizing profitable recommendations

⁴⁰ Investment Adviser Association, SEC No-Action Letter (pub. avail. Dec. 2, 2005).

⁴¹ Richard Silverman, SEC No-Action Letter (pub. avail. Mar. 27, 1985); New York Investors Group, Inc., SEC No-Action Letter (pub. avail. Sept. 7, 1982). *See also* Kurtz Capital Management, SEC No-Action Letter (pub. avail. Jan. 18, 1988) (stating that bona-fide unbiased third party reports are generally not subject to the prohibition against testimonials and the distribution of a bona-fide article drafted by an unbiased third party is not subject to the requirements of Rule 206(4)-1(a)(2) where past specific recommendations happen to be referred to within the article).

⁴² Stalker Advisory Services, SEC No-Action Letter (pub. avail. Jan. 18, 1994); New York Investors Group, Inc., SEC No-Action Letter (pub. avail. Sept. 7, 1982).

⁴³ Advertisements by Investment Advisers, SEC Release No. IA-121 (Nov. 1, 1961).

while ignoring unprofitable ones, a practice commonly referred to as “cherry picking.”⁴⁴ Rule 206(4)-1(a)(2) makes it a fraudulent, deceptive, or manipulative act, practice or course of business for any registered investment adviser to publish, circulate or distribute any advertisement that makes a direct or indirect reference to past specific recommendations of the adviser that were or would have been profitable unless: (i) the advertisement sets out or offers to furnish *free of charge* a list of all recommendations made within the immediately preceding period of not less than one year;⁴⁵ and (ii) the advertisement (or list if furnished separately) contains the following pieces of information:

- the name of each security recommended;
- the date and nature of each recommendation (*e.g.*, buy, hold or sell);
- the market price at that time;
- the price at which the recommendation was to be acted upon;
- the market price of each listed security as of the most recent practicable date; and
- the following legend on the first page in print or type as large as the largest print or type used: “It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list.”

In *Scientific Market Analysis*, the SEC staff clarified that the earliest recommendation referred to in an advertisement would establish the beginning period from which the list of all recommendations must be presented.⁴⁶ For instance, if an adviser wanted to refer to profitable securities recommendations made for the period from 2002 to the present, it must include in its list every recommendation made from 2002 to the present.⁴⁷

[1] Partial List of Recommendations

Although contrary to the plain language of the Rule, the Commission staff interprets Rule 206(4)-1(a)(2) strictly to preclude any references in advertisements to past specific recommendations that were or would have been profitable without setting out all past recommendations during the preceding year, even when accompanied by an offer to provide such

⁴⁴ See *id.* See also *Franklin Management, Inc.* (pub. avail. Dec. 10, 1998) (stating that use of objective, non-performance based selection criteria of past specific recommendations in reports issued by an adviser will not raise the dangers of cherry-picking, which the Rule was designed to prevent); *National Corporate Sciences, Inc.* (pub. avail. July 24, 1976) (rule serves to protect against misleading clients about the adviser’s performance by referring only to profitable recommendations while ignoring unprofitable ones); *Starr and Kuehl, Inc.* (pub. avail. Apr. 17, 1976) (same).

⁴⁵ In *Scientific Market Analysis*, the SEC staff stated that Rule 206(4)-1(a)(2) “could be interpreted to require that such list be furnished free of charge to prospective clients, since an adviser might be able to avoid the rule’s requirements by charging a fee for a list of recommendations for which prospective clients might be unwilling to pay.” *Scientific Market Analysis*, SEC No-Action Letter (pub. avail. Mar. 24, 1976).

⁴⁶ *Id.* (“[T]he earliest recommendation referred to establishes the pertinent time period.”).

⁴⁷ See *id.*

information separately.⁴⁸ Therefore, an adviser may not refer to select recommendations in its advertisements with an offer to furnish the remainder. Rather, Rule 206(4)-1(a)(2) permits advertisements that either: (i) contain a full list of recommendations made during the preceding period of not less than one year with certain disclosures; or (ii) an advertisement with an offer to provide such a list.⁴⁹

[2] Article Reprints

In *New York Investors Group, Inc.* and *Dow Theory Forecasts, Incorporated*, the SEC staff took the position that the inclusion in an advertisement of an article that commends an adviser for its ability to select stocks that perform well in favorable and unfavorable market conditions is an indirect reference to the adviser's past specific recommendations and violates Rule 206(4)-1(a)(2) unless it contains all the recommendations made by the adviser within the preceding year.⁵⁰ However, the SEC staff seemingly reversed its position in *Kurtz Capital Management* when it stated that the distribution of an article drafted by an unbiased third party that "happens" to refer to past specific recommendations made by the adviser is not subject to the requirements of Rule 206(4)-1(a)(2), but is still subject to the prohibition against misleading and fraudulent advertisements under Rule 206(4)-1(a)(5).⁵¹

[B] Non-Performance Based Recommendations

In *Franklin Management, Inc.*, the staff broadened its interpretation of the Rule 206(4)-1(a)(2) to permit discussions of past specific securities bought, sold or held for the adviser's accounts in quarterly reports to existing and prospective clients so long as:

- (1) the securities discussed are selected on objective, non-performance based criteria;
- (2) the same selection criteria will be consistently applied each quarter;

⁴⁸ See Mr. Norman L. Yu & Company, Inc. (pub. avail. Apr. 12, 1971) ("[A]ny advertisement by an investment adviser which contains a partial list of recommendations and an offer to furnish a list of all recommendations made during the previous 12 month period would be viewed by us as an attempt to 'wet the appetite' of the general public and would clearly be in violation of [Rule 206(4)-1] and be deemed to be a misleading and fraudulent advertisement."). See also *Dow Theory Forecasts, Inc.*, SEC No-Action Letter (pub. avail. Nov. 7, 1985) ("Rule 206(4)-1(a)(2) under the [Advisers] Act does not permit an advertisement which refers to selected past recommendations of an investment adviser which were or would have been profitable to any person, even if the advertisement offers to provide a list of all recommendations made by the adviser within the past year."); James B. Peeke & Company, Inc., SEC No-Action Letter (pub. avail. Sept. 13, 1982); Scientific Market Analysis (pub. avail. Mar. 24, 1976); J. D. Minnick & Company, SEC No-Action Letter (pub. avail. Apr. 30, 1975); Mr. Charles Swanson, SEC No-Action Letter (pub. avail. Apr. 10, 1972).

⁴⁹ See *Dow Theory Forecasts, Inc.*, SEC No-Action Letter (pub. avail. Nov. 7, 1985); J. D. Minnick & Company, SEC No-Action Letter (pub. avail. Apr. 30, 1975).

⁵⁰ *Dow Theory Forecasts, Incorporated*, SEC No-Action Letter (pub. avail. Nov. 7, 1985) (advertisement of a New York Post article that contains references to past specific recommendations made by an adviser must satisfy the requirements in Rule 206(4)-1(a)(2)); *New York Investors Group, Inc.*, SEC No-Action Letter (pub. avail. Sept. 7, 1982) (finding that quoting an article that lauds the Company or its officer's success in selecting stocks is an indirect reference to past specific recommendations in violation of Rule 206(4)-1(a)(2) without referencing all past recommendations within the preceding year).

⁵¹ *Kurtz Capital Management*, SEC No-Action Letter (pub. avail. Jan. 18, 1988).

- (3) the advertisement does not discuss, directly or indirectly, realized or unrealized profits or losses of the named securities;
- (4) the advertisements include cautionary disclosures; and
- (5) the adviser maintains, and makes available to the SEC staff upon request, records that evidence: (i) the complete list of all securities recommended by the adviser in the preceding year for the specific investment category covered by the advertisement; (ii) the information set forth in Rule 206(4)-1(a)(2) for each recommendation; and (iii) the criteria used to select the specific securities listed in each advertisement.⁵²

The SEC staff believed that the use of objective, non-performance selection criteria and the omission of any discussion on the profitability of any security would limit the ability of the adviser to cherry-pick profitable recommendations and mislead prospective clients about the adviser's performance.⁵³ In *Franklin Management, Inc.*, the staff also clarified that advertisements that identify and discuss current or unprofitable recommendations of the adviser are not within the prohibitions of the Rule.⁵⁴ However, while current or unprofitable recommendations are not prohibited under the Rule, it is difficult, if not impossible, to predict whether, at the time such recommendations are written, the listed securities held in the portfolio will subsequently be sold or whether the unprofitable holdings will subsequently become profitable.

§ 6.2.4 Charts and Formulas

Rule 206(4)-1(a)(3) under the Advisers Act prohibits an adviser from making any claim in its advertisements that a graph, chart, formula or other device being offered: (i) can be used to determine which securities to buy or sell, when to buy or sell the securities, or (ii) will assist persons in making such decisions, unless the limitations and difficulties regarding the use of the device are prominently disclosed.⁵⁵ The SEC staff has clarified that the former restriction is absolute; that is, an advertisement may never make a claim that a device can be used to make decisions on which securities to buy or sell, or the timing of such decisions, irrespective of what limitations and difficulties are discussed.⁵⁶

§ 6.2.5 Free Reports or Services

⁵² *Franklin Management, Inc.*, SEC No-Action Letter (pub. avail. Dec. 10, 1998).

⁵³ *Id.*

⁵⁴ *See id.* at note 11.

⁵⁵ Rule 206(4)-1(a)(3) under the Advisers Act.

⁵⁶ *Bache & Co. Incorporated*, SEC No-Action Letter (pub. avail. Feb. 5, 1976); *Mottin Forecast*, SEC No-Action Letter (pub. avail. Nov. 29, 1975); *S. H. Dike & Company, Inc.*, SEC No-Action Letter (pub. avail. Apr. 20, 1975); *Investor Intelligence*, SEC No-Action Letter (pub. avail. Apr. 18, 1975).

Rule 206(4)-1(a)(4) prohibits the distribution of an advertisement that states that any report, analysis or other service will be furnished for free or without charge if there are any conditions or obligations connected with the receipt of such report, analysis or service.⁵⁷

§ 6.2.6 Anti-Fraud Catchall Provision

Rule 206(4)-1(a)(5) deems it to be a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206(4) of the Advisers Act for any adviser to distribute, directly or indirectly, any advertisement that contains an untrue statement of material fact or that is otherwise false or misleading.⁵⁸ This is a catchall provision that is used by the SEC to sanction investment adviser firms for advertising violations that do not fit within the specific prohibitions listed in subparagraphs (a)(1) through (a)(4) of Rule 206(4)-1. Whether an advertisement is false or misleading under Rule 206(4)-1(a)(5) largely depends upon the particular facts and circumstances.⁵⁹ An adviser should consider the following three factors when conducting an analysis under Rule 206(4)-1(a)(5):

- *the form and content of the advertisement:* An adviser should make sure that all relevant information is included in the advertisement so that its audience receives a clear and unbiased picture of the adviser's investment skills;⁶⁰
- *the implications that arise out of the context of the communication:* An adviser should examine its advertisement to determine whether the audience may infer something about the adviser's competence or future investment results that would not be true had the advertisement included all material facts;⁶¹ and
- *the prospective client's sophistication:* An adviser should determine whether the advertisement is being presented to a sophisticated client in a one-on-one presentation, to a retail investor, or distributed broadly through a newspaper, magazine, radio or on the internet.⁶²

⁵⁷ Rule 206(4)-1(a)(4) under the Advisers Act. See, e.g., Dow Theory Forecasts, Inc., SEC No-Action Letter (pub. avail. May 21, 1986) (stating that an advertisement's offer of a free subscription to an investment newsletter on the condition that the Dow Jones Industrial Average not rise 10 points during the subscription period violates Rule 206(4)-1(a)(5)).

⁵⁸ Rule 206(4)-1(a)(5) under the Advisers Act.

⁵⁹ Franklin Management, Inc., SEC No-Action Letter (pub. avail. Dec. 10, 1998).

⁶⁰ For example, an adviser that directs his clients' investments in mutual fund shares has a duty to disclose that in addition to the adviser's fees, additional fees and expenses associated with an investment in mutual fund shares will be incurred. See James B. Peeke & Company, Incorporated, SEC No-Action Letter (pub. avail. Sept. 13, 1982).

⁶¹ See, e.g., *In re Valicenti Advisory Services, Inc.*, SEC Release No. IA-1774 (Nov. 18, 1998) (concluding that an adviser willfully violated Section 206(1) and Rule 206(4)-1(a)(5) thereunder for, among other things, presenting performance of a "composite" that failed to disclose that the performance reflected was achieved only by a small sampling of accounts chosen by the adviser's principal).

⁶² See, e.g., *In re LBS Capital Management, Inc.*, SEC Release No. IA-1644 (July 18, 1997); *Clover Capital Management, Inc.*, SEC No-Action Letter (pub. avail. Oct. 28, 1986); *Anametrics Investment Management*, SEC No-Action Letter (pub. avail. May 5, 1977); *In re Spear & Staff, Inc.*, SEC Release No. IA-188 (Mar. 25, 1965).

An advertisement may be deemed to be misleading even if each individual statement in an advertisement is factually correct. In *In re Spear & Staff, Incorporated*, the SEC found that the advertisements at issue “were deceptive and misleading in their over-all effect even though it might be argued that when narrowly and literally read, no single statement of a material fact was false.”⁶³ Generally, an advertisement may be considered false or misleading if it implies something about the adviser or its client’s experiences that is not true, or that the client would not have inferred if the adviser had disclosed all material facts.⁶⁴

§ 6.3 Performance Advertising

§ 6.3.1 General Requirements

Although the SEC does not prescribe the method by which investment advisers must calculate or present their past performance, it does rely upon Rule 206(4)-1(a)(5) to police what it deems to be fraudulent or misleading advertising of performance.

In one of the most seminal advertising no-action letters issued by the SEC staff, *Clover Capital Management, Inc.*, the SEC staff took the opportunity to set forth the advertising practices in connection with the presentation of either model or actual returns that it believed were prohibited under Rule 206(4)-1(a)(5):

- Failure to disclose the effect of material market or economic conditions on the results portrayed;⁶⁵
- Presentation of model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses a client would have paid or actually paid, unless an exemption applies;
- Failure to disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;⁶⁶
- Failure to disclose the possibility of loss when the advertisement suggests or makes claims about the potential for profit;
- Failure to disclose all material facts relevant to any comparison made between model or actual results and an index (*e.g.*, disclose, if applicable, that the volatility of an index materially differs from a model portfolio);⁶⁷

⁶³ *In re Spear & Staff, Incorporated*, SEC Release No. IA-188 (Mar. 25, 1965).

⁶⁴ Investment Adviser Association, SEC No-Action Letter (pub. avail. Dec. 2, 2005).

⁶⁵ See Edward F. O’Keefe, SEC No-Action Letter (pub. avail. Apr. 13, 1978) (“Information concerning performance of accounts over a period or periods attended by special market characteristics may imply or cause an inference to be drawn about the competence of the adviser or the possibility of a client enjoying a similar experience which would not arise if such characteristics were also disclosed.”).

⁶⁶ See, *e.g.*, *In re Schield Management Company et al.*, SEC Release No. IA-1872 (May 31, 2000) (finding that an adviser violated Rule 206(4)-1(a)(5) for, among other things, failing to disclose that performance presented reflected the reinvestment of dividends).

- Failure to disclose any material conditions, objectives, or strategies used to obtain the results portrayed (*e.g.*, failure to disclose that certain investment practices or instruments contributed overwhelmingly to performance, especially when it is doubtful that the performance could be expected to continue including IPO investments or other material events that may not repeat themselves);⁶⁸ and
- Failure to disclose, if applicable, that actual results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and any material effect of this practice on the results portrayed.⁶⁹

Advisers should not rely on the *Clover Capital* no-action letter as a safe harbor when presenting actual and model returns, nor should advisers consider the *Clover Capital* list to be an exhaustive list of all factors to be considered.⁷⁰ Moreover, the SEC staff has clearly stated that a disclaimer to the effect of "Past performance is not a guarantee of future returns" may not, in and of itself, be sufficient to cure a misleading presentation.⁷¹ Each communication of the adviser should be reviewed in its totality to determine whether its audience may imply something about the adviser or its competence that would not be true if all material facts were presented.

§ 6.3.2 Model Performance

Neither Section 206 nor Rule 206(4)-1 thereunder speaks to the use of model performance results. However, the SEC staff has explicitly stated that "the applicable legal standard governing the advertising of model or actual results is that contained in paragraph (5) of the rule, i.e., whether the particular advertisement is false or misleading."⁷² At least thirty years ago, the SEC staff took the position that the advertisement of model performance was *per se* misleading, and could not be cured by any amount of disclosure.⁷³ The SEC staff eventually

⁶⁷ See, *e.g.*, Scientific Market Analysis, SEC No-Action Letter (pub. avail. Mar. 24, 1976) (stating that comparison of performance of hypothetical separate advisory accounts with a Lipper Mutual Fund Index may be inappropriate since individual advisory accounts are not likely to be as broadly diversified as a mutual fund portfolio).

⁶⁸ See, *e.g.*, *In re* The Dreyfus Corporation and Michael L. Schonberg, SEC Release No. IA-1870 (May 10, 2000) (finding willful violation of Section 206(2) for failing to disclose that a large portion of advertised performance was attributable to investments in IPOs); *In re* Van Kampen Investment Advisory Corp. and Alan Sachtleben, SEC Release No. IA-1819 (Sept. 8, 1999) (finding a willful violation of Section 206(2) for failing to disclose that IPO securities had a large impact on the fund's return, disclosure which "would have significantly altered the total mix of information available to investors");

⁶⁹ For instance, the SEC staff has indicated that the provision of performance covering select periods or select accounts would be misleading if other periods or other accounts would modify the implication that arises or the inference that is drawn from the information as originally presented. See Edward F. O'Keefe, SEC No-Action Letter (pub. avail. Apr. 13, 1978).

⁷⁰ *Clover Capital Management, Inc.*, SEC No-Action Letter (pub. avail. Oct. 28, 1986).

⁷¹ See Edward F. O'Keefe, SEC No-Action Letter (pub. avail. Apr. 13, 1978).

⁷² *Clover Capital Management, Inc.*, SEC No-Action Letter (pub. avail. Oct. 28, 1986).

⁷³ See, *e.g.*, *A.R. Schmeidler & Co. Inc.*, SEC No-Action Letter (pub. avail. June 1, 1976) ("In fact, in view of the misleading nature of performance figures of a hypothetical fund it is doubtful whether any form of disclosure would offset the misleading impact of such figures without at the same time making clear that such figures are essentially meaningless."). See also *Clover Capital Management, Inc.*, SEC No-Action Letter (pub. avail. Oct. 28, 1986) ("The

abandoned this position and currently permits model disclosure so long as it is not false or misleading in contravention of Rule 206(4)-1(a)(5). In *Clover Capital*, the SEC staff clarified that advisers who present model returns must equip prospective investors with additional information in light of the heightened chance that model returns may give rise to an erroneous inference about future investment returns.⁷⁴ In addition to the presentation and disclosure requirements applicable to both model and actual returns, the SEC staff opined that the failure to make the following disclosures would be prohibited by Rule 206(4)-1(a)(5):

- the limitations inherent in model results, particularly that model returns do not reflect actual trading and may not reflect the impact that material economic and market factors may have had on the adviser's decision-making had the adviser actually managed client funds;
- if applicable, that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period portrayed in the advertisement and, if so, the effect of any such change on the results portrayed;
- if applicable, that any of the securities contained in, or the strategies followed with respect to, the model portfolio do not relate, or only partially relate, to the type of advisory services currently offered by the adviser (*e.g.*, the model reflects securities that are no longer recommended for clients);⁷⁵ and
- if applicable, that the adviser's clients had investment results materially different from the results portrayed in the model.

§ 6.3.3 Hypothetical Backtested Performance

Unlike model performance, backtested performance presents hypothetical performance based upon the retroactive application of an adviser's investment strategy over a select market period. Great care should be taken when presenting backtested performance, which is regarded as highly suspect by the SEC. Backtested returns should only be presented to sophisticated (*i.e.*, non-retail) clients.⁷⁶ Through enforcement actions addressing this practice, the SEC has admonished advisers for failing to disclose the following in connection with the presentation of hypothetical backtested returns:

staff no longer takes the position, as it did a number of years ago, that the use of model or actual results in an advertisement is per se fraudulent under Section 206(4) and the rules thereunder, particularly Rule 206(4)-1(a)(5).").

⁷⁴ *Clover Capital Management, Inc.*, SEC No-Action Letter (pub. avail. Oct. 28, 1986).

⁷⁵ The SEC has admonished an investment adviser for advertising hypothetical returns based upon a timing system that was no longer in use by the adviser. See *In re Bond Timing Services, Inc. and Vilis Pasts*, SEC Release No. IA-920 (July 23, 1984).

⁷⁶ *In re LBS Capital Management, Inc.*, SEC Release No. IA-1644 (July 18, 1997) (stating that in concluding that an advertisement containing backtested performance was misleading, the SEC considered that the advertisement was distributed to existing and prospective retail clients.).

- that backtested performance was derived from the retroactive application of a model developed with the benefit of hindsight (*e.g.*, disclosure that the adviser began to offer its strategy after the period depicted);⁷⁷
- the inherent limitations of data derived from the retroactive application of a model developed with the benefit of hindsight and the reasons why actual results may differ;⁷⁸
- whether the trading strategies retroactively applied were not available during the periods presented;⁷⁹
- that actual performance with client accounts was materially less than the advertised hypothetical results for the same period;⁸⁰
- all material economic and market factors that may have impacted the adviser's decision-making when using the model to actually manage client funds;⁸¹
- whether the advertised performance reflects the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid;⁸²
- all material facts relevant to any comparison between backtested performance and its benchmark;⁸³ and
- the potential for loss.⁸⁴

⁷⁷ *In re Schield Management Company et al.*, SEC Release No. IA-1872 (May 31, 2000); *In re Meridian Investment Management Corporation et al.*, SEC Release No. IA-1779 (Dec. 18, 1998); *In re LBS Capital Management, Inc.*, SEC Release No. IA-1644 (July 18, 1997); *In re Patricia Owen-Michel*, SEC Release No. IA-1584 (Sept. 27, 1996).

⁷⁸ *In re Market Timing Systems, Inc. et al.*, SEC Release No. IA-2047 (Aug. 28, 2002); *In re Schield Management Company et al.*, SEC Release No. IA-1872 (May 31, 2000). For instance, in *In re Schield Management Company*, the SEC admonished an adviser for failing to disclose that the hypothetical strategy, when actually executed, underperformed its benchmark even though the backtested performance presented showed that the hypothetical strategy consistently outperformed the benchmark each year.

⁷⁹ *See, e.g., In re Leeb Investment Advisors et al.*, SEC Release No. IA-1545 (Jan. 16, 1996) (admonishing an adviser under Section 17(a)(2) of the Securities Act and Section 34(b) of the 1940 Act for stating that an investor could turn an investment made in 1980 into millions by the 1990s without disclosing that this result would depend on using trading strategies that were not available in 1980).

⁸⁰ *In re Market Timing Systems, Inc. et al.*, SEC Release No. IA-2047 (Aug. 28, 2002). *See also In re Profitek, Inc.* and *Edward G. Smith*, SEC Release No. IA-1764 (Sept. 29, 1998) (finding a violation of Section 206(4) and Rule 206(4)-1(a)(5) thereunder, among other violations, for failing to disclose that performance data of model portfolios were based on hypothetical stock transactions that bore no resemblance to the actual performance of its client accounts).

⁸¹ *In re Patricia Owen-Michel*, SEC Release No. IA-1584 (Sept. 27, 1996).

⁸² *Id.*

⁸³ *Id.*

With respect to the requirement that advisers disclose that backtested performance was derived from the retroactive application of a model developed with the benefit of hindsight, the SEC has indicated that labeling backtested returns as “pro forma” or “hypothetical,” in and of itself, is insufficient to satisfy this requirement.⁸⁵ Moreover, the SEC has stated that the inclusion of general disclaimers to the effect of, “Future results based upon past performance, including hypothetical returns, cannot be guaranteed” is also insufficient to remove the erroneous suggestion that the performance was achieved through actual trading.⁸⁶ In *In re LBS Capital Management, Inc.*, the SEC noted that disclosure that backtested returns were “pro-forma” and that “actual results were available upon request” was insufficient to convey that the advertised performance were achieved by retroactive application of a model, or otherwise dispel the misleading suggestion that the advertised performance represented actual trading.⁸⁷

§ 6.3.4 Gross-of-Fee and Net-of-Fee Performance

[A] Net-of-Fee Performance

As a general matter, investment adviser performance must be advertised after the deduction of advisory fees, brokerage or other commissions, and any expenses that a client paid or would have paid.⁸⁸ The SEC staff has clarified that custodial fees do not have to be reflected in net-of-fee returns since custodians are ordinarily selected and paid directly by advisory clients.⁸⁹ Except under limited circumstances,⁹⁰ the SEC staff deems the presentation of gross-of-fee performance alone to be misleading under Rule 206(4)-1(a)(5) since an average investor would make an inference about the future returns of the adviser or its competence that would not be true if the adviser had presented returns on a net-of-fee basis.⁹¹ This is largely due to the fact that gross-of-fee returns fail to reflect the impact that fees have on performance or the compounded effect on performance of not deducting fees.⁹²

[B] Gross-of-Fee Performance

[i] One-on-One Presentations

⁸⁴ *Id.*

⁸⁵ *In re Schield Management Company et al.*, SEC Release No. IA-1872 (May 31, 2000)

⁸⁶ *In re Patricia Owen-Michel*, SEC Release No. IA-1584 (Sept. 27, 1996).

⁸⁷ *In re LBS Capital Management, Inc.*, SEC Release No. IA-1644 (July 18, 1997).

⁸⁸ *See* Clover Capital Management, Inc., SEC No-Action Letter (pub. avail. Oct. 28, 1986).

⁸⁹ *See* Investment Company Institute, SEC No-Action Letter (pub. avail. Aug. 24, 1987).

⁹⁰ *See* discussion *infra*, § 6.3.4[B].

⁹¹ *See* Investment Company Institute, SEC No-Action Letter (pub. avail. Sept. 23, 1988). *See also* *In re Bond Timing Services, Inc. and Vilis Pasts*, SEC Release No. IA-920 (July 23, 1984) (finding an adviser to have fully violated Section 206(4) and Rule 206(4)-1(a)(5) thereunder for distributing advertisements of annualized returns that did not reflect advisory fees, sales loads, and transfer fees).

⁹² *See id.*

In a no-action letter issued to the Investment Company Institute (the “*ICI II* no-action letter”), the SEC staff permitted the presentation of gross-of-fee performance returns in a one-on-one presentation to certain prospective clients that are in a position to negotiate their advisory fees⁹³ (e.g., wealthy individuals, pension funds, universities and other institutional investors) so long as the adviser provides the following disclosures to the client in writing:

- performance disclosures do not reflect the deduction of advisory fees;
- the client’s return will be reduced by the advisory fees and any other expenses it may incur in the management of its advisory account;
- the adviser’s fees are described in Part II of its Form ADV; and
- a representative example (e.g., table, chart, graph, or narrative) that shows the effect an advisory fee, compounded over a period of years, could have on the total value of a client’s portfolio.⁹⁴

To constitute as a “one-on-one presentation,” the presentation must be private and confidential in nature and the prospective client must have ample opportunity to discuss the type of advisory fees that may be paid.⁹⁵ In addition, the presentation must not be publicly available through any print, electronic or other medium.⁹⁶

[ii] Consultants

An adviser may present performance information to a consultant on a gross-of-fee basis in a one-on-one presentation so long as the adviser instructs the consultant to present such performance data to prospective clients only on a one-on-one basis with the disclosures set forth in the *ICI II* no-action letter.⁹⁷

[iii] Side-by-Side Gross and Net of Fee Performance

In a no-action letter issued to the Association for Investment Management and Research, the SEC staff stated that an adviser may distribute an advertisement that presents composite performance on a gross and net-of-fee basis, so long as: (i) the gross and net performance is

⁹³ The SEC staff has acknowledged that “a client’s ability to negotiate fees with an adviser is directly related to the amount of client assets subject to the adviser’s management.” Investment Company Institute, SEC No-Action Letter (pub. avail. Sept. 23, 1988). The SEC staff acknowledged that information on the fees and expenses associated with performance of other advisory clients is not as material to a client that has bargaining power over its advisory fees. *See id.*

⁹⁴ *See* Investment Company Institute, SEC No-Action Letter (pub. avail. Sept. 23, 1988).

⁹⁵ *See id.*

⁹⁶ *See id.*

⁹⁷ *See* Investment Company Institute, SEC No-Action Letter (pub. avail. Sept. 23, 1988); Bypass Wall Street, Inc., SEC No-Action Letter (pub. avail. Jan. 7, 1992). In *Clover Capital Management, Inc.*, SEC No-Action Letter (pub. avail. July 19, 1991), the SEC staff denied a request to allow the presentation of gross-of-fee performance to plan sponsors and investment consultants without complying with the conditions set forth in *ICI II*.

presented with equal prominence; (ii) the presentation is in a format designed to facilitate the ease of comparison between the gross and net performance; and (iii) the advertisement contains sufficient disclosure (*e.g.*, that gross-of-fee performance does not reflect the payment of advisory fees and other expenses) that would ensure that the presentation is not otherwise misleading.⁹⁸

§ 6.3.5 Model Fees

An adviser may advertise performance reflecting the deduction of a model fee so long as the resulting performance is no higher than the performance that would have resulted if actual fees were deducted, and the performance data is accompanied by disclosure that: (i) the performance reflects the deduction of the highest fee charged to an advisory customer employing that particular strategy during the period under consideration; (ii) actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size; and (iii) the advisory fees are available upon request and may be found in Part II of the adviser's Form ADV.⁹⁹ There are two other situations in which the SEC staff has permitted "model" advisory fees to be used in lieu of the actual fee. These include:

- **Composites containing wrap and non-wrap accounts.** Advertisements that present composites containing both wrap and non-wrap fee accounts may calculate net-of-fee performance using the actual fees from wrap accounts and a model fee from non-wrap accounts, which is equal to the highest fee charged to a wrap fee account, so long as the advertisement contains sufficient disclosure to ensure that the information presented is not misleading.¹⁰⁰
- **Multi-manager accounts.** A composite that includes advisory accounts that consist of a portion of the assets of a multi-manager account¹⁰¹ can be presented on a net-of-fee basis after deducting only those fees and costs related to the assets managed by the adviser, including transaction costs and all fees and charges paid by the account to the adviser or its affiliate, provided that it is accompanied with a statement that identifies those fees and costs that have been deducted.¹⁰²

§ 6.3.6 Portability

"Portability" of performance refers to the ability of one adviser to reference in its own performance presentation the historical performance record of either a predecessor firm or that of the adviser's portfolio managers achieved while at another firm. A number of SEC staff no-action letters considered whether an adviser's advertisement of performance results of accounts managed by a predecessor would be misleading and therefore deemed fraudulent for purposes of Section 206(4) and Rule 206(4)-1. These no-action letters take the position that an advertisement that includes prior performance of accounts managed by portfolio managers at

⁹⁸ Association for Investment Management and Research, SEC No-Action Letter (pub. avail. Dec. 18, 1996).

⁹⁹ See J.P. Morgan Investment Management, Inc., SEC No-Action Letter (pub. avail. May 7, 1996).

¹⁰⁰ See Association for Investment Management and Research, SEC No-Action Letter (pub. avail. Dec. 18, 1996).

¹⁰¹ In a multi-manager account, different investment firms manage a discrete portion of the account's assets.

¹⁰² See Association for Investment Management and Research, SEC No-Action Letter (pub. avail. Dec. 18, 1996).

their prior place of employment will not, in and of itself, be misleading under Section 206(4) and Rule 206(4)-1 thereunder so long as:

(1) the person(s) managing accounts at the adviser are also those primarily responsible for achieving the prior performance results;¹⁰³

(2) the accounts managed at the prior adviser are so similar to the accounts currently under management that the performance would provide relevant information to prospective clients;¹⁰⁴

(3) all accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance;¹⁰⁵

(4) the advertisement is consistent with SEC staff interpretations with respect to the advertisement of performance results;¹⁰⁶ and

¹⁰³ Fiduciary Management Associates, Inc., SEC No-Action Letter (pub. avail. Mar. 5, 1984) (stating that it is not misleading for a new adviser to use the performance of another adviser when, among other things, the investment personnel are the same). *See also* Bramwell Growth Fund, SEC No-Action Letter (pub. avail. Aug. 7, 1996) (finding that Section 206 does not prohibit the inclusion in a mutual fund's prospectus performance of another registered investment company previously managed by the fund's portfolio manager provided that (1) no other individuals played a significant part in achieving the prior performance, and (2) the performance is not presented in a misleading manner and does not obscure or impede understanding of information required to be in the prospectus); Great Lakes Advisors, SEC No-Action Letter (pub. avail. Apr. 3, 1992) (finding that it may be misleading for an adviser to advertise the performance results of accounts managed at an employee's prior place of employment when the employee was one of several persons responsible for selecting the securities for those accounts). The SEC staff has clarified that whether this requirement is satisfied requires a review of the investment team both at the prior firm *and* the new firm. That is, the individuals primarily responsible for achieving the prior performance results must also be those individuals primarily responsible for the accounts at the new firm. *See* Horizon Asset Management, LLC, SEC No-Action Letter (pub. avail. Sept. 13, 1996). In *Horizon Asset Management*, the SEC staff found that although the sole portfolio manager who was responsible for achieving the prior performance was now a member of an advisory committee at his new firm, this in and of itself would not bar the portability of the prior performance so long as the portfolio manager was actually responsible for making investment decisions without the need for consensus from the other committee members. *See id.*

¹⁰⁴ Horizon Asset Management, LLC, SEC No-Action Letter (pub. avail. Sept. 13, 1996).

¹⁰⁵ *See id.*; Conway Asset Management Incorporated, SEC No-Action Letter (pub. avail. Jan. 27, 1989) (allowing newly registered adviser solely owned by an employee to use performance data of several accounts managed by employee prior to registration); Fiduciary Management Association, Incorporated, SEC No-Action Letter (pub. avail. Mar. 5, 1984). Although the advertisement of performance of a prior adviser's select accounts is not *per se* prohibited so long as such performance is not materially higher than the composite performance, the Global Investment Performance Standards ("GIPS") prohibits a firm from linking select accounts of the composite's performance history. *See* Guidance Statement on Performance Record Portability (Revised), Application No. 2 (effective Jan. 1, 2006) (hereinafter, "Portability Guidance Statement") ("In addition to meeting all the elements of the Guidance Statement, in order for a firm to be able to link the composite from the old firm to the on-going performance of the new firm, the entire composite performance history, including all portfolios, must be used.")

¹⁰⁶ *See, e.g.,* Clover Capital Management, Inc., SEC No-Action Letter (pub. avail. Oct. 28, 1986) (stating that Rule 206(4)-1(a)(5) prohibits an advertisement that (i) fails to disclose the effect of material market or economic conditions on the results portrayed; (ii) includes model or actual results that do not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client paid or would have paid; (iii) fails to disclose whether and to what extent returns reflect the reinvestment of dividends and other earnings; (iv) suggests the potential for profit without disclosing the possibility of loss; (v) compares model or actual results to an index

(5) the advertisement includes all relevant disclosures, including that the performance results were from accounts managed at another entity.¹⁰⁷

Through no-action letters and administrative proceedings, the SEC and its staff has emphasized that an investment adviser who advertises the prior performance of another adviser may not do so unless it can comply fully with the recordkeeping requirements of Rule 204-2(a)(16).¹⁰⁸

§ 6.3.7 Recordkeeping

Rules 204-2(a)(11) and 204-2(a)(16) under the Advisers Act govern the maintenance of records associated with investment adviser advertising. Rule 204-2(a)(11) requires generally that every registered investment adviser “make and keep true, accurate and current . . . a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly to 10 or more persons.”¹⁰⁹ Rule 204-2(a)(16) generally requires that each federally registered investment adviser maintain:

all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with the investment adviser).¹¹⁰

without disclosing all material facts relevant to the comparison; (vi) fails to disclose any material conditions, objectives or investment strategies used to obtain the results portrayed; (vii) fails to disclose prominently the limitations inherent in model results, if applicable; (viii) fails to disclose, if applicable, that the conditions, objectives, or investment strategies of the model portfolio changed materially during the time period portrayed and, if so, the effect of any such change on the results portrayed; (ix) fails to disclose, if applicable, that any of the securities contained in, or the investment strategies followed with respect to, the model portfolio do not relate, or only partially relate, to the type of advisory services currently offered by the adviser; (x) fails to disclose, if applicable, that the adviser’s clients had investment results materially different from the results portrayed in the model; (xi) fails to disclose prominently, if applicable, that the results portrayed relate only to a select group of the adviser’s clients, the basis on which the selection was made, and the effect of this practice on the results portrayed if material).

¹⁰⁷ See, e.g., Horizon Asset Management, LLC, SEC No-Action Letter (pub. avail. Sept. 13, 1996); *In re Seaboard Investment Advisers Inc.*, SEC Release No. IA-1431 (Aug. 3, 1994) (finding a violation of Section 206(4) and Rule 206(4)-1(a)(5) for, among other things, using the prior performance of an adviser’s control persons without disclosing the source of the performance).

¹⁰⁸ Horizon Asset Management, LLC, SEC No-Action Letter (pub. avail. Sept. 13, 1996); Taurus Advisory Group (pub. avail. July 15, 1993); Great Lakes Advisors, Inc., SEC No-Action Letter (pub. avail. Apr. 3, 1992). See also *In re Seaboard Investment Advisers, Inc.*, SEC Release No. IA-1431 (Aug. 3, 1994).

¹⁰⁹ Rule 204-2(a)(11).

¹¹⁰ Rule 204-2(a)(16) under the Advisers Act. Rule 204-2(e)(3)(i) generally requires such books and records to be maintained and preserved in an easily accessible place for a period of not less than 5 years, the first 2 years in an appropriate office of the adviser, from the end of the fiscal year during which the adviser last published or otherwise

Rule 204-2(a)(16) applies to any advertised performance, both actual and model.¹¹¹ Rule 204-2(a)(16) also provides that an adviser is deemed to satisfy the requirements of the Rule if, with respect to the performance of its managed accounts, the adviser retains: (i) all account statements so long as they reflect all debits, credits, and other transactions in the client's account for the period of the statement; and (ii) all worksheets that are necessary to demonstrate the calculation of the performance or rate of return of the managed accounts.¹¹² In the adopting release to Rule 204-2, the SEC emphasized that these account statements must be prepared contemporaneously with the period reported, and that all account statements for the period for which performance is calculated be kept, irrespective of whether a particular account is included in the computation of an advertised performance figure.¹¹³ The SEC staff has acknowledged that neither the Rule nor the releases proposing or adopting the Rule states that this safe harbor for managed accounts is the exclusive method of satisfying the requirements of Rule 204-2(a)(16).¹¹⁴ However, as a matter of policy, the SEC staff will not provide no-action assurances under the Rule regarding whether an adviser's particular records are sufficient to form the basis of, or demonstrate the calculation of, the investment performance of an adviser's managed accounts.¹¹⁵ The SEC's purpose in adopting the Rule was to assist SEC examiners in their efforts to substantiate performance claims made by advisers in their advertisements.¹¹⁶

Although Rule 204-2(a)(16) may be satisfied through the reliance on internally generated records, the SEC staff has noted that advisers can facilitate the SEC's examination of advertised performance by maintaining: (i) records prepared by a third party (*e.g.*, custodial and brokerage statements) that confirm the accuracy of client account statements and other performance-related records maintained by the adviser; and (ii) reports prepared by an independent auditor that verify

directly or indirectly disseminated the advertisement or communication. The Advisers Act performance recordkeeping requirements are applicable to the delivery of performance information to "ten or more persons" in the aggregate. Accordingly, if a specific performance calculation is requested by a potential client, or the client's consultant, that is unique to a particular situation and does not go to more than nine persons, then the performance recordkeeping requirements are not applicable. This exception is relied upon by firms that prepare specific information in response to consultant's questionnaires.

¹¹¹ See, *e.g.*, *In re Meridian Investment Management Corporation et al.*, SEC Release No. IA-1779 (Dec. 28, 1998).

¹¹² Rule 204-2(a)(16).

¹¹³ Recordkeeping by Investment Advisers, SEC Release No. IA-1135, at fn. 3 (Aug. 17, 1988) (Adopting Release).

¹¹⁴ Salomon Brothers Asset Management Inc., SEC No-Action Letter (pub. avail. July 23, 1999). Rule 204-2(a)(16) may also be satisfied by retaining published materials listing the net asset values of an account together with worksheets demonstrating the performance calculations based on the net asset values, provided the net asset values were accumulated contemporaneously with the management of the account. See Solomon Brothers Asset Management Inc., SEC No-Action Letter (pub. avail. July 23, 1999).

¹¹⁵ Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000).

¹¹⁶ Recordkeeping by Investment Advisers, SEC Release No. IA-1135, at fn. 3 (Aug. 17, 1988) (Adopting Release); Recordkeeping by Investment Advisers, SEC Release No. IA-1093 (Nov. 5, 1987) (Proposing Release). See also Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000) ("The purpose of Rule 204-2(a)(16) was to deter the use of false or misleading performance advertisements by advisers by requiring advisers to make and keep for inspection by the Commission's examination staff all records necessary to substantiate the performance information in their advertisements.").

performance.¹¹⁷ On at least one occasion, the SEC staff has indicated a *preference* for independent records to substantiate advertised returns.¹¹⁸ Lori Richards, the Director of the SEC Office of Compliance Inspections and Examinations has questioned the reliability of internally generated documents, stating that advisers may easily manipulate their internal statements to support false performance and advisers are therefore encouraged to support their performance claims with third party records (*e.g.*, brokerage or custodial records and statements).¹¹⁹ The SEC staff has acknowledged the value of third party records for not only assisting in the verification of performance claims, but also for enabling SEC examiners to confirm client assets and review for the misappropriation of client funds and securities.¹²⁰

The records required to be made under paragraphs (a)(11) and (a)(16) of Rule 204-2 must be maintained in an easily accessible place for at least five years, the first two years in an appropriate office of the adviser, beginning from the end of the fiscal year during which the adviser last disseminated the advertisement.¹²¹

§ 6.4 Global Investment Performance Standards (GIPS®)

§ 6.4.1 General Background

[A] Overview of the Standards

The Global Investment Performance Standards (“GIPS” or “Standards”) are performance presentation standards that are created, sponsored and interpreted by the CFA Institute (“CFAI,” which was formerly known as the Association for Investment Management and Research or “AIMR”). The objectives of the Standards are to: (i) establish a global standard for the

¹¹⁷ Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000). When reviewing auditor reports, the SEC indicated that it will consider all the facts and circumstances relating to the quality of the audit, including whether: (i) the auditor is appropriately independent from the adviser; (ii) the auditor reports are based on the review of data that were accumulated contemporaneously with the management of the relevant accounts; (iii) the auditor reviews sufficient information to afford a reasonable basis for its conclusions (*e.g.*, by reviewing custodian and brokerage statements and confirming data directly with custodians and brokers) and prepares the auditor reports in accordance with appropriate auditing standards; (iv) the adviser or the auditor maintains records underlying the auditor reports (*i.e.*, audit work papers) and the SEC staff has access to such records; (v) the performance verified by the auditor is consistent with the performance derived from other records maintained by the adviser; and (vi) whether the auditor reports include a clear and specific description of the standard used by the adviser to calculate performance. Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000).

¹¹⁸ Lori A. Richards, “Compliance Priorities for Investment Advisers,” Remarks at the Investment Adviser Compliance Summit (May 1, 2000) (“Because of the possibility of fraud, internal documentation prepared by the adviser may not be adequate alone to substantiate performance claims. In today’s technologically sophisticated world, it’s relatively easy for an adviser to artificially create internal statements supporting false performance returns. We have seen this scenario too often.”).

¹¹⁹ *Id.*

¹²⁰ Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000).

¹²¹ Rule 204-2(e)(3)(i) under the Advisers Act. For instance, if an advertisement contains performance over the last ten years, the documents that form the basis for the adviser’s performance for each of the ten years must be kept for five years, the first two years in an appropriate office of the adviser, after the end of the fiscal year in which the advertisement was last published or disseminated. See Jennison Associates LLC, SEC No-Action Letter (pub. avail. July 6, 2000).

calculation and presentation of investment performance in a fair, comparable format with full disclosure, (ii) ensure the accuracy and consistency of performance data for reporting, recordkeeping, marketing and presentations; (iii) promote competition among investment firms without barring entry of new investment firms; and (iv) foster industry self-regulation on a global basis.¹²² Although firms must always adhere to the fundamental principles of fair representation and full disclosure, the Standards primarily address the presentation of performance to prospective clients. Presentations to existing clients do not have to adhere to the GIPS standards since “[p]erformance reporting to existing clients is something that should be agreed upon between the firm and the client.”¹²³

The Standards are comprised of eight sections that reflect what the CFAI perceives to be the basic components involved in presenting performance: fundamentals of compliance; input data; calculation methodology; composite construction; disclosures; presentation and reporting; real estate; and private equity. Within each section, the Standards are divided into required provisions and recommended provisions. Each firm that claims compliance with the Standards must adhere to the required provisions and is “strongly encouraged” to adhere to the recommended provisions under the Standards.¹²⁴ Failure to adhere to the recommended provisions will not in any way bar a firm’s claim of GIPS compliance.

[B] Interpretation of the Standards

Each firm that claims compliance with the Standards is required to comply with all reports, Guidance Statements, interpretations, or clarifications published by the CFAI and the IPC, which is posted on the CFAI website (www.cfainstitute.org) and in the *GIPS Handbook*.¹²⁵ The Standards are interpreted by the Investment Performance Council (“IPC”) of the CFAI, which consists of 36 members from 15 countries.¹²⁶ Under this framework, the IPC delegates interpretation of the Standards to the Interpretations Subcommittee that “has the responsibility of ensuring the integrity, consistency, and applicability of the GIPS standards by providing guidance to the public on practical issues and clarifying areas of confusion.”¹²⁷ Interpretations of the Standards occur in one of three ways: through the “Standards Helpdesk” which provides brief responses to questions submitted by CFAI members individually; through Guidance Statements, which are in-depth responses to novel questions that the Standards may not directly address or

¹²² GIPS Introduction, I.C.6 – I.C.9.

¹²³ GIPS Interpretations on Client Reporting (Q: “Do I violate the GIPS standards if I report money-weighted rates of return for a single portfolio to an existing client?”).

¹²⁴ GIPS Standard 0.A.15 (“Firms are encouraged to comply with the recommendations and must comply with all applicable requirements of the GIPS standards”); GIPS Introduction to the Provisions of the Global Investment Performance Standards, II.

¹²⁵ GIPS Standard 0.A.15.

¹²⁶ GIPS Background of the GIPS Standards. CFAI has indicated that a new GIPS Executive Committee will replace the IPC and “will operate as a ‘think tank’ for performance measurement, presentation, research, and will develop new performance standards as needed by the industry.” IPC Meeting Information, at <http://www.cfainstitute.org/cfacentre/ips/ipc/meetings.html>. As of the date of this publication, the GIPS Executive Committee has not assumed the function of the IPC.

¹²⁷ GLOBAL INVESTMENT PERFORMANCE STANDARDS HANDBOOK §1-4, p. 2 (1st ed. 2002) (hereinafter, “GIPS HANDBOOK”).

require additional interpretation or clarification; or through members of the IPC, CFAI staff and others active in CFAI activities as volunteers, who publicly and privately speak on the Standards and various approaches to GIPS compliance, including interpretations of various provisions of the Standards.¹²⁸ Guidance Statements, which are subject to the most formalized finalization process of these three interpretive sources, are intended to consolidate and incorporate all existing interpretations by the IPC Interpretations Subcommittee.¹²⁹ Before new GIPS provisions or Guidance Statements are finalized, CFAI publishes its proposals for public comment on its website for a period of approximately 60-90 days, depending upon the complexity of the issue. At the conclusion of this period, the Interpretations Subcommittee presents a modified provision or Guidance Statement to the IPC for approval. Unlike Guidance Statements, interpretive responses electronically posted by the Standards Helpdesk are not submitted for public comment. The primary purpose of the Standards Helpdesk is to assist firms in complying with the Standards by responding to specific questions.

[C] Enforcement of the Standards

Compliance with the Standards is voluntary.¹³⁰ However, once a firm claims compliance, it must comply at all times on a firmwide basis.¹³¹ GIPS are ethical standards, not legally required, enforced or interpreted. Laws and regulations override GIPS when in conflict.¹³² However, if the Standards impose a higher standard than law and regulation, the Standards control. CFAI's enforcement of the Standards is limited to individuals that are members of CFAI and involved in the preparation or presentation of historical performance by a firm claiming GIPS compliance. CFAI does not have any authority over a firm that does not claim compliance with the Standards. Firms that choose to claim compliance with GIPS are expressly required to comply with all "updates, reports, guidance statements, interpretations or clarifications published by the CFA Institute and the Investment Performance Council"¹³³

The SEC takes an active role in enforcing the Standards.¹³⁴ As part of its investment adviser inspection program, the SEC Staff will determine whether a firm's claim of compliance with GIPS is accurate.¹³⁵ The SEC Staff will examine in detail all aspects of a firm's compliance

¹²⁸ See *Guidance Statements* <http://www.cfainstitute.org/cfacentre/ips/Guid_stmnt.html.

¹²⁹ See *id.*

¹³⁰ GIPS HANDBOOK §1-2, p. 1.

¹³¹ Guidance Statement on Definition of the Firm (Revised) (effective Jan. 1, 2006) (hereinafter, "Firm Definition Guidance Statement").

¹³² GIPS Introduction, I.D.10(i) ("In cases where applicable local or country-specific law or regulation conflicts with the GIPS standards, the Standards require firms to comply with the local law or regulation and make full disclosure of the conflict.")

¹³³ GIPS Standard 0.A.15

¹³⁴ See e.g., *In re* Stan D. Kiefer & Associates and Stanley D. Kiefer, SEC Release No. IA-2023 (Mar. 22, 2002); *In re* Schield Management Company et. al, SEC Release No. IA-1872 (May 31, 2000); *In re* Engebretson Capital Management, Inc. and Lester W. Engebretson, SEC Release No. IA-1825 (Sept. 13, 1999).

¹³⁵ See Lori A. Richards, Director of the SEC Office of Compliance Inspections and Examinations, Division of Investment Management: SEC Roundtable on Investment Adviser Regulatory Issues (May 23, 2000) ("[T]he most common type of area where I think there probably are misunderstandings by advisers is what it takes to constitute

with the Standards, including firm definition, discretion definition, composite creation and maintenance, calculation methodology, recordkeeping, and presentations. The SEC’s jurisdiction with respect to the Standards is based on whether a firm claims compliance with GIPS.¹³⁶ The SEC cannot impose the Standards on any firm that does not claim compliance with the Standards.

§ 6.4.2 Fundamentals of Compliance

The “Fundamentals of Compliance” section of the GIPS standards address the critical issues that a firm is required to consider when claiming GIPS compliance, including firm definition, documenting firm policies and procedures, maintaining compliance with interpretations and updates of the standards, and properly using the claim of compliance and references to GIPS verification.¹³⁷

[A] Definition of the Firm

[1] General Guidelines

Defining the firm is both the responsibility of the entity in question and the “foundation for firm-wide compliance,”¹³⁸ and creates defined boundaries for determining total firm assets.¹³⁹ The firm definition must be fairly and appropriately defined and also be “meaningful, rational, and fair.”¹⁴⁰ Firm definitions may not be defined too narrowly such that they serve as a substitute for defining composites.¹⁴¹ The GIPS standards recommend that a compliant firm adopt the broadest, most meaningful definition of the firm, and consider how it is viewed by the public.¹⁴² For instance, the scope of this definition should include all geographic offices operating under the same company regardless of the actual name of the individual investment

compliance with AIMR standards ... In many of our exams of advisers that claim that they’re AIMR compliant we find that in fact that they’re not appropriately applying the AIMR guidelines Whether it’s because of misunderstandings of the law or more intentional misconduct, the consequences can be very serious if it results in a performance claim or an advertisement that misstates actual performance results.”)

¹³⁶ Lori A. Richards, Director of the SEC Office of Compliance Inspections and Examinations, “Compliance Priorities for Investment Advisers,” Remarks at the Investment Adviser Compliance Summit (May 1, 2000) (“[T]he Commission does not require advisers to comply with AIMR standards *but* if an adviser claims AIMR compliance and has in fact not complied with the standards, the adviser may have made a material misrepresentation.”). The Director of the SEC’s Office of Compliance Inspections and Examinations has explicitly stated that due to the importance of the GIPS standards to potential clients, an erroneous claims of GIPS compliance will be cited in a deficiency letter and advisers may be required to put all clients, consultants and all other recipients of the materials containing a false claim on notice. *See id.* Moreover, if the adviser is deemed to have been fraudulent in its claim of GIPS compliance, the adviser may be referred to the enforcement staff of the SEC. *See id.*

¹³⁷ *See* GIPS Standards 0.A.1 – 0.A.15, Standards 0.B.1 – 0.B.3.

¹³⁸ Firm Definition Guidance Statement, p. 1.

¹³⁹ *Id.* at 4.

¹⁴⁰ *Id.* at 2.

¹⁴¹ *Id.*

¹⁴² Firm Definition Guidance Statement, p. 2; GIPS Standard 0.B.1.

management companies.¹⁴³ The GIPS standards require that each firm disclose its firm definition in its composite presentations¹⁴⁴ and verifiers are also required to verify that the firm's definition is appropriate.¹⁴⁵

Prior to January 1, 2006, firms were permitted to define themselves in one of two primary ways: (1) an entity registered with the appropriate national regulatory authority overseeing the entity's investment management activities; or (2) an investment firm, subsidiary or division held out to existing or potential clients as a distinct business unit.¹⁴⁶ Beginning January 1, 2006, firms may only be defined "as an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business entity."¹⁴⁷ In order to be defined appropriately under the standards, a firm must: (1) be a unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices; (2) retain discretion over the assets it manages and should have autonomy over the investment decision-making process; and (3) hold itself out to existing and potential clients as a separate firm.¹⁴⁸

Whether a business entity is "separate and distinct," and deemed to be held out to the public as a separate firm is a factual determination that may be affected by factors such as whether the business entity is a legal entity, has a distinct market or client type, or whether it uses a separate and distinct investment process.¹⁴⁹ However, whether the firm is a legal entity or utilizes a separate investment process is not necessarily dispositive of the issue of whether the firm is appropriately defined.¹⁵⁰ The Guidance Statement on Definition of the Firm explicitly states that the scope of the definition of the firm may include "[f]inancial service holding companies defined as one global firm with multiple brands, several legal entities, multiple offices, investment teams, and investment strategies."¹⁵¹

[2] Redefinition of the Firm

¹⁴³ Firm Definition Guidance Statement, p. 2; GIPS Standard 0.B.1.

¹⁴⁴ GIPS Standard 4.A.1.

¹⁴⁵ GIPS Verification, III.B.2.a.

¹⁴⁶ Introduction, AIMR-PPS Paragraph 12. *See also* IPC Firm Definition Guidance Statement, p. 1. Prior to January 1, 2005, firms that managed global assets were also permitted to define themselves as all assets managed to one or more base currencies.

¹⁴⁷ GIPS Standard 0.A.2.

¹⁴⁸ Firm Definition Guidance Statement, p. 2.

¹⁴⁹ *Id.*

¹⁵⁰ The IPC ultimately rejected the notion that a firm that holds itself as a separate entity yet does not maintain its own distinct investment process may not be defined as a firm. The proposed Firm Definition Guidance Statement initially had a guiding principle that required the firm to be a "distinct entity with its own distinct investment process." *See* Firm Definition Guidance Statement (Adopting Release), p. 4. The IPC ultimately removed this principle in response to commenters' opposition to the principle.

¹⁵¹ Firm Definition Guidance Statement, p. 2. Other examples of permissible firm definitions include: offices operating under a single brand name, other names resulting from mergers, acquisitions, etc., trading under a different name for branding purposes, a firm with one brand but employing multiple strategies and investment teams, or all offices trading under a globally recognizable trading name with regional/country specific additions. *See id.*

Changes in a firm's organization may not result in the modification of the firm's historical composite returns.¹⁵² If an entity redefines its firm definition, it should disclose the date and rationale behind the redefinition.¹⁵³ Changes in investment style, investment personnel, or a firm name change are not sufficient justifications for firm redefinitions unless the change has resulted in the firm being held out to the public in a significantly different way.¹⁵⁴ Consistent with GIPS' recommendation for expansive firm definitions, the Standards recognize the need for a multiple defined firm to clearly disclose the firms included within a parent company.¹⁵⁵ Accordingly, GIPS recommends that each firm: (i) disclose a list of the other firms within the parent company; and (ii) clearly state which firm claims GIPS compliance.¹⁵⁶ In addition, when jointly marketing with other firms, whether within an organization or externally, "the firm claiming compliance must be sure that it is clearly defined and separate relative to any other firms being marketed and that it is clear which firm is claiming compliance."¹⁵⁷

[3] Total Firm Assets

How a firm is ultimately defined will affect the boundaries for determining total firm assets.¹⁵⁸ Total firm assets should include all assets for which the firm has investment management responsibility, including assets managed by sub-advisers that the firm has discretionary authority to hire or fire.¹⁵⁹ Total firm assets are determined by aggregating the market value of all discretionary and non-discretionary assets under management, including both fee-paying and non-fee-paying accounts.¹⁶⁰ Assets to which GIPS cannot be applied (*e.g.*, investment vehicles based on cost or book values) must not be included in a firm's total firm assets.¹⁶¹

[4] Sub-Advisors

If a firm has discretionary authority to hire and/or fire a sub-advisor, the firm must include the sub-advisor's performance in its performance history and include those assets in the firm's total firm assets.¹⁶² Only the performance history attached to the assets assigned by the

¹⁵² GIPS Standard 0.A.5; Firm Definition Guidance Statement, p. 3.

¹⁵³ GIPS Standard 4.A.21; Firm Definition Guidance Statement, p.3.

¹⁵⁴ Firm Definition Guidance Statement, p. 3. It is important to note that a firm that redefines itself must examine whether its performance history may be preserved. See Guidance Statement on Performance Record Portability.

¹⁵⁵ *Id.* at 3.

¹⁵⁶ *Id.* ("When jointly marketing with other firms, the firm should be sure that it is clearly defined relative to the other firms being marketed and apparent which firm is claiming compliance If a parent company contains multiple defined firms, it is recommended that each firm within the parent company disclose a list of the other firms contained within the parent company.").

¹⁵⁷ Firm Definition Guidance Statement (Adopting Release), p. 2. See also GIPS Standard 0.A.14.

¹⁵⁸ Firm Definition Guidance Statement, p. 3.

¹⁵⁹ Firm Definition Guidance Statement, p. 3.

¹⁶⁰ GIPS Standard 0.A.3.

¹⁶¹ Firm Definition Guidance Statement, p. 3.

¹⁶² GIPS Standard 0.A.4; Firm Definition Guidance Statement, p.4.

firm to the sub-advisor may be included in the firm’s performance history.¹⁶³ In addition, beginning January 1, 2006, firms must disclose the use of a sub-advisor and the period during which the sub-advisor was used in their performance presentations.¹⁶⁴

[B] GIPS Policies and Procedures

One of the fundamentals of compliance under GIPS is the requirement that firms “document, in writing, their policies and procedures used in establishing and maintaining compliance with all the applicable requirements of the GIPS standards.”¹⁶⁵ Such policies and procedures may include the following:

- criteria used to define the firm;
- criteria used to define discretion;
- valuation policies;
- calculation methodologies;
- how large cash flows are handled;¹⁶⁶
- how new and terminated portfolios are handled; and
- policies for using a minimum portfolio size.¹⁶⁷

Firms that are registered under the Advisers Act are also required by that Act to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons.¹⁶⁸

[C] Claim of Compliance

A firm that satisfies the required provisions of the GIPS standards must use the following compliance statement in its presentations to its prospective clients: “[Firm name] has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).” The following claims of compliance are deemed to be inappropriate under the Standards:

¹⁶³ Firm Definition Guidance Statement, p. 4.

¹⁶⁴ GIPS Standard 4.A.18; Firm Definition Guidance Statement, p. 4.

¹⁶⁵ GIPS Standard 0.A.6.

¹⁶⁶ For additional information on dealing with large external cash flows, see the Guidance Statement on the Treatment of Significant Cash Flows (Revised) (effective Jan. 1, 2006).

¹⁶⁷ CFA Institute, “Questions and Answers on the Revised GIPS Standards,” p. 4.; see also GIPS Interpretations on Fundamentals of Compliance (Q: “What information must we include in our GIPS-compliance policies and procedures?”).

¹⁶⁸ Rule 206(4)-7 under the Advisers Act.

- claims of partial compliance with the Standards (*e.g.*, claims compliance with GIPS “except for”)¹⁶⁹
- claims that a calculation methodology is “in accordance” or “in compliance” with GIPS;¹⁷⁰ and
- claims that refer to the performance of a single, existing client as being calculated in accordance with GIPS, unless such claim is made in the course of reporting performance to that existing client.¹⁷¹

[D] Firm Fundamental Responsibilities

Once a firm claims compliance with the GIPS standards, it must make every reasonable effort to provide a GIPS-compliant performance to each of its prospective clients unless the client has received a compliant presentation within the previous 12 months.¹⁷² If a firm has provided a compliant presentation to a prospective client within the past 12 months, the firm may present additional information that does not meet the requirements of the GIPS standards.¹⁷³ Under such circumstances, a reference should be included that a composite presentation in compliance with the GIPS standards is available upon request.¹⁷⁴ Every firm must provide a list¹⁷⁵ and description¹⁷⁶ of its composites and/or a compliant presentation for any composite listed on such list upon request by a prospective client.¹⁷⁷

§ 6.4.3 Input Data¹⁷⁸

¹⁶⁹ GIPS Standard 0.A.8.

¹⁷⁰ GIPS Standard 0.A.9.

¹⁷¹ GIPS Standard 0.A.10.

¹⁷² GIPS Standard 0.A.11.

¹⁷³ See Interpretations on Client Updates (Q: “We provide a compliant presentation to all prospective clients when we first meet with them. However, we often are in discussions with large prospective clients for many months, if not years. We send them updated composite information quarterly. Must the quarterly updates include all required disclosures?”).

¹⁷⁴ See *id.*

¹⁷⁵ The composite list must reflect discontinued composites for 5 years at minimum since discontinuation. GIPS Standard 0.A.12.

¹⁷⁶ A composite description is defined by the Standards as “General information regarding the strategy of the composite. A description may be more abbreviated than the composite definition but includes all salient features of the composite.” GIPS Glossary, “Composite Description.” The full composite definition, which must be made available to clients upon request, includes the “detailed criteria that determine the allocation of portfolios to composites.” GIPS Glossary, “Composite Definition”; GIPS Standard 3.A.2. Composite definitions must be documented in the firm’s GIPS policies and procedures.

¹⁷⁷ GIPS Standards 0.A.12, 0.A.13.

¹⁷⁸ For additional information regarding valuation principles, see the Guidance Statement on Calculation Methodology (Revised) (effective Jan. 1, 2006) (hereinafter, “Calculation Methodology Guidance Statement”).

Standard 1.A.1 requires that all data and information that supports a firm's performance presentation and is necessary to perform the required calculations be captured and maintained.¹⁷⁹ The Standards also require that portfolios be valued at their market value, and not their cost or book value.¹⁸⁰ "Market value" is defined under the Standards as the "current price at which investors buy or sell securities at a given time."¹⁸¹ The frequency of which portfolios must be valued depends upon the relevant period; for periods prior to January 1, 2001, portfolios must be valued at least quarterly.¹⁸² From January 1, 2001 to January 1, 2010, portfolios must be valued at least monthly.¹⁸³ After January 1, 2010, portfolios must be valued: (a) on the date of all large external cash flows;¹⁸⁴ and (b) as of the calendar month-end or the last business day of the month.¹⁸⁵

All firms must use trade date accounting for periods beginning January 1, 2005.¹⁸⁶ Firms must use accrual accounting for fixed income securities and all other assets that accrue interest income.¹⁸⁷ Market values of fixed-income securities must include accrued income.¹⁸⁸ Beginning on January 1, 2006, the beginning and ending valuation dates of composites must be consistent and must be at calendar year-end or the last business day of the year, unless the composite is reported on a non-calendar fiscal year.¹⁸⁹

§ 6.4.4 Calculation Methodology¹⁹⁰

In order to facilitate the comparison between various investment firms' returns, the uniformity of method by which returns are calculated is integral.¹⁹¹ Therefore, GIPS requires that the following principles be followed by a GIPS-compliant firm when calculating *portfolio* returns:

¹⁷⁹ GIPS Standard 1.A.1.

¹⁸⁰ GIPS Standard 1.A.2.

¹⁸¹ GIPS Glossary, "Market Value."

¹⁸² GIPS Standard 1.A.3.

¹⁸³ GIPS Standard 1.A.3.

¹⁸⁴ The term "external cash flow" is defined as "cash, securities, or assets that enter or exit a portfolio." GIPS Glossary, "External Cash Flow." For additional information on dealing with large external cash flows, see the Guidance Statement on the Treatment of Significant Cash Flows (Revised) (effective Jan. 1, 2006).

¹⁸⁵ GIPS Standard 1.A.4.

¹⁸⁶ GIPS Standard 1.A.5. A firm that recognizes the asset or liability within at least 3 days of the date the transaction is entered into (*i.e.*, trade date, T+1, T+2 or T+3) will satisfy this requirement. GIPS Glossary, "Trade Date Accounting."

¹⁸⁷ GIPS Standard 1.A.6.

¹⁸⁸ GIPS Standard 1.A.6.

¹⁸⁹ GIPS Standard 1.A.7.

¹⁹⁰ For additional information on the GIPS requirements on guiding principles on calculation methodology, see the Calculation Methodology Guidance Statement.

¹⁹¹ See Calculation Methodology Guidance Statement, p. 1 ("Achieving comparability among investment management firms' performance presentations requires as much uniformity as possible in the methodology used to calculate portfolio and composite returns.")

- The calculation method employed must represent returns in a fair manner, not be misleading, and be applied consistently;¹⁹²
- Total return must be used, which must include realized and unrealized gains and losses plus income;¹⁹³
- Time-weighted rates of return¹⁹⁴ that adjust for external cash flows must be used and periodic returns must be geometrically linked;¹⁹⁵
- External cash flows must be treated pursuant to the firm’s documented composite-specific policy;¹⁹⁶
- For periods beginning January 1, 2005, the firm must, at a minimum, use approximated rates of return that adjust for daily-weighted external cash flows.¹⁹⁷ For periods beginning January 1, 2010, firm must, at a minimum, value portfolios on the date of all large external cash flows;¹⁹⁸
- Returns from cash and cash equivalents must be included in total returns;¹⁹⁹
- Actual trading expenses must be reflected in all returns; estimated trading expenses must not be used;²⁰⁰ and
- In the case of a bundled fee,²⁰¹ if actual direct trading expenses cannot be identified and segregated, then returns must be reduced as follows:
 - (a) *Gross-of-fee returns.* Returns must be reduced by the entire bundled fee or the portion that includes actual direct trading expenses.²⁰²

¹⁹² Calculation Methodology Guidance Statement, p. 2.

¹⁹³ GIPS Standard 2.A.1.

¹⁹⁴ The term “time-weighted rate of return” is defined as the “[c]alculation that computes period-by-period returns on an investment and removes the effects of external cash flows, which are generally client-driven, and best reflects the firm’s ability to manage assets according to a specified strategy or objective. GIPS Glossary, “Time-Weighted Rate of Return.”

¹⁹⁵ GIPS Standard 2.A.2.

¹⁹⁶ GIPS Standard 2.A.2. For additional information on dealing with large external cash flows, see the Guidance Statement on the Treatment of Significant Cash Flows (Revised) (effective Jan. 1, 2006).

¹⁹⁷ GIPS Standard 2.A.2.a.

¹⁹⁸ GIPS Standard 2.A.2.b.

¹⁹⁹ GIPS Standard 2.A.4.

²⁰⁰ GIPS Standard 2.A.5.

²⁰¹ A “bundled fee” is defined under the Standards as a fee that combines multiple fees into one fee, which may include any combination of management, transaction, custody and other administrative fees. GIPS Glossary, “Bundled Fee.”

²⁰² GIPS Standard 2.A.7.a.

- (b) *Net-of-fee returns.* Returns must be reduced by the entire bundled fee or the portion that includes direct trading expenses and the investment management fee.²⁰³

The following principles apply to the calculation of *composite* returns:

- Individual portfolio returns must be asset weighted to calculate composite returns, using beginning-of-period values or a method reflecting both beginning-of-period values and external cash flows.²⁰⁴
- For periods beginning January 1, 2006, composite returns must be calculated by asset weighting individual portfolio returns at least quarterly and for periods beginning January 1, 2010, monthly;²⁰⁵ and
- Periodic returns must be geometrically linked.

§ 6.4.5 Constructing Composites

How a firm defines its composites is one of the three most fundamental issues when claiming compliance with the Standards.²⁰⁶ Once the other two issues have been resolved, the firm definition and definition of discretion, a firm may construct composites based upon the strategies that it implements.²⁰⁷

A composite is defined under the Standards as an “[a]ggregation of individual portfolios representing a similar investment mandate, objective, or strategy.”²⁰⁸ In order to prevent firms from cherry-picking performance, firms must include all actual, fee-paying, discretionary portfolios in at least one composite, irrespective of whether the firm ever plans to market the strategy employed.²⁰⁹ Although neither model nor non-discretionary portfolios may be included in the firm’s composites, non-fee paying discretionary portfolios may be included in a composite so long as the firm discloses percentage of composite assets represented by non-fee-paying portfolios as of the end of each annual period.²¹⁰ Assuming that it qualifies for inclusion in a

²⁰³ GIPS Standard 2.A.7.b.

²⁰⁴ GIPS Standard 2.A.2.3.

²⁰⁵ GIPS Standard 2.A.6.

²⁰⁶ See Guidance Statement on Composite Definition (Revised), p. 1 (effective Jan. 1, 2006) (hereinafter, “Composite Definition Guidance Statement”).

²⁰⁷ Composite Definition Guidance Statement, p. 1.

²⁰⁸ GIPS Glossary, “Composite.”

²⁰⁹ See GIPS Standard 3.A.1; Composite Definition Guidance Statement, p. 1. See also GIPS Interpretations on Composite Construction (Q: “Firm B manages several portfolios according to a particular strategy; however, the firm does not ever plan to market the strategy. Do these portfolios have to be included in a composite?”).

²¹⁰ See GIPS Standard 3.A.1; Composite Definition Guidance Statement, p. 1; GIPS Interpretations on Model Results (Q: “Will a model portfolio, compiled by an adviser who does not have discretion to invest assets in accordance with the model, qualify for a composite?”) (“Model, or advisory-only assets are not considered assets of the firm, and are not included in total firm or composite assets.”). Moreover, if the firm decides to include non-fee-paying portfolios in its composites, it must treat the non-fee-paying portfolios to the same standards as its fee-paying

composite, a portfolio may be included in more than one composite.²¹¹ Each composite must only reflect actual assets under management within the defined firm; simulated or model portfolios may not be linked with actual performance.²¹² For instance, a firm may not substitute missing performance with the composite's benchmark return, irrespective of whether the missing performance is for a brief period (*e.g.*, quarter).²¹³

Composites must be defined according to similar investment objectives and/or strategies²¹⁴ and the full composite definition must be provided to clients upon request.²¹⁵ The CFAI suggests, but does not require, the following hierarchy for defining composites: investment mandate; asset classes; style or strategy; benchmarks; risk/return characteristics.²¹⁶ Composites may be further defined by relevant client constraints or guidelines, such as the extent of derivatives, hedging and/or leverage use; treatment of taxes; client type; instruments used; portfolio sizes; client characteristics; portfolio types; and base currency.²¹⁷

Each firm's composite definitions must provide detailed criteria on how the firm allocates its portfolios among its composites.²¹⁸ The criteria for defining composites must be applied consistently, and composites must be representative of the firm's products and be consistent with its marketing strategy.²¹⁹ If the firm sets a minimum asset level for inclusion in a composite, the firm must disclose the minimum asset level²²⁰ and consistently apply this requirement for inclusion in the composite by excluding all portfolios that fall below that asset level.²²¹ Any changes to the minimum asset level must not be applied retroactively.²²² In addition, the Standards recommend that firms refrain from marketing a composite with a minimum asset level to a prospective client that is unable to satisfy the minimum.²²³ Each firm that establishes a minimum asset level must document its policies on how portfolios are treated if they fall below

portfolios, such as refraining from moving the portfolio in and out of the composite without documented changes in client guidelines or a composite redefinition makes it appropriate to do so. *See Composite Definition Guidance Statement*, p. 1.

²¹¹ Composite Definition Guidance Statement, p. 1.

²¹² GIPS Standard 3.A.8.

²¹³ GIPS Interpretations on Model Results (Q: "Our firm had a composite which lost all of its constituent portfolios for one quarter. May we continue our track record without interruption by using the benchmark return for the missing quarter of performance?").

²¹⁴ GIPS Standard 3.A.2.

²¹⁵ GIPS Standard 3.A.2.

²¹⁶ Composite Definition Guidance Statement, p. 6.

²¹⁷ Composite Definition Guidance Statement, pp. 6-7.

²¹⁸ Composite Definition Guidance Statement, p. 4.

²¹⁹ Composite Definition Guidance Statement, p. 2.

²²⁰ GIPS Standard 4.A.3.

²²¹ GIPS Standard 3.A.9.

²²² GIPS Standard 3.A.9.

²²³ GIPS Standard 3.B.3.

the minimum, and apply this policy consistently.²²⁴ If all of the portfolios in a composite fall below the minimum and are removed from the composite pursuant to the firm’s policies, the performance record of the composite would terminate. If, subsequently, the portfolios meet the minimum asset level or new portfolios are added to the composite, the prior performance may be presented but not linked to the ongoing performance results of the composite.²²⁵

The redefinition of a composite should occur only rarely, and should not result from a modification of an existing strategy.²²⁶ Rather, changes in investment strategies should result in the construction of a new composite.²²⁷ In the event that the firm determines to redefine a composite, it must not apply the change retroactively and must disclose the nature and date of the change.²²⁸ Changes to a composite’s name must also be disclosed.²²⁹ Composites that are discontinued must remain on the firm’s list of composites for five years from the date of discontinuation.²³⁰

Firms are prohibited from including its non-discretionary portfolios in its discretionary composites.²³¹ Each firm is responsible for creating its own definition of discretion, applying this definition on a consistent basis, and documenting the definition of discretion in its GIPS policies and procedures.²³² Whether a portfolio is non-discretionary depends upon whether the firm is unable to implement its intended strategy.²³³ If a client-driven investment restriction prevents the firm from fully implementing its strategy to the extent that the portfolio would no longer be representative of the strategy, a firm may either (i) characterize the portfolio as non-discretionary, or (ii) create a composite with portfolios carrying similar restrictions.²³⁴ Examples of client-imposed restrictions that may render a portfolio to be non-discretionary include: restriction of trading subject to client approval; firm restrictions on asset allocation; tax considerations; limiting sale of certain securities; restriction on purchase of types of securities;

²²⁴ Composite Definition Guidance Statement, p. 4.

²²⁵ Composite Definition Guidance Statement, p. 4.

²²⁶ Composite Definition Guidance Statement, p. 4.

²²⁷ Composite Definition Guidance Statement, p. 4.

²²⁸ GIPS Statement 4.A.22; Composite Definition Guidance Statement, p. 4.

²²⁹ GIPS Statement 4.A.23; Composite Definition Guidance Statement, p. 4.

²³⁰ Composite Definition Guidance Statement, p. 4.

²³¹ Composite Definition Guidance Statement, p. 2.

²³² See Composite Definition Guidance Statement, p. 2; GIPS Interpretation on Discretion (Q: “Firm C manages a portfolio that recently had new investment restrictions placed on it by the client, rendering it non-discretionary. Should the firm retroactively remove that portfolio from its composite?”).

²³³ Composite Definition Guidance Statement, p. 2.

²³⁴ Composite Definition Guidance Statement, p. 2.

cash flow requirements; or legal restrictions.²³⁵ If a firm classifies a portfolio as non-discretionary, it should document its reasons for doing so.²³⁶

New portfolios must be added to composites on a timely and consistent basis after the portfolio has come under the firm's management, unless otherwise directed by the client.²³⁷ Portfolios that have been terminated must be reflected in the historical returns of the composite up to the last full measurement period that the portfolio was managed.²³⁸ Portfolios may not be moved from one composite into another, except where there are documented changes by the client²³⁹ or in the rare case in which a composite has been redefined.²⁴⁰ The portfolio's historical record must remain with the appropriate composite.²⁴¹

[A] Carve-Outs

General Requirements

A carve-out is defined under the Standards as "a single or multiple asset segment of a multiple asset class portfolio."²⁴² Carve-outs are "used to create a track record for a narrower mandate from a portfolio managed to a broader mandate" and are usually based upon characteristics such as asset class, geographic region, or industry sector.²⁴³ The use of carve-out returns raises two concerns: (1) the presentation of carve-out returns may be misleading if it does not represent what would have been achieved in a portfolio that was dedicated to that strategy;²⁴⁴ and (2) if cash is not accounted for separately and not allocated to the carve-out returns, the accuracy of the calculation of the carve-out returns is jeopardized.²⁴⁵ To address the former concern, the Standards require that the carved-out segment "be discretionary and structured materially the same as a portfolio dedicated to that strategy and have a risk profile that is substantially similar."²⁴⁶ A firm may not combine different carve-outs to construct a composite that represents a simulated strategy for purposes of complying with GIPS, but may

²³⁵ See Composite Definition Guidance Statement, pp. 2-3. The CFAI warns, however, that "[f]ew of these restrictions are reasons to *automatically* classify a portfolio as non-discretionary, as the firm must determine if the restriction will significantly hinder the implementation of the intended strategy." See *id.* at 3.

²³⁶ Composite Definition Guidance Statement, p. 2.

²³⁷ GIPS Standard 3.A.3.

²³⁸ GIPS Standard 3.A.4.

²³⁹ Documentation may include letters, faxes, e-mails and/or written memoranda documenting oral conversations with the client. See Composite Definition Guidance Statement, pp. 4-5.

²⁴⁰ GIPS Standard 3.A.5; Composite Definition Guidance Statement, p. 2.

²⁴¹ GIPS Standard 3.A.5.

²⁴² GIPS Glossary, "Carve-Out."

²⁴³ See Guidance Statement on the Treatment of Carve-Outs (Revised), p. 1 (effective Jan. 1, 2006) (hereinafter, "Carve-Out Guidance Statement").

²⁴⁴ See Carve-Out Guidance Statement, p. 1.

²⁴⁵ See Carve-Out Guidance Statement, p. 1.

²⁴⁶ Carve-Out Guidance Statement, p. 2.

present such information as supplemental information.²⁴⁷ The firm is responsible for establishing a policy for creating, using and calculating carve-out returns and applying this policy on a consistent basis.²⁴⁸

If the segment is carved-out of a particular strategy, the firm must carve-out all similar portfolio segments that are managed to that strategy and include such performance results in the composite.²⁴⁹ Firms are prohibited from cherry-picking specific portfolios to include in the stand-alone composite, and must include all portfolios that satisfy the criteria for inclusion in the composite.²⁵⁰ In addition, when presenting net-of-fees performance of composites that contain carve-outs, the carve-out returns must reflect the deduction of fees, which must be representative of the fees charged for a separately managed portfolio for the asset class carved-out considering the fee schedule for the composite containing the carve-outs.²⁵¹

Cash Allocation Requirements

Carve-out segments that exclude cash must not be used to represent a discretionary portfolio and therefore may not be included in composite returns.²⁵² Prior to January 1, 2010, if a single asset class is carved out of a multiple asset class portfolio to be presented as part of a single asset composite, a firm must allocate cash to the carve-out returns in a timely and consistent manner.²⁵³ The Standards do not require that a specific cash allocation methodology be employed, but the method that the firm selects must be documented and applied consistently.²⁵⁴ The Guidance Statement on the Treatment of Carve-Outs specify two acceptable allocation methods for use prior to January 1, 2010: (i) *Beginning of Period Allocation*, in which the cash allocation for each portfolio segment is identified at the beginning of the period; and (ii) *Strategic Asset Allocation*, in which the cash allocation is based directly upon the target strategic asset allocation (*i.e.*, the cash position will constitute the difference between the actual asset allocation and strategic asset allocation).²⁵⁵ Until 2010, the Standards recommend, but do not require, that the carve-out be managed separately with its own cash balance (*i.e.*, the segment should be managed as if it were a separate portfolio rather than a segment of a larger portfolio).²⁵⁶ However, beginning January 1, 2010, this recommendation will become a

²⁴⁷ Carve-Out Guidance Statement, p. 4. For example, a firm may not carve-out an equity and fixed income portion from its composites to create a simulated balanced composite and link it to the actual results of the firm. *See id.*

²⁴⁸ Carve-Out Guidance Statement, p. 2.

²⁴⁹ Carve-Out Guidance Statement, p. 2. However, if a firm decides to carve-out a particular segment of a portfolio, it does not have to carve-out the remaining portions of the portfolio to form a stand-alone composite. *See id.*

²⁵⁰ Composite Definition Guidance Statement, p. 2.

²⁵¹ Carve-Out Guidance Statement, p. 2.

²⁵² GIPS Standard 3.A.7.

²⁵³ GIPS Standard 3.A.7.

²⁵⁴ Carve-Out Guidance Statement, p. 2; GIPS Interpretations on Carve-Outs (Q: “Our firm has a balanced portfolio with a defined asset allocation”)

²⁵⁵ Carve-Out Guidance Statement, pp. 2-3.

²⁵⁶ GIPS Standard 3.B.1.

requirement in order for a carve-out to be included in single asset class composite returns.²⁵⁷ Acceptable methods of accounting for cash positions include: (i) *Separate Portfolios*, where cash and securities are actually segregated into a separate portfolio at the custodian; (ii) *Multiple Cash Accounts*, where each segment's cash is accounted for separately; and (iii) *Sub-Portfolios*, where each portfolio segment is accounted for as if it were a separate portfolio.²⁵⁸ If a firm creates carve-outs and allocates cash to the carve-out prior to January 1, 2010, but does not choose to apply any method for accounting for the cash position to the carve-out (thereby discontinuing the carve-out for periods after January 1, 2010): (1) the performance record of the carve-out using a cash allocation method must not be changed; (2) the firm must disclose the historical inclusion of the carve-out and the period of inclusion in its presentation; and (3) if the composite consists only of carve-outs using cash allocation methods and does not apply any method of accounting for the cash position to any of the carve-outs in the composite for periods after January 1, 2010, the firm must treat the composite as discontinued but maintain the composite on its list of composites for five years after discontinuation.²⁵⁹

Required Disclosures

Beginning January 1, 2006, if a composite includes or is formed using single-asset class carve-outs, the firm must disclose the percentage of the composite that is composed of carve-outs prospectively for each period.²⁶⁰ In addition, firms must disclose the cash allocation method employed for periods prior to January 1, 2010 and are encouraged to disclose changes to such methods, if any.²⁶¹

Net of fee performance results must disclose the fee that was applied to the carved-out portion of the composite. For periods prior to January 1, 2010, Standard 4.A.15 requires that firms disclose the cash allocation method when a single asset class is carved out of a multiple asset portfolio and the returns are presented as part of a single asset composite.²⁶² The firm should also disclose any modification to the cash allocation method.²⁶³ If a composite is formed using single-asset carve-outs from multiple asset composites, Standard 5.A.6 requires that the presentation include: (i) a list of the underlying composites from which the carve-out was drawn; and (ii) the percentage of each composite the carve-out represents. Beginning on January 1, 2006, if a composite includes or is formed using single asset class carve-outs from multiple asset class portfolios, the presentation must include just the percentage of the composite that is composed of carve-outs prospectively for each period.²⁶⁴

²⁵⁷ GIPS Standard 3.A.7.

²⁵⁸ Carve-Out Guidance Statement, p. 3.

²⁵⁹ Carve-Out Guidance Statement, pp. 3-4.

²⁶⁰ GIPS Standard 5.A.5; Carve-Out Guidance Statement, p. 4.

²⁶¹ GIPS Standard 4.A.11; Carve-Out Guidance Statement, p. 4.

²⁶² AIMR-PPS Standard 4.A.15.

²⁶³ Guidance Statement on the Treatment of Carve-Outs, p. 5.

²⁶⁴ See GIPS Standard 5.A.5.

§ 6.4.6 Disclosures

A firm that claims compliance with GIPS must disclose the following information in its GIPS-compliant presentations:²⁶⁵

- firm definition used to determine total firm assets and firm-wide compliance;²⁶⁶
- availability of a complete list and description of the firm's composites;²⁶⁷
- minimum asset level (if any), and any changes thereto, below which portfolios are excluded from the composite;²⁶⁸
- currency used to express performance;²⁶⁹
- presence, use and extent of leverage or derivatives (if material), and description of the use, frequency and characteristics of the instruments to identify risks;²⁷⁰
- whether returns are gross or net-of-fees;²⁷¹
- details of the treatment of withholding tax on dividends, interest income, and capital gains. If indexes are net-of-taxes, the firm must disclose the tax basis of the benchmark versus that of the composite;²⁷²
- known inconsistencies in the exchange rate used among portfolios within a composite and between the composite and the benchmark;²⁷³
- fee schedule appropriate to the presentation;²⁷⁴
- if a composite contains portfolios with bundled fees, the firm must disclose: (i) for each annual period shown the percentage of composite assets that is bundled fee portfolios;²⁷⁵ and (ii) the various types of fees included in the bundled fee;²⁷⁶

²⁶⁵ Firms are not required to give negative assurance for disclosures that are not applicable to the firm. See CFA Institute, "Questions and Answers on the Revised GIPS Standards," p. 4 ("If a situation described in a disclosure requirement does not exist at a firm, or is not applicable to a specific composite, no disclosure is required.").

²⁶⁶ GIPS Standard 4.A.1.

²⁶⁷ GIPS Standard 4.A.2.

²⁶⁸ GIPS Standard 4.A.3.

²⁶⁹ GIPS Standard 4.A.4.

²⁷⁰ GIPS Standard 4.A.5.

²⁷¹ GIPS Standard 4.A.6.

²⁷² GIPS Standard 4.A.7.

²⁷³ GIPS Standard 4.A.8.

²⁷⁴ GIPS Standard 4.A.12.

²⁷⁵ GIPS Standard 4.A.13.

- when presenting gross-of-fee returns, whether any other fees are deducted in addition to direct trading expenses;²⁷⁷
- when presenting net-of-fee returns, whether any other fees are deducted in addition to the advisory fee and direct trading expenses;²⁷⁸
- that additional information regarding policies for calculating and reporting returns is available upon request;²⁷⁹
- the composite description²⁸⁰ and composite creation date;²⁸¹ and
- the dispersion measure presented.²⁸²

The following disclosures must be made only if applicable to the firm and/or the particular composite presentation:

- the date and reason for any firm redefinition;²⁸³
- beginning January 1, 2006, the use of a subadviser and the periods of use;²⁸⁴
- that the presentation adheres to law that conflicts with the GIPS requirements, and the manner in which it conflicts;²⁸⁵
- for performance presented for non-compliant periods prior to January 1, 2000, the period of non-compliance and how the presentation is not compliant with the Standards;²⁸⁶
- for periods prior to January 1, 2010, when a single asset class is carved out of a multiple asset portfolio and returns are presented as part of a single asset composite, the policy used to allocate cash to the carve-out returns;²⁸⁷

²⁷⁶ GIPS Standard 4.A.14.

²⁷⁷ GIPS Standard 4.A.15.

²⁷⁸ GIPS Standard 4.A.16.

²⁷⁹ GIPS Standard 4.A.17.

²⁸⁰ GIPS Standard 4.A.20.

²⁸¹ GIPS Standard 4.A.24. The composite creation date is the date that the firm first groups the portfolios to create the composite. See Composite Definition Guidance Statement, p. 4. The composite creation date is not the same as its inception date, which is the earliest date that performance is reported for the composite. See *id.*

²⁸² GIPS Standard 4.A.26.

²⁸³ GIPS Standard 4.A.21.

²⁸⁴ GIPS Standard 4.A.18.

²⁸⁵ GIPS Standard 4.A.9.

²⁸⁶ GIPS Standard 4.A.10.

- the date and nature of a composite redefinition;²⁸⁸
- changes to the name of a composite;²⁸⁹ and
- that prior to January 1, 2010, the firm does not use calendar month-end portfolio valuations or valuations on the last business day of the month.²⁹⁰

§ 6.4.7 Presentation and Reporting

A firm that claims compliance with the Standards must include in its presentations the following required items:

- for each composite presented, at least 5 years²⁹¹ of performance that meets the Standards (or since firm or composite inception if the firm or composite has existed for less than 5 years), which must be increased annually until 10 years of performance is presented.²⁹² Performance of less than one year may not be annualized;²⁹³
- annual returns for each year presented;²⁹⁴
- number of portfolios and amount of assets in the composite at the end of each annual period, unless the composite contains 5 portfolios or less in which case the number of portfolios is not required;²⁹⁵

²⁸⁷ GIPS Standard 4.A.11.

²⁸⁸ GIPS Standard 4.A.21.

²⁸⁹ GIPS Standard 4.A.23.

²⁹⁰ GIPS Standard 4.A.25.

²⁹¹ A firm that has been in existence for less than 1 year is not prohibited from claiming compliance with the Standards. A firm may be GIPS compliant so long as it meets the requirements of the Standards and has any performance to report. See GIPS Interpretations on Partial Period Returns (Q: “Provision 5.A.1.b requires the presentation of annual returns for all years”).

²⁹² A firm that has claimed compliance with an IPC-endorsed Country Version of GIPS (“CVG”) prior to the effective date of the revised GIPS standards, such as the AIMR-PPS Standards, may not eliminate previously reported CVG-compliant periods. The CFA Institute has clarified, “Since the GIPS Standards require firms to show five year of compliant track record building to ten years, the firm that previously complied with a CVG must continue to show their historical performance, building up to ten years, or since composite inception.” CFA Institute, “Questions and Answers on the Revised GIPS Standards,” p. 2. Therefore, an AIMR-PPS compliant firm that previously reported 10 years of performance may not present only 5 years of history and claim compliance with the GIPS standards. Rather, the firm must present all 10 years of performance results.

²⁹³ GIPS Standard 5.A.3; see also GIPS Interpretations on Partial Period Returns (Q: “Firm A was established on 1 March 1998 and claims compliance with the GIPS standards”) (stating that firms are prohibited from annualizing partial year returns, and that firms must clearly state that any returns of less than 1 year is for a partial period).

²⁹⁴ GIPS Standard 5.A.1.b.

²⁹⁵ GIPS Standard 5.A.1.c.

- either the percentage of total firm assets represented by the composite or the amount of total firm assets at the end of each annual period;²⁹⁶
- measure of dispersion of the individual portfolio returns for each annual period, unless the composite contains 5 portfolios or less for the full year;²⁹⁷
- beginning January 1, 2006, if a composite includes or is formed using single asset class carve-outs from multiple asset class portfolios, the percentage of the composite comprised of carve-outs prospectively for each period;
- total return for the benchmark(s) that reflects the investment strategy of the composite for each annual period, or if none then an explanation why no benchmark is disclosed;²⁹⁸
- if applicable, the date and reasons for changes to a composite's benchmark;²⁹⁹
- if applicable, a description of the creation and re-balancing process of a custom benchmark or combination of multiple benchmarks;³⁰⁰ and
- if applicable, the percentage of the composite assets represented by non-fee-paying portfolios as of the end of each annual period.³⁰¹

Returns that are not GIPS compliant may be linked to compliant returns if the non-compliant returns are for periods prior to January 1, 2000 and the firm discloses the non-compliant periods and explains how the presentation is not in compliance with the Standards.³⁰²

[A] Performance Record Portability

In situations where an existing firm acquires an investment team or another firm, the performance achieved at the prior firm may be substantially relevant to potential clients of the new affiliation. Under the GIPS portability standards, the historical performance record of an investment firm belongs to that firm. A firm's performance record is the product of many factors beyond personnel, including processes, discipline and strategy.³⁰³ If specific GIPS requirements are met, a firm claiming GIPS compliance is *required* under the Standards to "link" the historical

²⁹⁶ GIPS Standard 5.A.1.c.

²⁹⁷ GIPS Standard 5.A.1.d.

²⁹⁸ GIPS Standard 5.A.6.

²⁹⁹ GIPS Standard 5.A.6.

³⁰⁰ GIPS Standard 5.A.6.

³⁰¹ GIPS Standard 5.A.7.

³⁰² GIPS Standard 5.A.2.; GIPS Introduction, I.E.12.c ("Firms may link a non-GIPS-compliant performance record to their compliant history so long as no noncompliant performance is presented after 1 January 2000 and the firm discloses the periods of noncompliance and explains how the presentation is not in compliance with the GIPS standards.").

³⁰³ See GIPS Standard 5.A.4.a; Portability Guidance Statement, p.1.

performance record of the prior firm to its ongoing performance record, thus creating the appearance of a continuous performance history.³⁰⁴ Where such linking is required under the Standards, multiple firms may claim the same performance history as their own.³⁰⁵ However, an SEC-registered adviser that claims compliance with GIPS must also satisfy the regulatory requirements that govern the advertisement of a prior firm's performance records.³⁰⁶ If the GIPS requirements are not met, non-portable performance is *per se* prohibited from being linked to the ongoing performance of a firm claiming GIPS compliance.³⁰⁷ However, a firm may present the performance of the prior firm as supplemental information so long as the presentation is consistent with the Standards' ethical principles, contains appropriate disclosures, and is otherwise compliant with the IPC Guidance Statement on the Use of Supplemental Information.³⁰⁸

A portability analysis under the Standards involves an evaluation of a number of issues and the presence or lack of a particular fact is not necessarily determinative of whether investment performance is portable. Rather, “[d]ue to the unique circumstances surrounding the use of prior performance results, portability of performance must be addressed on a case-by-case basis.”³⁰⁹ Standard 5.A.4 and the Portability Guidance Statement each state that when a portfolio manager, group of managers, or an entire firm joins a new firm, a composite's past performance must be linked to the ongoing results of the new firm if all of the following conditions are true for that composite:

- substantially all the investment decision-makers are employed by the new firm (*i.e.*, research department, portfolio managers, and other relevant staff);

³⁰⁴ See Portability Guidance Statement, p. 2. Performance that is not portable may be presented as “supplemental information” attached to a fully compliant GIPS report, but such non-portable performance may not be linked to the ongoing performance record. Supplemental information is defined as “any performance-related information included as part of a compliant performance presentation that supplements or enhances the required and/or recommended disclosure and presentation provisions of the GIPS standards. Supplemental information should provide users of the composite presentation with the proper context in which to better understand the performance results.” IPC Guidance Statement on the Use of Supplemental Information, p. 1 (effective Jan. 1, 2006) (hereinafter, “Supplemental Information Guidance Statement”). A new firm may represent the historical record of the prior firm as supplemental information to a fully compliant performance presentation so long as (i) the performance is clearly identified as the past record of a prior firm, (ii) the performance is not linked to the performance of the new affiliation, (iii) the performance is supported with appropriate records, and (iv) the use of the past performance record is relevant. See Portability Guidance Statement, p. 1.

³⁰⁵ See Portability Guidance Statement, p. 1.

³⁰⁶ See discussion *supra* § 6.3 Performance Advertising.

³⁰⁷ See Supplemental Information Guidance Statement, p. 2 and discussion *infra* § 6.4.7 Supplemental Information. The only exception to this prohibition is when the performance is specifically requested by a prospective or currently client in a one on one presentation. See Supplemental Information Guidance Statement, p. 2 (“This Guidance Statement does *not* prohibit firms from preparing and presenting information according to specific request from prospective clients.”).

³⁰⁸ See Supplemental Information Guidance Statement.

³⁰⁹ AIMR-PPS Interpretation on Portability (Q: “With regard to portability, if 11 of the 13 investment professionals left their old firm to join a new firm (along with all of the support staff), can the new firm meet the criteria for linking performance history?”).

- the staff and investment decision-making process remain intact and independent within the new firm;
- the new firm has records that document and support the reported performance; and
- the new firm discloses that the performance results from the old firm are linked to the performance record of the new firm.³¹⁰

In the context of one firm joining an existing firm, the foregoing factors must be satisfied *and* substantially all of the assets from the former firm’s composite must transfer to the new firm in order to link the former firm’s performance to the ongoing record of the new firm.³¹¹ If the acquired or acquiring firm is not GIPS-compliant, the combined firm has one year to bring non-compliant assets into compliance with the Standards.³¹²

In essence, the crux of the determination of whether portability of a prior firm’s performance is required is whether the historical records “still warrant having the same label as the old entity.”³¹³ Ultimately, the “applicability and integrity of the performance record is only as good as the ongoing integrity of the strategy and all the contributing factors.”³¹⁴ If the portability requirements are satisfied, the Portability Guidance Statement requires that the *entire* composite history from the old firm, including all portfolios included in the composite, must be used by the new firm and supported by the records necessary to substantiate the performance history of that composite.³¹⁵

In addition to requiring the transfer of substantially the same investment decision-making processes and personnel, both the Standards and the Portability Guidance Statement require that the presentation of linked performance be supported by records that document and support that performance.³¹⁶ The Standards explicitly require that each firm claiming GIPS compliance maintains sufficient records to permit, if needed, the recalculation of account-level and composite-level returns.³¹⁷ A fundamental principle of the Standards is the need for firms to be capable of substantiating or recalculating their performance history if questioned by a potential client, verifier, or regulator. All investment firms are required under the Standards to retain

³¹⁰ See Standard 5.A.4; Portability Guidance Statement, p.2.

³¹¹ Standard 5.A.4.c.

³¹² GIPS Standard 5.A.4.d.

³¹³ Portability Guidance Statement, p. 1.

³¹⁴ Portability Guidance Statement, p. 1.

³¹⁵ See Portability Guidance Statement, Application No. 2 (“In addition to meeting all the elements of the Guidance Statement, in order for a firm to be able to link the composite from the old firm to the on-going performance of the new firm, the entire composite performance history, including all portfolios, must be used.”).

³¹⁶ Standard 5.A.4(a)(iii); Portability Guidance Statement, p. 2.

³¹⁷ See Standard 1.A.1 (“All data and information necessary to support a firm’s performance presentation and to perform the required calculations must be captured and maintained.”). The IPC has proposed, but has not yet adopted, a Guidance Statement on Portfolio Recordkeeping Requirements. See IPC Proposed Guidance Statement on Portfolio Recordkeeping Requirements (proposed effective date Jan. 1, 2006) (“Proposed Recordkeeping Guidance Statement”).

supporting documentations, such as confirmations and statements “that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return (current and historical performance results) of any or all managed accounts that the advisor uses in advertisements.”³¹⁸ Firms must have supporting documentation for each year that the firm shows performance results for all portfolios that are reflected in the performance shown.³¹⁹ Therefore, in order for a firm to properly present the previous performance history of prior firm, *i.e.*, in order for the historical performance to be portable, the new firm must have the underlying data necessary to recreate the performance of its composites for those periods, including beginning and ending market values of all portfolio holdings and intra-period cash flows for the composite for each account in the composite. Although the Standards do not identify specific records that will suffice, records that would be needed to meet the GIPS recordkeeping requirement are typically custodian statements that include a list of all holdings and inflows and outflows.³²⁰ If records are not readily available, the new firm can obtain supporting records in one of two ways: (i) obtain permission of the prior firm to obtain copies of the supporting records; or (ii) attempt to obtain the supporting records from third parties such as clients, custodians, or consultants.³²¹ If the new firm is unable to acquire or obtain access to the records supporting the prior firm’s performance, the new firm may not properly link to the prior firm’s historical performance.³²²

[B] Supplemental Information

Each firm that claims GIPS compliance is encouraged to present relevant additional and supplemental information in order to fully explain performance that is presented in a GIPS-compliant presentation.³²³ “Supplemental information” is defined as “[a]ny performance-related information included as part of a compliant performance presentation that supplements or enhances the required and/or recommended disclosure or presentation provisions of the GIPS standards.”³²⁴ The following is excluded from this definition:

³¹⁸ AIMR PERFORMANCE PRESENTATION STANDARD HANDBOOK, at p. 79 (2nd ed. 1997).

³¹⁹ GIPS HANDBOOK § 4-1.A.1, p. 1; *see also* GIPS Interpretation on Recordkeeping (Q: “Firm A claims compliance with the GIPS standards. It maintains hard copies of the records supporting compliance for three years and discards all records older than three years in an effort to save office space. The performance reported on all its composite presentations shows five years of history. Is the firm in compliance with the GIPS standards?”) (stating that a firm claiming compliance with GIPS must maintain records that support presented performance and “all other relevant data on the firm’s composite presentations.”).

³²⁰ Proposed Recordkeeping Guidance Statement, p. 1 (“Although most firms are looking for a very precise list of the minimum supporting evidence that must be maintained in order to be able to recreate the firm’s performance history, there is not a single list of records that will suffice in all situations.”).

³²¹ *See* GIPS HANDBOOK § 4-5, p.5 (“If the records are not readily available, [a firm] can seek the permission of the team’s previous firm to obtain copies or try to obtain them from third parties who may have retained the records such as clients, custodians or consultants.”).

³²² *See* Portability Guidance Statement, p. 2.

³²³ GIPS Introduction, I.D.10(g); Supplemental Information Guidance Statement, p. 1.

³²⁴ GIPS Glossary, “Supplemental.”

- *Additional information.* “Additional information” is defined under the Standards as “[i]nformation that is required or recommended under the GIPS standards and is not considered as ‘supplemental information’ for the purposes of compliance.”³²⁵
- *Non-performance related information.* Non-performance information includes, but is not limited to, details about the firm, its investment strategy, or its investment process.³²⁶
- *Misleading information.* Misleading information can never be presented under the Standards. Unless specifically requested by a prospective or existing client to be presented in a one-on-one presentation, a firm may not link (1) model, hypothetical, backtested or simulated returns to actual performance,³²⁷ or (2) prior firm non-portable performance to the new firm’s ongoing performance results.³²⁸

Examples of supplemental information may include: carve-out returns that exclude cash; non-portable returns *not linked* to the ongoing performance of the new firm; unlinked model, hypothetical, backtested, or simulated returns; representative account information (e.g., portfolio-level country or sector weightings, and portfolio-level risk measures); attribution; peer group comparisons; risk-adjusted performance; and specific holdings information (composite or portfolio-level).³²⁹ Since supplemental information could potentially mislead clients, the CFAI encourages firms to adhere to the guiding principle of GIPS, i.e., fair representation and full disclosure.³³⁰ A firm may not contradict the information contained in its GIPS-compliant presentation through supplemental information.³³¹

If a firm chooses to provide supplemental information, a firm must make clear that the information is supplemental to a particular GIPS-compliant presentation, which must be provided prior to or with the supplemental information.³³² The CFAI does not prohibit a firm from presenting supplemental and compliant information on the same page or preceding compliant information with supplemental information so long as the placement does not mislead prospective or existing clients, contradict compliant information, is clearly labeled, and references the appropriate GIPS-compliant presentation.³³³ If the presentation of supplemental

³²⁵ GIPS Glossary, “Additional Information.”

³²⁶ See Supplemental Guidance Statement, p. 1.

³²⁷ See Supplemental Guidance Statement, p. 1.

³²⁸ See Supplemental Guidance Statement, p. 2.

³²⁹ See Supplemental Guidance Statement, p. 2.

³³⁰ See Supplemental Guidance Statement, p. 2.

³³¹ See Supplemental Guidance Statement, p. 2.

³³² See Supplemental Guidance Statement, pp. 2, 3.

³³³ See Supplemental Guidance Statement, p. 2; GIPS Interpretations on Supplemental Information (Q: “Can supplemental information be presented on the same page as the compliant presentation?”). See also GIPS Interpretations on Supplemental Information (“XYZ created a presentation booklet that primarily highlights performance information that is considered supplemental. The booklet shows an appropriate compliant presentation in the back of the book as an appendix. Is it acceptable for the supplemental information to precede the compliant presentation?”).

and compliant information on the same page may have the tendency to mislead potential and existing clients, firms should place the information on separate pages.³³⁴

§ 6.4.8 Advertising Guidelines

Firms that advertise their claim of compliance with the GIPS standards in any advertisement (*i.e.*, written material distributed to maintain existing clients or solicit new clients other than a one-on-one presentation or individual client reporting) must adhere to the GIPS Advertising Guidelines or the full GIPS standards.³³⁵ For purposes of the GIPS Advertising Guidelines, “an advertisement includes any materials that are distributed to or designed for use in newspapers, magazines, firm brochures, letters, media, or any other written or electronic material addressed to more than one prospective client.”³³⁶ Although the full GIPS standards must be followed in one-on-one presentations, advertisements that include a claim of GIPS compliance may adhere to either the GIPS Advertising Guidelines or the full GIPS standards. Under no circumstance do the GIPS Advertising Guidelines alter the SEC’s regulatory requirements that govern investment adviser advertising; firms that advertise performance returns must also satisfy any and all applicable regulatory requirements that govern their advertising activities. In the event that applicable law conflicts with the GIPS Advertising Guidelines, the law must control and the firm must disclose the conflict between the legal requirement and the GIPS Advertising Guidelines.³³⁷

All advertisements that include a claim of GIPS compliance must include: (1) a firm description; (2) how to obtain a GIPS-compliant presentation and/or a list and description of the firm’s composites; and (3) the GIPS Advertising Guidelines compliance statement (“[Firm name] claims compliance with the Global Investment Performance Standards (GIPS®).”). If performance of the firm is also advertised, the following information must also be presented, which must be taken or derived from a GIPS-compliance presentation:

- a description of the investment strategy of the advertised composite;
- period-to-date composite performance, and *either*: (a) 1, 3, and 5-year cumulative annualized composite returns with the end-of-period date clearly identified (or since composite inception if inception is greater than 1 and less than 5 years); or (b) 5 years of annual composite returns with the end-of-period date clearly identified (or since composite inception if inception is less than 5 years). Periods of less than 1 year may not be annualized. The annualized or annual returns, as applicable, must be calculated through the same period as presented in the corresponding GIPS compliant presentation;
- whether performance is gross or net of advisory fees;

³³⁴ See Supplemental Guidance Statement, p. 3.

³³⁵ GIPS Advertising Guidelines, Introduction.

³³⁶ GIPS Advertising Guidelines, Introduction.

³³⁷ GIPS Advertising Guidelines, Introduction.

- total return of the benchmark for the same periods that composite returns are presented and a benchmark description, and if no benchmark is presented, an explanation why no benchmark is presented;³³⁸
- currency used to express returns;
- description of the use and extent of leverage and derivatives if used as an active part of the strategy and has a material effect on returns; and
- if performance or supplemental information is presented for non-compliant periods prior to January 1, 2000, disclosure of the period(s) of non-compliance, which information is non-compliant, and the reason(s) the information is non-compliant with the GIPS standards.

In addition to the information required under the GIPS Advertising Guidelines, firms may present supplemental or additional information so long as the supplemental information is clearly labeled as supplemental and is presented with equal or less prominence than the required information.³³⁹

§ 6.4.9 Verification

Firms that claim GIPS compliance are encouraged, but are not required under the Standards, to undergo the verification process.³⁴⁰ Verification is the process by which an independent third party confirms that the firm's claim of compliance is appropriate. Specifically, GIPS verification confirms that: (i) the firm has complied with the composite construction requirements on a firm-wide basis; and (ii) the firm's processes and procedures are designed to calculate and present performance results in compliance with the Standards.³⁴¹ The verification process is not confirmation that a particular performance claim is appropriate.³⁴²

Verification is conducted on a firm-wide basis, and not on a composite basis.³⁴³ Although a firm may arrange for a performance audit of a specific composite presentation, firms are prohibited from claiming that it a particular composite presentation has undergone the

³³⁸ The appropriate benchmark return that should be advertised is the same benchmark total return presented in the GIPS compliant presentation for the composite. See GIPS Advertising Guidelines, B.7.

³³⁹ GIPS Advertising Guidelines.

³⁴⁰ The CFAI will reevaluate in 2010 whether verification should be mandatory under the Standards. See Verification Guidance Statement, p. 3.

³⁴¹ Guidance Statement for Verification (Revised), p.2 (effective Jan. 1, 2006) (hereinafter, "Verification Guidance Statement"). See also GIPS Verification, III.A.1.

³⁴² Verification Guidance Statement, p.3.

³⁴³ GIPS Verification, III.A.1.

verification process.³⁴⁴ Moreover, a firm may not claim that it has been verified until the verification process has concluded and a verification report has been issued.³⁴⁵

Section III of the Standards outlines the minimum procedures that a verifier must follow when verifying a firm's compliance with the GIPS standards. These procedures generally include verification that:³⁴⁶

- (1) the firm definition is, and has been appropriately defined,³⁴⁷
- (2) the firm has defined and maintained composites according to GIPS standards and the firm's guidelines, that the discretionary fee-paying portfolios are included in the composite, that no accounts have been excluded from a particular composite, that composite benchmarks are consistent with composite definitions, and the firm's list of composites is complete,³⁴⁸
- (3) the firm's classification of accounts as discretionary or nondiscretionary is appropriate,³⁴⁹
- (4) the firm's open and closed accounts are in compliance with the Standards, which may be accomplished through a selected sample of the firm's accounts;³⁵⁰
- (5) the timing of initial inclusion in and exclusion from the composite is consistent with the firm's policies, the manager's composite definition is consistent with the objectives set forth in the account agreement, portfolio summary and composite definition, portfolios with the same guidelines are included within the same composite, and that transfers from one composite to another are appropriate;
- (6) the firm has calculated performance consistent with its policies and disclosures;³⁵¹ and
- (7) the information and disclosures required by GIPS are included in the sample of composite presentations reviewed by the verifier.³⁵²

A firm that has been verified should disclose in its composite presentations or advertisements that it has been verified and state the periods of verification if the presentation

³⁴⁴ GIPS Verification, III.C.

³⁴⁵ GIPS Verification, III.C; Verification Guidance Statement, p. 3.

³⁴⁶ GIPS Verification, III.B.

³⁴⁷ GIPS Verification, III.B.2.a.

³⁴⁸ GIPS Verification, III.B.2.b(i-vii).

³⁴⁹ GIPS Verification, III.B.2.c.

³⁵⁰ GIPS Verification, III.B.2.d.

³⁵¹ GIPS Verification, III.B.2.f.(i-11).

³⁵² GIPS Verification, III.B.2.g.

includes results for periods that were not subject to a firm-wide verification.³⁵³ The Standards recommend the following disclosure: “[Insert name of firm] has been verified for the periods [insert dates] by [name of verifier]. A copy of the verification report is available upon request.”³⁵⁴ Although verifications do not necessarily “expire,” references to verifications that cover periods of more than 24 months ago may be deemed to misleading.³⁵⁵

³⁵³ GIPS Standard 0.B.3.

³⁵⁴ GIPS Standard 0.B.3.

³⁵⁵ Verification Guidance Statement, p. 5. (*Applications*: “Our firm has been in compliance with the GIPS standards since 2000. We obtained a verification from an independent verifier which covered the periods from 1995 through December 31, 2002. At what point does our verification ‘expire’?”).

MUTUAL FUND BASICS

George P. Attisano
Candace C. Cavalier

www.klgates.com

Overview

- Organizing a Mutual Fund
- The Registration Process and the Registration Statement
- The Fund's Contracts and Board Approval
- Investment Objectives and Policies - Managing the Portfolio

Organizing a Mutual Fund

- Form of Organization
 - Corporations
 - (Maryland, Delaware)
 - Business/Statutory Trusts
 - Massachusetts Business Trusts
 - Delaware Statutory Trusts
- Organizational and Corporate Documents
 - Certificate of Trust (Delaware)
 - Declaration of Trust, Trust Instrument or Articles of Incorporation
 - Bylaws

Organizing a Mutual Fund

- Structuring the Fund
 - Separate Fund Entities or Series Funds?
 - Advantages/Disadvantages
 - Multiple Class or Master-Feeder Arrangements?
 - Advantages/Disadvantages
- Organizational Meeting

SEC Registration

■ Primary Laws Governing Federal Registration

➤ Securities Act of 1933

- Section 5 - Registration of Securities
- Section 10 - Information Required in a Prospectus
- Regulation C - Rules 421, 480-486 and 495-497
- Section 11 liability:
 - False or Misleading Registration Statements
 - Liable: signatories, directors, experts, underwriters
 - Due diligence defense: reasonable investigation
- Section 12 liability:
 - False or Misleading Prospectuses or Oral Communications
 - Liable: sellers and offerors
 - Reasonable care defense

➤ Investment Company Act of 1940

- Section 8 - Registration of Investment Companies
- Section 24(f) - Number of Shares Registered

SEC Registration

- The Registration Process
 - Notification of Registration (Form N-8A)
 - Registers entity as an investment company
 - Registration Statement (Forms N-1A and N-2)
 - Registers the fund and its shares
 - SEC Staff Review
 - Registration Statement ordered “effective” by SEC
 - File definitive prospectus and SAI within 5 days of effectiveness under Rule 497(c) or
 - File Rule 497(j) Certification of no changes from last registration statement or amendment

SEC Registration

- Form N-1A: Registration Statement
 - Facing Sheet
 - Part A: Prospectus
 - Part B: Statement of Additional Information (SAI)
 - Part C: Other Information
 - Signature Pages
 - Exhibit Index/Exhibits
 - Transmittal Letter

SEC Registration

- SEC Staff Review
 - Selective Review
 - Comments (typically oral, usually within 30 days)
 - Responses (letter – possible registration statement amendment)
 - Tandy Representations

SEC Registration

- Annual update of registration statement
 - Update no later than 4 months from most recent fiscal year end (stale financials)
 - Rule 485(a): Material changes
 - E.g., changes in investment objectives/policies, termination of advisory contract, auditor resignation, new class or series
 - Automatically effective 60 days after filing
 - 75 days for new series
 - Rule 485(b): Non-material “routine” changes
 - E.g., updated financials, changes to shareholder info
 - Automatically effective upon filing
 - May use to update 485(a) filing
 - Counsel provides representation letter
 - Rule 497 stickers: Update material changes
 - E.g., for current disclosure about small but material changes, most commonly PM changes

SEC Registration

- Due Diligence Checklist for Post-Effective Amendments
 - Updated copy of Form N-1A
 - New SEC rules not yet incorporated into Form N-1A
 - Board materials and resolutions
 - Proxy statements
 - Stickers/Supplements
 - Shareholder reports
 - Exemptive Orders/No-Action Letters
 - Sign-off (portfolio managers, counsel, accountants)

SEC Registration

- Shareholder Reports
 - Annual and semi-annual financial statements and portfolio holdings delivered to shareholders within 60 days of period end date
 - Annual report must include management discussion of fund performance (not required of money market funds)
- Form N-CSR
 - Used to file shareholder reports with the SEC within 10 days of delivery to shareholders
 - Includes additional information
 - Sarbanes-Oxley Act certifications

SEC Registration

- Form N-Q
 - File complete portfolio holdings with the SEC within 60 days of end of first and third quarter
 - No delivery but available to shareholders upon request
 - Sarbanes-Oxley Act certifications

- Form 24F-2
 - Filing fees
 - File notice within 90 days of fiscal year end
 - Fees based on shares sold less shares redeemed

SEC Registration

- Form N-SAR
 - Annual and semi-annual report filed with the SEC within 60 days of period end date
- Form N-PX
 - Record of proxy votes for 12-month period ending June 30
 - Due no later than August 31

Mutual Fund Contracts

- Advisory Contracts - What *process* does the 1940 Act require?
 - Shareholder and board approvals
 - Board meeting (the 15(c) meeting)
 - “in person”
 - “for the purpose”
 - Contract renewals and amendments
 - Section 15 applies equally to advisory and subadvisory agreements

Mutual Fund Contracts

- Advisory Contracts - What *content* does the 1940 Act require?
 - Written agreement
 - “precisely describes all compensation to be paid thereunder”
 - Two year term for initial contract; then annual renewals
 - Termination without penalty
 - Non-Assignment clause

Mutual Fund Contracts

- Advisory Contracts - Non-assignment clause
 - What is an “assignment”?
 - Any direct or indirect transfer of a contract, or of a controlling block of an adviser’s outstanding voting securities
 - “control” presumed at 25%
 - By rule, a transfer that does not result in a change of actual control is not an “assignment”
 - Upon assignment, a mutual fund advisory contract *automatically terminates*

Mutual Fund Contracts

- Advisory Contracts - Other provisions and issues
 - Scope of authority
 - Delegation authority
 - Standard of care
 - Brokerage discretion and soft dollars
 - Proxy voting
 - Use of name
 - Hedge clauses
 - No penalty for early termination
 - Standard contractual provisions

Mutual Fund Contracts

- Advisory Contracts - Fee arrangements
 - Reasonable fees
 - Fee structures
 - Asset-based fees (traditional for funds)
 - Fulcrum fees--Section 205(b)(2) of the Advisers Act

Mutual Fund Contracts

- Advisory Contract Renewal - Responsibilities of Fund Independent Directors
 - Process is important
 - Fiduciary duties and the Business Judgment Rule
 - Responsibilities and duties under the 1940 Act
 - Independence
 - Fund governance rules
 - Director liability

Mutual Fund Contracts

- Advisory Contract Renewal - Gartenberg and Section 36(b)
 - Section 36(b) - imposes a fiduciary duty on the *adviser* as to the receipt of compensation
 - Standard:
 - To violate Section 36(b), an adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining

Mutual Fund Contracts

- Advisory Contract Renewal - What factors should the Board consider?
 - Nature, extent and quality of services provided
 - Investment performance
 - Competitiveness of fee
 - Costs of services and profits realized by the adviser
 - Economies of scale
 - Whether fee levels reflect economies of scale
 - Comparisons to fees charged other clients
 - “Fall-out” benefits stemming from relationship
- Factors considered must be disclosed in shareholder reports

Mutual Fund Contracts

- Other Contracts and Service Providers
 - Mutual funds typically do not have employees and must contract for all services
 - Principal Underwriter (Section 15 contract)
 - Administrator
 - Transfer Agent
 - Custodian
 - Insurance

Managing the Portfolio

- Investment Objectives and Policies
 - Investment objectives: short statement describing what the fund seeks to achieve for shareholders
 - Fundamental policies: cannot be changed without shareholder vote
 - Fund names: at least 80% of fund assets must be invested in investments suggested by the fund's name
 - Final responsibility for monitoring for compliance lies with manager, not subadviser

Managing the Portfolio

- **Fundamental Policies**

- **Senior Securities**
- **Borrowing Money**
- **Underwriting**
- **Concentration**
- **Commodities**
- **Loans**
- **Real Estate**
- **Diversification**

Managing the Portfolio

- **Monitoring Of Portfolios' Diversification Requirements**
 - Securities law requirements: at least 75% of the portfolio must be in cash, government securities, and companies where < 5% of the fund's assets are invested in > 10% of the company's voting stock
 - Special money market fund requirements: < 5% of fund's assets in any one issuer and < 5% of assets in second-tier or conduit securities, < \$ 1 million or 1% of the issuer's assets
 - Federal tax law requirements: (1) at least 50% of the portfolio must be in cash, government securities, and companies where < 5% of the fund's assets are invested in > 10% of the company's voting stock; and (2) no more than 25% of that portfolio may be invested in any one issuer or two or more issuers that it controls

Managing the Portfolio

- Liquidity - Section 22(e)
 - Sec. 22(e) requires that mutual funds honor redemption requests within 7 days, with certain emergency exceptions
 - SEC interpretive guidance imposes a limit on holdings of illiquid assets by funds of 15%, 10% for money market funds
 - An illiquid asset is one that cannot be sold or disposed of in the ordinary course of business with 7 days at approximately the value at which the fund has valued it
 - The valuation committee should have procedures to monitor for potentially illiquid securities, including notification by PM or sub-adviser of market events, testing for low volume

Investment Objectives

- Senior Securities -- Section 18
 - Limits on traditional borrowing: leverage only allowed if there is 300% asset coverage, i.e., 1 to 3.
 - Prohibition on issuing senior securities, i.e., securities with a claim on assets prior to other security holders. The SEC interprets to include leverage-creating derivatives, e.g., futures, forwards, when-issued securities.
 - Compliance measures to mitigate leverage risk:
 - Cover exposure, e.g., purchase underlying instrument for short futures position.
 - Segregate liquid assets equal to amount of obligation.
 - Final responsibility for monitoring for compliance lies with manager, not subadviser.

ORGANIZING A MUTUAL FUND

I. SELECTING THE ORGANIZATION FORM – BUSINESS TRUSTS AND CORPORATIONS

Investment companies are organized as business trusts or corporations (or, occasionally, limited partnerships) under state law. The organizers have to choose the form of organization and the state in which to organize.

A. Business Trusts

A business trust is an unincorporated association governed by a board of trustees. Business trusts are created when trustees sign a trust instrument, often called a declaration of trust, and file the document with the state of organization. Most mutual funds employing the business trust form are organized under Delaware or Massachusetts law (in Delaware, such entities are designated by statute as “statutory trusts”). In both states, the business or statutory trust form is burdened by few substantive limitations, offering a high degree of operational and organizational flexibility. In Delaware, comprehensive statutory provisions provide guidance.

B. Corporations

Another form of organization for investment companies is the corporation. The corporate form remains attractive because of the traditional protection from liability afforded to shareholders and, to a lesser degree, directors. At one time, the corporate venue of choice was Delaware, but Maryland corporations have become increasingly popular because Maryland corporate law has removed a number of corporate encumbrances for investment companies.

C. Comparison of Primary Modes of Organization

<u>Issue</u>	<u>Massachusetts Business Trusts</u>	<u>Delaware Statutory Trusts</u>	<u>Maryland Corporations</u>
1. <u>Shareholder Liability</u>	Remote possibility of shareholder liability that must be disclosed in statement of additional information; should attempt to limit by declaration of trust and/or contractual provisions.	Limited by statute that provides for liability – equivalent to that afforded shareholders of Delaware corporation. However, certain states (e.g., Texas) may not recognize Delaware law on this issue. Should attempt to limit by trust instrument and/or contract.	Limited by statute.
2. <u>Trustee/ Director Liability</u>	May be limited by declaration of trust and/or contractual provisions.	May be limited by trust instrument and/or contractual provisions. Also, recognized by statute.	May be limited by charter provisions; may indemnify directors for acts not involving bad faith, active and deliberate dishonesty, improper personal benefit.
3. <u>Annual Shareholder Meetings</u>	No statutory requirement; only if required by declaration of trust.	Only if required by declaration of trust.	No statutory requirement; only if required by articles of incorporation.
4. <u>Shareholder Approval of Certain Actions</u>	No statutory requirement; only if required by trust instrument.	No statutory requirement; only if required by trust instrument.	– Merging, consolidating or selling all or substantially all of the assets; – Spinning a series off to become a separate corporation; – Changing domicile; – Amending articles of incorporation; – Dissolving the corporation.
5. <u>Ability to Amend Organization Document</u>	Subject to provisions of declaration of trust.	Trustees may amend the trust instrument regarding management of the trust, rights and obligations of the trustees and shareholders without shareholder vote.	Shareholder vote required to amend articles of incorporation.
6. <u>Numbers of Authorized Shares</u>	Unlimited.	Unlimited.	Articles of Incorporation must provide for a definite number of shares to be issued, which may be

	<u>Issue</u>	<u>Massachusetts Business Trusts</u>	<u>Delaware Statutory Trusts</u>	<u>Maryland Corporations</u>
				increased by board of directors without shareholder approval.
7.	<u>Treatment of Multiple Classes/Series</u>	Subject to provisions in declaration of trust.	Statute specifically recognizes separation of class/series.	Statute specifically recognizes separation of classes. Board of directors authorized by statute to classify or reclassify unissued stock.
8.	<u>Development of Controlling Law</u>	Law is not well-developed and subject to much interpretation. Massachusetts corporation law is often used by analogy.	Law of business associations is highly developed and, to the extent such law applies to Delaware statutory trusts, provides somewhat clearer guidelines as to obligations and rights of the Delaware statutory trust and its shareholders.	Corporate law is well-developed, providing probably the most clear guidelines to the rights and obligations that apply to a fund formed as a Maryland corporation.
9.	<u>State Income Taxation</u>	None.	With some exceptions, the net income of regulated investment companies is the same as its federal investment company taxable income, <u>i.e.</u> , none if it meets certain requirements.	With some exceptions, the net income of a regulated investment company is the same as its federal investment company taxable income, <u>i.e.</u> , none if it meets certain requirements.
10.	<u>Franchise Taxes</u>	None.	Franchise tax that applies to regulated investment companies.	None.

II. THE ORGANIZATION PROCEDURE

In connection with the organization of any entity, certain statutory and/or organizational actions must be taken before the entity commences operations, including the following:

A. Declaration of Trust or Articles of Incorporation

The declaration of trust or articles of incorporation establish an entity's legal existence. In the case of a business or statutory trust, a certificate is typically filed with the state. In the case of a corporation, the articles are filed with the state, which typically issues a certificate of incorporation. The declaration of trust and articles of incorporation typically set forth the powers, duties and obligations of the corporation or trust in broad terms. Matters addressed in these documents usually include the following: (1) entity name, (2) number of directors/trustees,

(3) purpose clause, (4) powers clause, and (5) special clauses, such as the indemnification of directors/trustees. In most cases, certain provisions of the declaration of trust or articles of incorporation can be amended only by a vote of shareholders.

B. By-Laws

An entity's by-laws are generally prepared at the time the entity is organized and govern the internal management of the entity. While the declaration of trust or articles of incorporation are concerned with broad matters, the by-laws cover more technical issues relating to management such as the election of directors, the appointment of committees, the duties of officers, the conduct of board and shareholder meetings, and other similar issues. The by-laws can usually be amended by the directors/trustees themselves without shareholder approval.

C. Organizational Meeting

Before an entity commences operations, it typically holds an organizational meeting of its trustees or directors. At the meeting, the trustees or directors take all actions to allow the entity to commence doing business, including the following: (1) the formal election of trustees/directors and officers, (2) the ratification of the articles of declaration of trust/incorporation and adoption of the by-laws, and (3) the transaction of other business, including approval of arrangements with fund service providers (such as its investment adviser, transfer agent, distributor and custodian), adoption of procedures, and the conduct of other actions mandated by regulatory requirements or that are otherwise deemed appropriate.

III. SEPARATE FUND ENTITIES AND SERIES FUNDS

A. In General

If a fund sponsor plans to offer more than one registered investment company, it must decide how it will create those portfolios. On the one hand, the sponsor may create a separate trust or corporation for each fund. On the other hand, the sponsor may use a single legal entity to offer multiple portfolios or "series" of shares, each having different investment objectives, policies, and potential investors, i.e., a "series fund."

B. Series Companies

1. Structure

Each series in a series fund represents a segregated portfolio of the fund's assets. A single board of directors governs the series fund. Each series must vote separately on matters not affecting all series alike. For example, each series must vote to approve its investment advisory agreement (which may differ for each series), or to approve changes in fundamental investment policies. On the other hand, all series of a fund vote together on trustee/director elections or certain modifications to the fund's declaration of trust or articles of incorporation.

2. Potential Advantages

- a. A series company can eliminate duplication of various activities and expenses, including (1) initial and ongoing organizational expenses, such as legal, incorporation and ongoing state doing-business fees, and (2) the preparation and filing of multiple registration statements, periodic reports and other regulatory filings.
 - (1) Unlike with a separate entity, a new fund formed as a series of an existing registrant can obtain automatic effectiveness within 75 days of filing its registration statement. See Rule 485(a)(2) under the Securities Act of 1933 (the "Securities Act").
 - (2) Creation of a new series does not require the sponsor to invest \$100,000 seed capital; this is required only for new registrants, i.e., new trusts or corporations.

3. Potential Disadvantages

- a. With respect to company-wide votes, such as the election of the fund's board of directors and approval of the fund's auditors, holders of similar numbers of shares in different series may have the same voting power, despite any disparity in the net asset values of their shares. To avoid this problem, some funds have arranged to have shareholder votes determined by the dollar value of shares rather than the number of shares.
- b. Although we are not aware of any court decisions on this point, one series of a company potentially could be liable for the

liabilities of one or more other series in the company. This risk is generally considered remote. The Delaware statutory trust statute specifically recognizes the separation between series.

- c. Certain judicial rulings have given the shareholder of one series standing to sue a sponsor on behalf of all series in a fund for allegedly excessive management fees. See, e.g., Barrett v. Van Kampen Meritt Inc., No. 93-C-366 (N.D. Ill. Mar. 30, 1993).
- d. The corporation and trust laws of some states do not expressly recognize the separation of assets and liabilities into separate series. It is a wise idea to specify in fund contracts that no series is liable for any debt or obligation of any other series.

C. Separate Fund Entities

Series funds are subject to the theoretical risks of being liable for the debts of other funds discussed above. There is little or no other advantage to offering a family of funds with a separate legal entity for each fund. Multiple legal entities inevitably require duplication and expense resulting from separate governing boards, periodic reports, and other regulatory filings. However, maintaining too many series in the same entity can cause administrative difficulties in handling board meetings and preparing and filing shareholder reports and registration statements, which are usually on the same schedule for all series. Thus, many fund sponsors with a large number of funds use several series companies, each containing several series, and often having different fiscal year-ends.

IV. METHODS OF MULTI-LEVEL DISTRIBUTION: MULTIPLE CLASS AND MASTER-FEEDER ARRANGEMENTS

A. Introduction

1. Background

There has been substantial growth in the offering/sales arrangements that accompany each investment product offered by mutual funds. There are several distinct markets for funds, including retail (including direct-sold and broker-sold) and institutional (primarily banks and pension plans). Each selling arrangement is designed to enable a product to reach and satisfy a broader range of investors by offering an alternative with respect to the cost and service features applicable to the investment product. Each has its own distinct needs and appropriate fee structure. Initially, fund groups addressed these distinct needs by establishing two or more virtually

identical “clone” funds, each of which would be offered to different markets. More recently, the fund industry has attempted to develop structures that enable funds to be offered in different markets more efficiently.

2. **Section 22(d) and Rule 22d-1**

The innovations that have occurred in the packaging of mutual fund products have overcome in large part the constraints imposed on the sale of fund shares by the Investment Company Act of 1940, as amended (the “1940 Act”).

- a. Section 22(d) of the 1940 Act prohibits a fund, its principal underwriter, or a dealer in its securities from selling such securities to any person except at a current public offering price described in the fund’s prospectus. Rule 22d-1, as amended, permits any scheduled variation in sales charges provided that it is applied uniformly to all offerees in the class specified. See Investment Company Act Release No. 14390 (Feb. 22, 1985).
- b. Section 18(f)(1) of the 1940 Act prohibits an open-end investment company from issuing any senior security. Pursuant to the definition of a senior security in Section 18(g) as interpreted by the Securities and Exchange Commission (the “SEC”), a multiple class arrangement would cause the issuance of a senior security, absent Rule 18f-3 discussed below.
- c. In order to provide further flexibility, marketing innovations such as the “multiple class” structure and the “master-feeder” structure have been developed.

B. **Master-Feeder Funds**

1. **Background and Structure**

- a. The master-feeder structure basically divides the functions of the traditional mutual fund into two parts – a master fund and one or more feeder funds. Public investors invest in the feeder funds. The feeder funds invest in the master fund, which, in turn, invests in the individual securities. Through several feeder funds, a single investment pool can present several different faces to the public.
 - (1) Portfolio management and custody functions occur at the master fund level.

- (2) Distribution, shareholder servicing, and transfer agent functions are focused at the feeder funds level.

b. The Master Fund

- (1) For federal tax purposes, the master fund is usually organized as a common law trust (taxable as a partnership).
- (2) The master fund is primarily engaged in the purchasing, holding and selling of securities and must register as an investment company under the 1940 Act.
- (3) Like a traditional single-tiered mutual fund, the master fund retains an investment adviser to manage its portfolio as well as a custodian to hold its assets and that custodian or another entity to perform the fund accounting functions. Thus, the master fund incurs investment advisory and custodial fees as well as some fund administration expenses.
- (4) Interests in the master fund are sold privately only to one or more feeder funds. Because the master fund interests are not publicly offered, the offering does not require registration under the Securities Act, and the master fund does not incur any significant distribution, transfer agent or shareholder servicing expenses.

c. The Feeder Funds

- (1) Feeder funds can be registered investment companies as well as unregistered offshore funds, bank collective funds for pension fund assets that are exempt from registration under the Securities Act and the 1940 Act, and other institutional accounts exempt from registration.
- (2) Each feeder fund may have administration, distribution and transfer agent expenses but, because it invests all of its assets in a master fund with the same investment objectives, it normally will incur little or no investment management or custodial expenses.
- (3) Because a feeder fund is a separate legal entity, it has its own board, auditors and legal counsel.

- (4) Feeder funds that are registered investment companies can be organized as separate corporations or business trusts or as series companies, with each series investing in a different master fund. For tax reasons, two series of the same feeder fund should not invest in the same series of the master fund.

2. **Regulatory Treatment of Master-Feeder Funds**

a. Investment Company Act of 1940

- (1) A master fund is required to register under the 1940 Act as an open-end management investment company and is subject to the full panoply of 1940 Act regulation. This means that the master fund must file with the SEC a Form N-8A Notification of Registration and a Form N-1A registration statement designating 1940 Act registration. The master fund must also comply with the capital structure, corporate governance and affiliated transaction restrictions of the 1940 Act. Because there is a great deal of similarity in the Form N-1A filings of the master and feeder funds, the master fund is permitted to incorporate by reference from a feeder fund's Form N-1A. See, e.g., Eaton Vance Funds, Inc. and Neuberger & Berman Funds (pub. avail. Dec. 12, 1996).
- (2) Section 12(d)(1) of the 1940 Act contains limitations that restrict the amount which an investment company may invest in another investment company and thereby generally prevents the establishment of fund holding companies, i.e., fund of funds arrangements. The master-feeder structure is able to take advantage of an exception to these limitations for investment companies that invest exclusively in a single investment company security. See Section 12(d)(1)(E).

b. Securities Act of 1933

- (1) As noted above, the master fund does not make a public offering of its shares. Instead, its shares are issued only to the feeder funds and, as such, offerings of interests in the master fund have been treated as exempt from registration under the private offering exemption contained in Section 4(2) of the Securities Act. The absence of registration

under the Securities Act for offerings of interests in the master fund is essential to the feasibility of the master-feeder structure under U.S. tax law. If interests in the master fund were deemed to be “publicly offered,” the master fund could be categorized as a “publicly traded” partnership, an entity that is treated as a corporation for federal income tax purposes. Such treatment could cause the master fund not to qualify for flow-through tax treatment.

- (2) The SEC exempts the master fund from Securities Act registration on the condition that feeder fund registrants include the following in their registration statements:
 - (a) the information material to the master fund’s operations, including information relating to the master fund’s investment objectives and policies; its investment advisers, administrators, and custodians; and the execution of its portfolio transactions;
 - (b) a consolidated fee table setting forth all expenses of both the master and feeder funds; and
 - (c) all the financial statements that would be contained in a master fund registration statement.
- (3) In addition, the SEC staff requires the master fund and its principal officers and directors to sign each feeder fund’s registration statement, thereby exposing them to potential liability for false or misleading registration statements under Section 11 of the Securities Act.

C. **Multiple Class Funds**

1. **Background and Structure**

- a. Under multiple class arrangements, a single registered investment company, or series thereof, issues two or more separate classes of shares to investors. By definition, the assets of the company or series, as applicable, are invested in a single pool. A single board of directors oversees the business affairs of the entire company and bears fiduciary responsibility for the interests of the shareholders of each class of shares. Classes of shares of an investment company or series can differ with respect to fees and charges that

can be characterized as related to distribution and, to a limited extent, with respect to fees for certain administrative services.

- b. Probably the two most popular types of multiple class arrangements are the following:
 - (1) Companies offering a choice of two or more classes of shares to a single category of investor. Sponsors of this type of class structure typically offer investors the option of purchasing either a class of shares subject to a front-end sales charge and a low or no ongoing Rule 12b-1 distribution fee (often called “Class A” shares), or a second class of shares without a front-end sales charge but subject to a higher Rule 12b-1 distribution fee and a contingent deferred sales load (often called “Class B” shares). Sponsors may also offer the latter class of shares with a conversion feature under which shares convert to shares of the lower expense class after sufficient time has passed for the distributor to recover its initial investment in distribution costs. Often, a third class of shares is offered, varying the duration of the contingent deferred sales load but maintaining the higher 12b-1 distribution fee (often called “Class C” shares).
 - (2) Companies offering multiple classes of shares, each targeted for purchase by a different category of investor. This type of multiple class arrangement is commonly used by mutual fund sponsors that offer funds through different distribution channels, such as directly to retail investors, institutional investors, retirement plan intermediaries, and through brokers and/or other financial intermediaries. The distribution and administration fees of these classes tend to differ based upon the differing level of costs that the sponsor expects to incur in relation to each class.

2. **Regulatory Treatment of Multiple Class Funds**

- a. Because the issuance of multiple classes of shares would generally be deemed to constitute the prohibited issuance of a senior security under the 1940 Act, a fund must comply with Rule 18f-3 under the 1940 Act or obtain exemptive relief from the SEC in order to use a multiple class structure.

b. Rule 18f-3

In 1995, the SEC adopted Rule 18f-3 under the 1940 Act to permit mutual funds to issue multiple classes of shares without first obtaining exemptive relief. See Securities Act Release No. 7143 (Feb. 23, 1995). Set forth below are the relevant conditions of the Rule.

(1) Variation Among Classes

- (a) The Rule requires that each class have a different arrangement for shareholder services or distribution of securities, or both. Arrangements qualify if there are differences in the amount or form of payment or the nature and extent of services provided, or both.
- (b) The Rule permits each class to have other expense differences that are either (a) related to the shareholder services or distribution arrangement, or (b) actually incurred in a materially different amount for that class than for other classes. Advisory or custodial fees and other expenses related to management of the fund's assets may not be allocated differently among classes.
- (c) The Rule expressly permits the waiver or reimbursement of class-specific expenses by the fund's investment adviser or underwriter and the ability to impose particular conversion features and exchange privileges on a class.
- (d) The Rule's provisions on voting rights mandate that shareholders of a class have the right to vote on matters in which they have an interest and that only the interested class vote on class-specific matters.

(2) Accounting Matters

The Rule requires that income, realized and unrealized gains and losses, and expenses of the fund not allocated to a particular class, must be allocated to each class on the basis of (1) the net assets of that class in relation to the net assets of the fund, (2) the so-called "simultaneous equations method," which is defined in the Rule, or (3) for money

market funds and other daily dividend funds, the relative net assets of each class, excluding the value of subscriptions receivable.

(3) Board Responsibilities

The Rule imposes a number of responsibilities on a fund's board. The Rule requires that the board adopt for the fund a written plan setting forth the separate arrangement and expense allocation of each class and any related conversion features or exchange privileges. The fund's board, including a majority of the independent directors, is required to approve the plan before the issuance of multiple classes of shares and annually thereafter. In approving the plan, the board is required to make a finding that the plan was fair to, and in the best interests of, each class and the fund as a whole.

- (4) A fund wishing to rely on Rule 18f-3 will have to comply with the SEC's fund governance standards. See Rule 0-1(a)(7) under the 1940 Act.

c. Exemptive Relief

Prior to the adoption of Rule 18f-3, which is discussed above, the SEC granted many exemptive orders to permit the issuance of multiple classes. Because Rule 18f-3 was based on those exemptive orders, many of the requirements are the same, but the exemptive orders were more restrictive in several respects. Most funds now rely on Rule 18f-3. However, if a particular multiple class arrangement does not comply with Rule 18f-3, exemptive relief from the SEC should be considered.

D. Relative Advantages of Multiple Class and Master-Feeder Funds

1. Comparison

The multiple class and master-feeder structures each offer the same basic advantage over the traditional single tiered, single class mutual fund -- the ability to attract a broader range of investors through variation in shareholder services and charges, while also providing the economies of scale in portfolio management available to a larger fund. While sharing this common feature, each structure also offers certain advantages over the other.

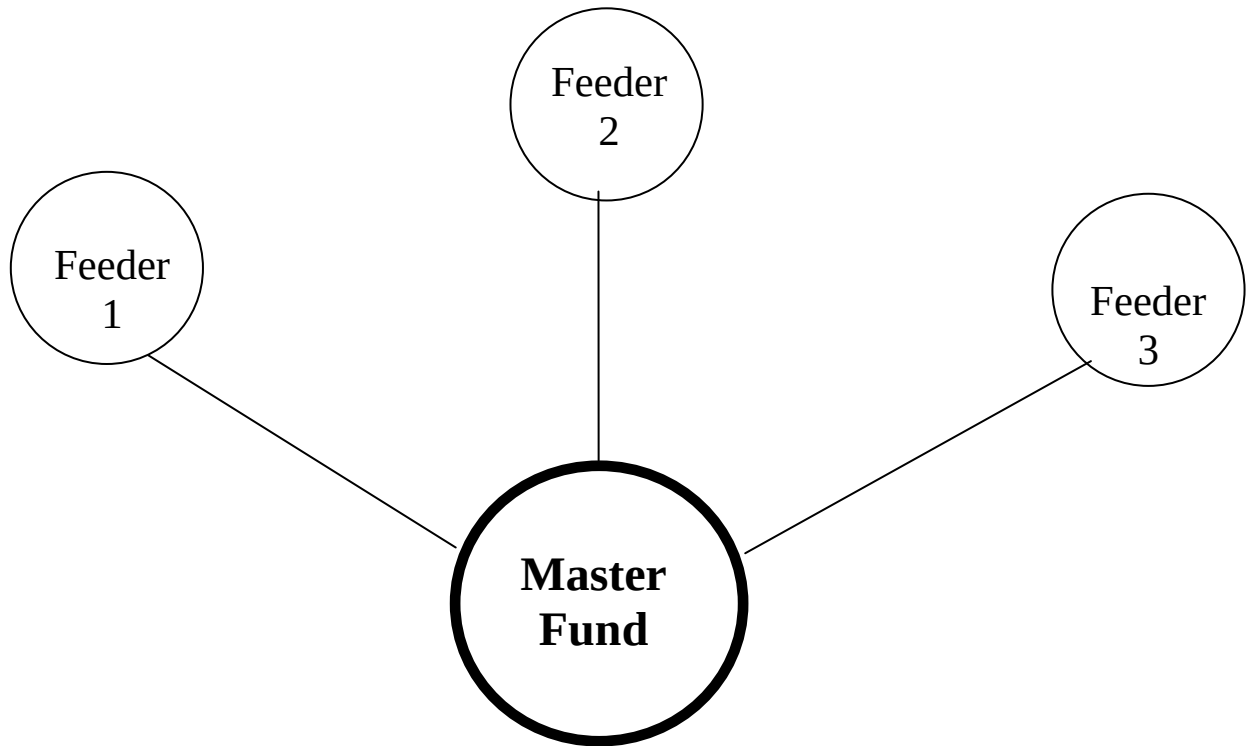
2. **Advantages of the Multiple Class Structure**

- a. The multiple class structure is somewhat less costly to establish and maintain than the master-feeder structure.
 - (1) The master-feeder structure requires establishment of new investment companies, each of which is required by the 1940 Act to commence operations with \$100,000 in seed money.
 - (2) In the master-feeder structure, legal, auditing and certain fund administration expenses are incurred at both the master fund level and the feeder fund level.
- b. Shareholder approval is normally not required to establish multiple classes unless corporate documents, which require shareholder approval to amend, must be amended to accommodate the multiple class structure. The master-feeder structure in contrast generally requires shareholder approval of changes in the fund's fundamental investment policies necessary for the conversion to master-feeder.

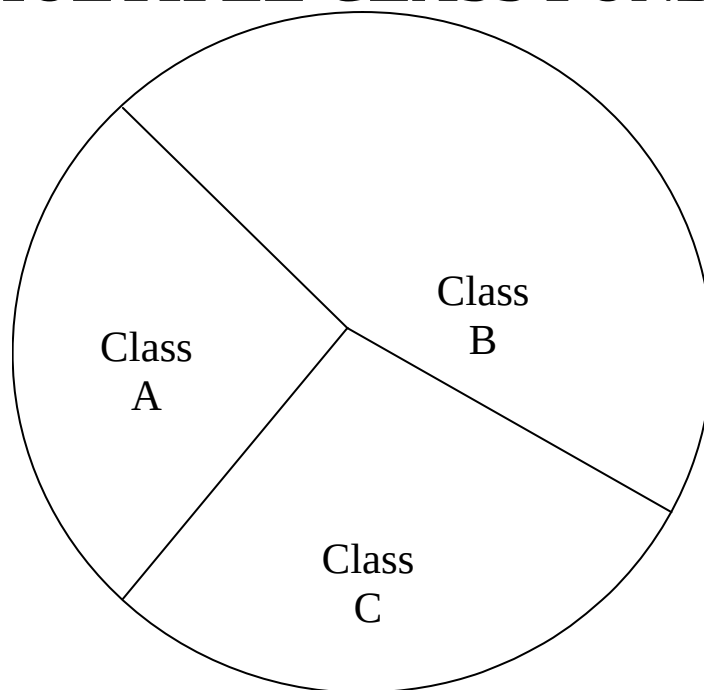
3. **Advantages of the Master-Feeder Structure**

- a. Feeder funds investing in a common master fund may include feeder funds that are not registered under the Securities and 1940 Acts, such as offshore funds and bank collective funds, thereby permitting increased potential assets in master funds and increased economies of scale.
- b. No Internal Revenue Service ("IRS") or SEC position restricts the manner in which expenses and fees may vary among the feeder funds investing in a common master fund. For example, IRS positions restrict the ability of a fund administrator or investment adviser to waive fees or reimburse expenses to one class and not others, unless those fees are class-specific.
- c. Because each feeder fund and the master fund are normally separate legal entities, each feeder fund may have a board composed of directors who do not serve on the board of any other feeder fund or on the board of the master fund. This feature may be attractive to distributors of proprietary funds who wish to maintain some level of control over their customers' assets.

MASTER-FEEDER FUND



MULTIPLE CLASS FUND



THE OFFERING DOCUMENTS**I. REGISTRATION AND THE REGISTRATION STATEMENT – SECURITIES ACT AND 1940 ACT REQUIREMENTS****A. Initiating a Registration****1. Notification of registration**

Section 8(a) of the Investment Company Act of 1940, as amended (the “1940 Act”), provides that an investment company may initiate a registration under the 1940 Act by filing a notification of registration with the SEC. The prescribed form is designated Form N-8A (“Notification of Registration”). A company becomes “registered” when the form is received by the SEC. Because the Internal Revenue Code provides pass-through tax treatment to entities that, among other requirements, are registered as investment companies every day of the tax year, the N-8A is normally filed the same day the entity is organized as a corporation or trust.

2. 1940 Act registration statement

Section 8(b) of the 1940 Act and Rule 8b-5 thereunder provide that, within three months after filing the notification of registration on Form N-8A, the registrant must file a registration statement describing its objectives, investment policies, investment restrictions, method of operations and management. It also must include certain important corporate documents. Open-end management companies use Form N-1A, closed-end management companies use Form N-2.

3. Combined registration statement

Section 8(c) authorizes the SEC to permit the use of an issuer’s registration statement under the Securities Act of 1933, as amended (the “Securities Act”) or response filed by it under the Securities Exchange Act of 1934 to supply the portions of the information required under Section 8(b). Forms N-1A and N-2 are utilized for registration of mutual funds and closed-end investment companies under both the 1933 and 1940 Acts.

B. Registration on Form N-1A

Form N-1A, the registration statement for open-end investment companies, consists of three parts:

1. Part A - Prospectus

Part A of Form N-1A contains information which must be included in the prospectus pursuant to Section 10(a)(1) of the Securities Act. The prospectus must provide essential information about the registrant in a way that will assist a shareholder or prospective shareholder in making an informed decision about whether to purchase the securities being offered. The information contained in the prospectus must be presented in a clear, concise and understandable manner. In particular, the front and back cover pages, information about the fund's principal strategies and risks, and its performance and expenses must be disclosed in "plain English" as provided in Rule 421(d) under the Securities Act. The required information includes:

- a. Item 1 – Front and Back Cover Pages. Only three items are required on the front cover page: the fund's name, the date of the prospectus, and a disclaimer about the SEC's approval of the securities being offered. The back cover page should include disclosure concerning the availability of the fund's statement of additional information ("SAI"), and the annual and semi-annual shareholder reports, as well as the fund's 1940 Act file number (the fund's "811 number").
- b. Items 2 and 3 - Risk/Return Summary. The risk/return summary includes a narrative description of the fund's investment objectives, strategies and risks, a bar chart and table showing the fund's year-to-year volatility, and a fee table showing shareholder fees and annual fund operating expenses. Funds must also include after-tax return, calculated using the highest federal income tax rate. (This requirement does not apply to money market funds or to prospectuses used only for investors in tax-deferred vehicles.) Funds that invest in other investment companies must also disclose the total fees and expenses of the underlying funds.
- c. Item 4 - Investment Objective, Strategies and Risk Disclosure. The Fund's objective must be stated, including whether the objective can be changed without shareholder approval. Principal investment strategies and the principal risks of investment must be disclosed. A fund must also state that a description of the fund's policies and procedures with respect to the disclosure of its

portfolio securities is available in its SAI and on its website, if applicable.

- d. Item 5 - Management, Organization and Capital Structure. Funds must disclose information about advisory services provided to, and advisory fees paid by, the fund, the identity of the portfolio manager, pending legal proceedings against the fund, its adviser or its principal underwriter. With respect to disclosure of advisory services, the fund must also state that a discussion regarding the board of directors' basis for approving any investment advisory contract is available in the fund's shareholder report. With respect to disclosure about the portfolio manager, the fund must disclose each member of a portfolio management team who is jointly and primarily responsible for the day-to-day management of the fund's portfolio (or, if more than five persons are jointly and primarily responsible, state only the five persons with the most significant responsibility). The fund must also disclose that additional information concerning the portfolio manager or management team is available in the SAI.
- e. Item 6 - Shareholder Information. A fund must disclose the procedures for pricing shares, including, if applicable, its policy of using fair value pricing, the procedures for purchasing and redeeming shares, its policy with respect to dividends and distributions, and the tax consequences of buying, holding, exchanging and selling shares. A fund's fair value pricing disclosure must explain briefly the circumstances under which they will use fair value pricing and the effects of using fair value pricing. The fund must also disclose any risks to shareholders of frequent purchases and redemptions of fund shares, and whether a fund has adopted such policies and procedures with respect to such frequent purchases and redemptions. The SEC staff has suggested that this disclosure be presented in "plain English." See Letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (Apr. 30, 2001).
- f. Item 7 - Distribution Arrangements. A fund must include a brief description of arrangements that result in sales load breakpoints, including a summary of shareholder eligibility requirements and the methods used to value accounts in order to determine whether a shareholder has met sales load breakpoints. Disclosure about 12b-1 fees, master-feeder fund arrangements and multiple class plans also must be provided.

- g. Item 8 - Financial Highlights. An audited table of financial highlights covering the last five fiscal years must be disclosed.
- h. Items 1, 2 and 3 must be presented in order, and information about obtaining additional information must be on the back cover. Otherwise, the Form N-1A does not impose any order of the items in the prospectus.

2. **Part B - Statement of Additional Information**

Part B of Form N-1A, the SAI, is intended to provide additional information about the registrant that is not required to be included in the prospectus but which the SEC has concluded may be of interest to some shareholders. The SAI must be provided upon request to recipients of the prospectus. To obtain a measure of protection against liability for omissions from the prospectus, most funds incorporate the SAI by reference into the prospectus. This was effective to protect a fund in at least one litigated case. See White v. Melton, 757 F. Supp. 267 (S.D.N.Y. 1991). Information that must appear in the SAI includes:

- a. Item 9 - Cover Page and Table of Contents. Must include the fund's name, the date of the SAI and a statement that the SAI is not a prospectus with disclosure regarding how the prospectus may be obtained. If the fund's annual report is incorporated by reference into the SAI, this must be disclosed on the cover page, along with information to obtain a copy of the annual report.
- b. Item 10 - General Information and History. Must provide the date and form of organization of the fund, including the jurisdiction in which it is organized and a general history of its operations.
- c. Item 11 - Investment Strategies and Risks. Should not include a repetition of the information presented in the prospectus; requires disclosure of fundamental policies (*i.e.*, those investment policies that may be changed only by a majority vote of the outstanding shares). A fund must disclose its policies and procedures with respect to the disclosure of its portfolio securities and any ongoing arrangements to make available information about its portfolio securities.
- d. Item 12 - Management of the Fund. Includes the identification and description of occupations of all directors and officers of the fund; requires the disclosure of all directors who are "interested persons," officers' and directors' associations with fund affiliates, the investment adviser, and principal underwriters; must include

information concerning the compensation of directors, officers and members of the advisory board (if any). The SAI must also show associations of certain members of the directors' families with fund affiliates (beyond those associations that might make the director an "interested person" of the fund). In addition, the SAI must disclose the directors' ownership of shares of the funds that they govern, and of shares of funds in the entire fund complex. A fund is required to disclose whether it and its investment adviser and principal underwriter have adopted codes of ethics under Rule 17j-1 under the 1940 Act, and for a fund that invests in voting securities, to describe its proxy voting policies and procedures and how shareholders can obtain information on how the fund voted its proxies.

- e. Item 13 - Control Persons and Principal Holders of Securities. Requires disclosure of any controlling person (ownership of 25% of the fund's voting securities or actual control) and a description of the control relationship; also requires the disclosure of the name and address of any person or beneficiary who holds of record more than 5% of the fund's equity securities.
- f. Item 14 - Investment Advisory and Other Services. Includes a description of the advisory agreement, underwriting agreement, management related service contract, and plan of distribution, and disclosure of compensation to underwriters, dealers and sales personnel.
- g. Item 15 - Portfolio Managers. A fund must provide information regarding other accounts managed by any of its portfolio managers, including a description of material conflicts of interest that may arise in connection with simultaneously managing the fund and the other accounts. A fund must disclose the structure of, and the method used to determine, the compensation of each portfolio manager. A fund must also disclose each portfolio manager's ownership of securities in the fund.
- h. Item 16 - Brokerage Allocation. Must describe the fund's policy in effecting securities transactions and selecting brokers and the aggregate commissions incurred during the three most recent fiscal years; must disclose brokerage commissions paid to affiliates and the percentage of the commissions paid by the fund which this amount represents.
- i. Item 17 - Capital Stock and Other Securities. Includes a full description of authorized securities of the fund and the particular

attributes of the fund's capital stock.

- j. Item 18 - Purchase, Redemption and Pricing of Shares. Includes an explanation of the offering of fund shares, description of how the fund's portfolio securities are valued, and the fund's redemption procedures. The fund must also disclose any arrangements with any person to permit frequent purchases and redemptions of fund shares, including the identity of such person and any compensation or consideration received by the fund for such arrangements.
- k. Item 19 - Taxation. Requires an explanation of any tax information relevant to investors, including whether the fund qualifies for pass-through tax treatment under Subchapter M of the Internal Revenue Code.
- l. Item 20 - Underwriters. Includes a description of the principal underwriter's commissions in the aggregate for the last three fiscal years and more detailed information about amounts received by each principal underwriter who is an affiliate of the fund.
- m. Item 21 - Calculation of Performance Data. This item provides an explanation and formulae for the calculation of performance data included in the prospectus.
- n. Item 22 - Financial Statements (typically incorporated by reference from the annual report sent to shareholders). In addition to providing financial statements and schedules in accordance with Regulation S-X, a fund is required, among other things, to include management's discussion of fund performance and to discuss within the report, in reasonable detail, the material factors and the conclusions that formed the basis for the board of directors' approval of any investment advisory contract. The fund's discussion must include factors relating to both the board's selection of the investment adviser, and its approval of the advisory fee and any other amounts to be paid under the advisory contract. The factors include: (1) the nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale for the benefit of fund investors.

3. **Part C - Other Information**

Part C of Form N-1A contains information that is not required to be in the prospectus or SAI but must nevertheless appear in the registration statement. Part C must include the following:

- a. Item 23 - Exhibits (including Articles of Incorporation, By-laws, advisory, custodian, transfer agency and other contracts entered into by the fund). After an exhibit is filed, it may be incorporated by reference in subsequent amendments.
- b. Item 24 - A list of persons controlled by or under common control with registrant.
- c. Item 25 - Indemnification. Requires disclosure of the general effect of any contract, arrangement or statute under which any director, officer, underwriter, or affiliated person of the registrant is insured or indemnified in any manner against any liability that may be incurred in such capacity, other than insurance provided by the above persons for their own protection).
- d. Item 26 - Business and Other Connections of Investment Adviser.
- e. Item 27 - Principal Underwriters (identity and certain other information).
- f. Item 28 - Location of Accounts and Records.
- g. Item 29 - Management Services.
- h. Item 30 - Undertakings (of the fund).
- i. Signatures. Persons required to sign the registration statement include the registrant, its principal executive officer(s), its principal financial officer, and the majority of its board of directors or trustees. Because all filings are now electronic, funds must maintain signed originals at its offices.

C. **SEC Review of the Initial Registration Statement**

1. **Transmitting the registration statement**

When filing a registration statement or amendment with the SEC, a fund should include a letter of transmittal describing: (a) any material changes from the most recent filing of the same kind by that complex; (b) any problem areas that warrant particular attention; (c) any new investment

techniques, products, or methods of distribution; and (d) any prior filings intended as precedent for the current filing. (See Investment Company Act Release No. 13768 (February 15, 1984)).

2. Review of the registration statement by the Office of Disclosure Policy and Review

Any mutual fund registration statement filed with the SEC, unless it is an insurance product, is assigned to the Office of Disclosure Policy and Review, which is within the Division of Investment Management. Funds and fund complexes are assigned to a particular branch, and all disclosure matters relating to that fund complex are customarily reviewed by that particular branch. In addition to the reviewing branches, the Office of Disclosure Policy and Review has a Senior Accountant who generally is called upon by the branches to review complex financial matters.

3. Type of review to expect

- a. Full Review. Full review of the entire registration statement will occur if the registrant does not specifically request selective review of certain portions of its registration statement.
- b. Selective Review. A registrant may request selective review of a registration statement if the registration statement is substantially similar to disclosure contained in previous filings by a fund in the same complex that was reviewed by the staff relatively recently (See Securities Act Release No. 6510 (Feb. 15, 1984)).
 - (1) Conditions for selective review of a new fund registration include that the disclosure for the new fund may not be substantially different from that in the previous filed registration statement or other documents cited as similar.
 - (2) Where a registrant has requested selective review, the SEC staff will review the remainder of the registration statement only to confirm that a full review is not necessary.

4. Exchange of comments

Initial written comments from the SEC staff based upon its review of the filing typically are provided to the registrant within 30 days of filing. Responses to the staff comments may be handled in various ways.

- a. Telephone follow-up with the staff to clarify any comments given is usually productive. Certain branches permit oral responses to their comments; written responses are required by other branches.
- b. Pre-effective amendments to the registration statement generally should be filed only after all outstanding comments have been resolved.

5. **When registration becomes effective**

The registration statement usually becomes effective by SEC order, granted only when all SEC staff comments have been resolved. In rare cases, a registrant may force the issue by filing a pre-effective amendment that does not contain a delaying amendment, after which the registration becomes effective automatically in 20 days. This should be done only where the registrant is confident that the SEC staff will not issue a stop order; even then, it can create ill will with the staff, so it is very rarely used. As soon as the registration statement is effective, sale of fund shares may commence.

6. **Tandy Representations**

In connection with responding to SEC staff comments, the staff often requests that the fund provide a written statement acknowledging that:

- a. The fund is responsible for the adequacy and accuracy of the disclosure in the filings;
- b. Staff comments or changes to disclosure in response to staff comments in the filings reviewed by the staff do not foreclose the SEC from taking any action with respect to the filing; and
- c. The fund may not assert staff comments as a defense in any proceeding initiated by the SEC or any person under the federal securities laws of the United States.

In addition, Tandy Representation requests are accompanied by a statement that the Division of Enforcement has access to all information provided to the staff of the Division of Investment Management in fund filings and in response to staff comments on filings.

D. **Rule 497 Filings**

- 1. *Definitive Forms of Prospectuses and SAIs.* No later than five calendar days after a registration statement containing a prospectus and SAI

becomes effective (or five days after the prospectus is first used in a public offering), the fund must file the definitive form of prospectus and SAI pursuant to Rule 497(c) under the Securities Act. The content of filings under Rule 497(c) may vary from the registration statement in non-materials ways, such as to correct typos or insert non-material information. Alternatively, if there are no alterations to the documents filed in the registration statement, the fund may file a certification pursuant to Rule 497(j) under the Securities Act.

2. *“Sticker” Amendments - Rule 497(e).* Material changes in the prospectus can also be made by supplementing the existing prospectus pursuant to Rule 497(e) under the Securities Act. These “sticker” amendments have the effect of providing material information on a current basis, without the need to wait 60 days until a post-effective amendment (discussed below) becomes effective.

E. Number of Shares Registered - Rule 24f-2

Open-end investment companies are deemed to have registered an indefinite number of shares under Section 24(f)(2) of the 1940 Act.

1. The investment company must file a Rule 24f-2 Notice within 90 days of the end of its fiscal year, accompanied by payment of registration fees on shares sold, less shares redeemed, during the period. Shares distributed in payment of dividends and distribution must be counted as sold for this purpose.
2. If the company does not pay the fee within that period, it will owe interest thereon, and may be subject to other penalties.

II. POST-EFFECTIVE AMENDMENTS

A. General

1. Modifications to a registration statement may be made after its original effective date by filing a “post-effective amendment” with the SEC. Rule 485 under the Securities Act was adopted to provide an easy, controllable mechanism to make amendments. The Rule distinguishes between “routine” and “non-routine” changes; the distinction affects the length of time necessary for the modification to become effective.
2. Post-effective amendments are generally needed in order to update financial information which has become stale. Section 10(a)(3) of the Securities Act prohibits any registrant from using a prospectus with audited financial statements that are more than 16 months old.

Amendments also are needed when a prospectus no longer accurately reflects fund operations or practices.

B. Non-Routine Amendments - Rule 485(a)

1. A non-routine amendment consists most often of material changes in a prospectus or SAI. Material changes include, but are not limited to -
 - a. Changes in a registrant's investment objectives or policies;
 - b. Termination of an investment advisory contract; or
 - c. Resignation of the registrant's independent registered public accounting firm or one of its directors.
2. Except as otherwise provided, a post-effective amendment becomes effective 60 to 80 days after filing, as designated by the registrant, unless the SEC, in the public interest and with due regard for investor protection, declares the amendment effective on an earlier date.
3. Post-effective amendments filed to establish a new series of an existing investment company registrant are also filed under Rule 485(a). Such amendments become effective 75 to 95 days after filing, as designated by the registrant.

C. SEC Staff Review

1. *SEC Staff Review.* Similar to the SEC staff review of initial registration statements, discussed above under "SEC Review of the Initial Registration Statement," the SEC staff will review post-effective amendments filed under Rule 485(a). SEC staff comments are usually provided in a phone conversation with the individual signing the transmittal letter and the fund must file on EDGAR a written response summarizing the comments and the fund's responses, along with the Tandy representations described above. SEC staff comments are customarily provided by the 45th day after the amendment is filed.
2. *Acceleration.* A registrant may request acceleration of its post-effective amendment to a date earlier than the date prescribed in Rule 485(a). Although the SEC staff is not obligated to satisfy this request, the staff customarily grants the request if all outstanding comments have been resolved to the staff's satisfaction. Registrants contemplating acceleration are required to notify the staff of this in the transmittal letter accompanying the filing of the amendment, and, once comments have

been resolved, the registrant and the underwriter must submit via EDGAR a separate formal request for acceleration.

D. Routine Amendments - Rule 485(b)

A routine post-effective amendment becomes effective on the date when it is filed or on a later date designated by the registrant on the facing sheet of the amendment. The date may be no later than 30 days after the date on which the amendment is filed. Prerequisites for filing pursuant to this subpart of the Rule are:

1. The amendment is filed for one of the following purposes and no other:
 - a. to update financial statements;
 - b. to designate a new effective date for a previously filed Rule 485(a) amendment;
 - c. to disclose or update information required by Form N-1A Items 5 (fund management) or 6(a)(2) (calculation of the fund's share price);
 - d. to make any non-material changes that the registrant deems appropriate (e.g., correcting inconsistencies, typographical or other technical errors or changes deemed immaterial by registrant); or
 - e. any other purpose which the SEC shall approve.
2. The registrant must represent that no material event requiring disclosure in the prospectus has occurred since the latest of these dates:
 - a. the effective date of the registrant's registration statement;
 - b. the effective date of its most recent post-effective amendment to its registration statement that included a prospectus; or
 - c. the filing date of a post-effective amendment which has not yet become effective.
3. If counsel prepares or reviews the post-effective amendment, it must furnish a written representation that the amendment does not contain disclosures that would render it ineligible under subsection (b).
4. The post-effective amendment must recite that it will become effective pursuant to subsection (b) of the Rule.

5. The signature page of the amendment must certify that the amendment meets all of the requirements for effectiveness pursuant to subsection (b) of the Rule.
6. Penalties for misusing Rule 485(b) include the suspension of the ability to file pursuant to that subsection.

E. Rule 497 Filings

1. *Definitive Forms of Prospectuses and SAIs.* Similar to the requirement for a fund to file a definitive form of prospectus and SAI after its initial registration statement becomes effective, no later than five calendar days after an amendment containing a prospectus and SAI becomes effective (or five days after the prospectus is first used in a public offering), the fund must file the definitive form of prospectus and SAI pursuant to Rule 497(c) under the Securities Act. The content of filings under Rule 497(c) may vary from the amendment in non-materials ways, such as to correct typos or insert non-material information. Alternatively, if there are no alterations to the documents filed in the amendment, the fund may file a certification pursuant to Rule 497(j) under the Securities Act.
2. *“Sticker” Amendments - Rule 497(e).* Material changes in the prospectus can also be made by supplementing the existing prospectus pursuant to Rule 497(e) under the Securities Act. These “sticker” amendments have the effect of providing material information on a current basis, without the need to wait 60 days until another post-effective amendment becomes effective.

III. SECURITIES ACT CIVIL LIABILITY

A. False or Misleading Registration Statements

The Securities Act provides a specific civil remedy for purchasers who acquire securities covered by false or misleading registration statements. A registration statement is misleading if at the time it becomes effective it contains “an untrue statement of material fact or omit(s) to state a material fact required to be stated therein, or necessary to make the statements therein not misleading.” (Section 11(a).)

1. Persons who may be liable:
 - a. Every person who signed the registration statement;
 - b. Every director of the issuer;

- c. Every person about to become a director, who with his or her consent is named in the registration statement;
- d. Every accountant, engineer, appraiser, attorney, or other person who gives an expert opinion with respect to a part of a registration statement;
- e. Every underwriter of the security; and
- f. Any controlling person of the foregoing.

2. Defenses

Defendants who can demonstrate that they did not know, and after a reasonable investigation did not have reason to suspect, that the registration statement contained a material misstatement or omission may not be held liable.

B. False or Misleading Prospectuses or Oral Communications

Section 12 of the Securities Act permits purchasers to sue any seller or offeror of a security who used a prospectus or oral communication that was false or materially misleading. The seller may defend on grounds that he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

C. Statute of Limitations

Section 13 of the Securities Act provides a statute of limitations for actions under Section 11 or 12 of the Act; i.e., one year from the date the purchaser discovers the violation, but in no event more than three years after the purchase.

IV. STATE SECURITIES LAWS

Funds must register their shares in each state in which the shares are offered to the public. This is referred to as “blue sky” registration. Accordingly, those states require certain notice filings and impose filing fees. Depending on the state, these may include copies of all registration statements and post-effective amendments and/or certain other state forms (such as Form NF or Form U-2).

The enactment of the National Securities Markets Improvements Act of 1996 eliminated the substantive regulation of SEC-registered mutual funds by state securities regulators, although states retain anti-fraud authority.

MUTUAL FUND DISTRIBUTION AND ADVERTISING

Trayne S. Wheeler

www.klgates.com

Mutual Fund Distribution Channels

- Broker-Dealers: A, B, C Shares
- Retirement Plans: R Shares
- Independent Investment Advisers
- Fee-based (“Wrap Fee”) Programs: F/W Shares
- Fund Supermarkets: Service Fee
- Banks
- Direct Sales: No Load
- Variable Insurance Products

Ways of Paying for Mutual Fund Distribution

- Mutual fund share sales charges are generally a combination of the following:
 - Front-end sales loads
 - Contingent deferred sales load (“CDSL”)
 - 12b-1 fees
- Issues with certain indirect payments that have legitimate uses but can hide distribution payments:
 - Shareholder servicing fees
 - Sub-transfer agency fees

FINRA - NASD Sales Charge Limits

- Limits on sales charges:
 - Funds without an asset-based sales charge:
 - No service fee: 8.5% on front-end load + CDSL
 - With service fee: 7.25% on FEL + CDSL
 - Funds with an asset-based sales charge:
 - No service fee: 7.25% on FEL + CDSL + AB charge
 - With service fee: 6.25% on FEL + CDSL + AB charge
 - 12b-1 fee limits:
 - Distribution charges: 75 bps
 - Service Charges: 25 bps
- “No load” rule: only if sales charges 25 bps or less

Rule 12b-1

- A mutual fund can “directly or indirectly finance any activity primarily intended to result in the sale of shares” only if it has adopted a compliant rule 12b-1 plan:
 - Director/shareholder initial approval
 - Directors find a “reasonable likelihood that the plan will benefit the fund and shareholders.”
 - Fund governance requirements
 - Annual renewal
 - Quarterly reports on expenditures

Rule 12b-1

- Issues:
 - Directors have difficulty finding “reasonable likelihood of benefit” because SEC factors are outdated and other standards are unclear.
 - The management fee cannot be used as a conduit for distribution expenses, but the manager can use “its own resources” or “legitimate profits” to finance distribution.
 - What this means is unclear, which complicates the directors’ findings on manager costs during the 15(c) process.
 - Supermarket fees: directors must determine whether some portion is for distribution and if so, they must be paid pursuant to a 12b-1 plan.
- Reform?

Rule 22d-1

- Sec. 22(d) prohibits sales of load fund shares except at the public offering price, which prevents competition between brokers on sales charges.
- Rule 22d-1 permits variations in sales charges, provided that:
 - Each sales charge variation and the class to which it applies is described in the prospectus and SAI
 - The variation is applied to all in the class
 - One year notice of changes to existing shareholders

Revenue Sharing

- Payments by investment advisers or their affiliates to fund distributors to compensate them for fund share distribution and shareholder services, including:
 - Payments for placement on preferred lists, access to sales force, and training and education in funds
 - Compensation for recordkeeping, account statements, shareholder communications
- Payments are outside of any 12b-1 plan; driven by NASD limits on loads and 12b-1 fees.

Revenue Sharing

- Issues:
 - If not adequately disclosed, revenue sharing may present a conflict of interest between the distributor and its clients
 - May compromise the advice that distributors offer to fund investors
 - The SEC transaction confirmation rule requires broker-dealers to disclose to clients at settlement
 - A series of SEC enforcement actions against broker-dealers for failing to disclose adequately
 - Revenue sharing may represent an indirect use of fund assets to finance distribution outside a fund's 12b-1 plan
 - BISYS Case

Revenue Sharing

- Broker-dealers disclose in separate statements, and mutual funds disclose in the prospectus and SAI:
 - Source/destination of payments
 - Range of payments
 - Uses of payments, *e.g.*, access, services
 - Potential for conflict of interest

Multiple Class and Master-Feeder Arrangements

- Multiple Class Funds
 - Organizing a fund with multiple classes is a simple way to target fund distribution to many types of investors
 - This raises suitability concerns for broker-dealers
- Master Feeder Funds
 - Valuable structure for distribution to taxable and tax exempt investors through onshore/offshore feeder funds with onshore master funds
 - The registered fund of hedge funds – 1940 Act only funds

SEC Regulation of Advertising

- Section 5 of 1933 Act Registration Limitations in Advertising
- Profile Prospectus – Rule 498
- Generic Advertising – Rule 135a
- Omitting Prospectus – Rule 482
 - Money Market Fund Disclosures
 - Standardized Performance Disclosures
 - Prominence and Disclaimer Requirements
- Supplemental Sales Materials – Rule 34b-1
- Advertising Standards – Rule 156

Mutual Fund Advertising Rules

- Sec. 5 prohibits offers (broadly defined) of securities except through a Sec. 10 prospectus. A series of rules define what is a compliant prospectus or else what is not a Sec. 5 offer.
 - N-1A: must be effective or “red herring”
 - Rule 482 “Omitting Prospectus”
 - Rule 134 Tombstone Advertising
 - Rule 135a Generic Advertising
 - Rule 498 Profile Prospectus
 - Rule 34b-1 Supplemental Sales Literature

Rule 482

- The primary mutual fund advertising rule because it is the only one that permits performance data.
 - Must generally comply with N-1A, but is not limited to info in the fund's filed N-1A
 - General required disclosures: availability of prospectus, source, should consider carefully
 - Performance data must be calculated in accordance with instructions to Form N-1A, as of the most recent practicable date.
 - Prominence requirements: same size, different style
 - Required performance disclosures:
 - Past performance does not guarantee future results
 - Return and principal will fluctuate
 - Contact info for current performance data
 - Reflects sales load or disclose that it doesn't, would reduce performance

Rule 135a

- Generic advertising that is not an offer to buy fund shares. The communication may only contain:
 - Explanatory information as to mutual fund shares generally, or to the nature of mutual funds, or to shareholder services
 - Mention and explanation of generic types of mutual funds, e.g. balanced, growth, income, stock, bond
 - Offers of services that are not securities and do not directly relate to mutual funds.
 - Bank account ok, wrap fee account not
 - Invitation to inquire for further information
- The communication must contain the name and address of the sponsor.

Supplemental Sales Literature

- Marketing materials that must be preceded or accompanied by a prospectus.
 - May contain any information that is not misleading; rule 34b-1.
- Newsletters can contain both 482 and 135a material, provided that 482 material is segregated and presented as a separate unit
 - Disclosure and prominence rules must be followed.
- Rule 156 sets forth a general rule that no sales material (whether or not relying on another rule) can be materially misleading or omit to state a material fact.

Use of Related Fund Performance

- The SEC staff has permitted the performance of related funds and accounts to be presented in fund advertising and sales material, in a series of no-action letters. Summary of requirements:
 - Equivalent investment objectives, policies and restrictions
 - No greater prominence to related performance than fund's own performance
 - Clear disclosure that it belongs to a different vehicle
 - Past performance is not indicative of future results
 - Compare to a relevant index
 - Calculated in accordance with SEC rules
 - Describe all material differences
- FINRA does not permit the use of related performance in materials filed with FINRA; as a practical matter, related performance can only be used in a fund prospectus.

FINRA Regulation and Review

- All mutual fund sales material must be filed with the SEC or, if used by a FINRA member, with FINRA.
- FINRA reviews to assure that they are fair, balanced, in good faith, not misleading, and compliant with FINRA rules.
- Specific requirements include:
 - Disclose name of FINRA member using material
 - If performance data is presented: maximum front-end load and CDSL and annual operating expense ratio in prominent text box
 - Fund ranking guidelines
 - Investment Analysis Tools
 - Bond Fund Volatility Ratings

FINRA Advertising Rules

- Rule 2210 – Communications with the Public
 - Materials must be filed with FINRA
- Rule 2211 – Institutional Sales Material and Correspondence
 - Fewer filing requirements
 - Same substantive application of FINRA rules

CLOSED-END FUNDS

Clair E. Pagnano
K&L Gates LLP

www.klgates.com

Overview of Closed-End Fund Program

1. The Closed-End Fund Structure
2. The Offering Process
3. Hot Topics in Closed-End Funds

The Closed-End Fund Structure:

What is a closed-end fund?

- Registered investment company
- Shares sold in one time IPO
- After IPO shares trade on an exchange (e.g., NYSE)

The Closed-End Fund Structure:

What are the advantages to a closed-end fund?

- Use financial leverage (debt or preferred shares)
- Invest 100% in illiquid securities
- Fixed asset based

The Closed-End Fund Structure:

What are the major structure differences with open-end funds?

- Shares not redeemable
- Shares not continuously offered
- Priced in secondary market
- Dividend and distribution policies

The Closed-End Fund Structure:

What are the major registration differences with open-end funds?

- Form N-2
- No requirement for annual updating of registration statement
- Register under the 1934 Act if exchange listed

The Closed-End Fund Structure:

What are the major reporting differences with open-end funds?

- Officers/directors file forms 3, 4 and 5 to report personal trading in fund
- Notification to exchange of major changes/activity
- Press releases required to notify public of major changes/activities

The Offering Process:

How are closed-end funds offered?

- Initial registration statement filed and must be approved by SEC
- Underwriting syndicate is formed to sell fund during a 30-day “road show”
- Initial share price determined through discussion with lead underwriter

The Offering Process:

Can closed-end funds make additional offerings?

- Additional shares registered with SEC and receive full review
- Preferred shares offering
- Rights offerings
- Shelf offerings

The Offering Process:

What are a closed-end fund's on-going regulatory requirements?

- Annual shareholder meeting
- Annual and semi-annual shareholders reports
- No annual registration statement updating

Current Issues Affecting Closed-End Funds:

What are closed-end funds “hot topics”?

- Auction rate securities liquidity crisis
- New money market fund eligible preferred shares
- Regulatory proceedings in connection with auction rate securities
- NAV discounts
- Shareholder activism
- Managed distribution orders

Current Issues Affecting Closed-End Funds:

What happened with auction rate securities?

- Mid-February 2008 auctions “failed”
- Major broker-dealers stopped buying for own accounts
- Shareholders could not sell securities

Current Issues Affecting Closed-End Funds:

What did funds do to bring liquidity to ARS holders?

- Replaced ARS with bank borrowings
- Many banks will not lend to fixed income funds
- Not available for tax-free municipal funds
- Tender option bonds

Current Issues Affecting Closed-End Funds:

Is there a replacement for ARS?

- Preferred shares with liquidity backstop
- Eaton Vance no-action letter – June 2008
- Eligible for purchase by money market funds

Current Issues Affecting Closed-End Funds:

What has been regulators reaction to ARS liquidity crisis?

- Proceedings against BDs for ARS sale practices
- Allege misrepresentations that ARS were safe and highly liquid
- Major BDs announced agreements to purchase ARS securities from certain investors
- Regulators imposed significant fines – up to \$125 million

Current Issues Affecting Closed-End Funds:

How are funds performing under current conditions?

- On-going credit market crisis impacts trading discounts
- Most funds experiencing significant NAV discounts and market price fluctuations

Current Issues Affecting Closed-End Funds:

How have shareholders reacted to these conditions?

- ARS holders withholding votes even in routine proxies
- Unified stance may be taken by activist investors and cause expensive delays
- Closed-end fund “raiders” may take more active role given steep NAV discounts

Current Issues Affecting Closed-End Funds:

Are closed-end funds doing anything to address dividends?

- SEC recommenced issuing Section 19(a) managed distribution orders
- Permits closed-end funds to distribute long-term gains as frequently as monthly
- Policy can assist funds in creating stable distribution rate and address trading discounts

SPECIAL ISSUES REGARDING CLOSED-END FUNDS

I. DIFFERENCES BETWEEN OPEN-END AND CLOSED-END FUNDS

A. Substantive Differences

Closed-end funds differ from open-end funds in several significant respects. These include:

1. Securities Not Redeemable

- a) The most fundamental difference between closed-end and open-end funds is that closed-end funds do not offer “redeemable securities.” In other words, a closed-end fund does not stand ready at any time to redeem shares presented by shareholders by giving shareholders their proportionate amount of the current value of the fund’s assets.
- b) Rather, a closed-end fund’s shares, once sold, are typically traded on a secondary market among shareholders and market makers and are rarely repurchased by the fund itself.

2. Not Continuously Offered

- a) Most open-end funds continuously offer their shares to the public. This means that they have a current registration statement on file with the SEC at all times and that, generally, they may sell as many new shares of the fund as investors are willing to purchase.
- b) Closed-end funds, on the other hand, generally have a single public offering (which can be followed by additional offerings if demand for a fund’s shares is sufficient). As a result, investors wishing to purchase closed-end fund shares after the public offering has been completed must purchase the shares in a secondary market (typically on a stock exchange).

3. Trading Price

- a) Open-end fund shares are offered to the public at net asset value (“NAV”), plus in some cases a sales load or contingent deferred sales charge. This means that the price of the fund’s shares directly reflects the value of its underlying portfolio securities.
- b) Closed-end fund shares, by contrast, are priced by the secondary market; i.e., they are only worth what investors are willing to pay for them. This pricing mechanism for closed-end funds often leads to some disparity between a fund’s NAV and its trading price. There is usually a “discount” between NAV and trading price, although a few funds are in such demand that they trade at a premium. This is discussed in more detail below.

B. Registration Differences

1. Use of Form N-2

- a) Unlike open-end funds, which must register their shares on Form N-1A, closed-end funds register their shares on Form N-2.
- b) Form N-2 resembles Form N-1A in many respects although, as of the date of this outline, the SEC has not yet issued its “simplified” form of Form N-2. As a result, the presentation of information in Form N-1A and Form N-2 can be quite different.
- c) In addition, while Form N-1A prescribes the use of a separate prospectus and SAI, the use of an SAI for closed-end funds is elective under Form N-2. As a result, many closed-end funds choose to have a combined prospectus and SAI. If a closed-end fund elects not to use an SAI, all of the information which would normally appear in the SAI must appear in the prospectus.

2. Updating the Closed-End Fund Registration Statement

- a) Open-end funds must annually update their registration statements to provide, among other items, the most recent audited financial statements of the registrant, pursuant to Section 10(a) of the 1933 Act and Rule 8b-16 under the 1940 Act.

- b) Because closed-end funds do not continuously offer their shares, they are exempt from 1933 Act updating requirements, and the SEC has also exempted closed-end funds from the requirements of annually updating their 1940 Act registration statements.
- c) Rule 8b-16(b) excepts closed-end funds from annual updates of their registration statements, provided that closed-end funds disclose relevant information to investors through their annual report. Rule 8b-16(b) includes a number of items that must be included in the annual report (in addition to the information that is already required in the annual report). These include:
 - information about the fund's dividend reinvestment plan;
 - material changes to the fund's investment objectives and policies that have not been approved by shareholders;
 - any changes to a fund's charter or by-laws that would impede a change of control transaction that have not been approved by shareholders;
 - any material changes in the principal risk factors associated with investment in the fund; and
 - any changes in personnel primarily responsible for day-to-day management of the fund's portfolio.

C. Reporting Differences of Closed-End Funds

1. Trading by Insiders

- a) Because the trading prices of closed-end fund shares are determined by market forces on an exchange (and not by NAV), they are susceptible to the same dangers of insider trading as industrial companies.
- b) As a result, the officers and directors of closed-end funds must be extremely careful to follow the trading guidelines established by the fund's investment adviser to avoid running afoul of the antifraud/insider trading prohibitions (Rule 10b-5, etc.) of the securities laws.

- c) Moreover, even when trading is permitted by the fund's guidelines, officers and directors of a closed-end fund are subject to the reporting requirements of Section 16(a) of the 1934 Act and Section 30(h) of the 1940 Act, as well as the disgorgement provisions of Section 16(b) of the 1934 Act.
- d) Consequently, officers and directors of a closed-end fund must file a Form 3 at the time of the initial public offering of the fund, a Form 4 to report their trading activity, and a Form 5 at the end of each fiscal year.
- e) Additionally, officers and directors must forego any profits from any purchases and sales, or sales and purchases, of a closed-end fund's shares within any six-month period.

2. **Notification of the Exchange**

- a) Any major activity or change in a closed-end fund must generally be reported to, and in some cases cleared by, the exchange on which the fund's shares are listed.
- b) In the case of the New York Stock Exchange, the "Listed Company Manual" contains detailed provisions regarding communications required between issuers and the Exchange.

3. **Obligation to Issue Press Releases**

- a) Closely tied to the concerns about insider trading is the necessity that closed-end funds issue press releases to notify the public about any major events regarding the fund.
- b) This is particularly true in situations in which the trading price of a closed-end fund's share could be affected by the event (e.g., the resignation of a portfolio manager).
- c) Prompt issuance of a press release ensures that any officers, directors or other insiders of the fund who do purchase or sell the fund's shares will not be accused of trading while in possession of material non-public information.

D. Operational Differences of Closed-End Funds**1. Initial Offering of Closed-End Fund Shares**

- a) The initial offering of shares of a closed-end fund more closely resembles an initial public offering of an industrial company than it does the offering of open-end shares.
- b) As with an open-end fund, the registration statement must be filed with and cleared by the SEC. In addition, the underwriter (by virtue of its NASD membership) is required to submit the registration agreement and underwriting agreement to the NASD for its review.
- c) Although not always the case, SEC/NASD review of and comments on closed-end fund registration statements tend to be somewhat heavier than for their open-end counterparts, in part because closed-end fund offerings involve an underwriting syndicate, pricing and distribution issues, and exchange listing questions not present with open-end funds.
- d) Typically, an IPO of a closed-end fund will offer for sale a definite number of shares at a price determined through negotiation between the fund's sponsor and one or more underwriters. The IPO will also typically include an over-allotment option (or "green shoe") permitting the underwriters to sell additional shares if the offering is over-subscribed.
- e) In addition, the offering is generally sold through an underwriting syndicate that is unaffiliated with the closed-end fund.

2. Additional Offerings of Closed-End Fund Shares

- a) After its initial public offering, if a closed-end fund is popular with investors, its sponsors may determine to offer additional shares of the fund.
- b) These additional shares must be registered with the SEC through another registration statement, which also will include any changes (in investment advisers, investment policies, etc.) that have occurred since the previous registration statement was declared

effective, even if such changes were previously disclosed in the fund's annual report.

- c) The new registration statement, unless it follows closely after the first registration statement, typically will receive a full review from both the SEC and the NASD.

3. **Liquidity of Portfolio Securities**

- a) Because an open-end fund must be able to make payment within seven days after its shares are proffered for redemption, open-end funds are generally limited to holdings in "illiquid" securities of no more than 15% of their net assets. (An "illiquid" security is one for which there is no established trading market or that cannot be assured of sale within seven days at approximately the price at which the fund is carrying it.)
- b) Closed-end funds, by contrast, have no redemption obligations, and therefore may invest all or any part of their net assets in illiquid securities.
- c) The practical effect of this difference is that if a fund complex wishes to establish a fund to invest primarily in securities for which the trading market is very thin or non-existent (e.g., certain developing market countries or certain debt instruments), it may be impossible to meet the liquidity requirements of an open-end fund and may be necessary to set up the fund as a closed-end vehicle.

4. **Diversification**

- a) Note that the diversification tests of Section 5(b)(1) of the 1940 Act apply to closed-end funds. Accordingly, if a closed-end fund wishes to be classified as "diversified," it would have to meet the single issuer limitations of Section 5(b)(1).
- b) As a practical matter, most closed-end funds are "non-diversified," because the markets in which they invest often have few issuers or small issuers whose securities can be purchased. Closed-end funds thus frequently invest more than 5% of their total assets in the securities of a single issuer and/or hold more than 10% of the outstanding securities of such issuers. To qualify as pass-through

entities for tax purposes, however, such funds still have to meet the diversification tests of the Internal Revenue Code.

5. Annual Meetings

- a) Open-end funds, unless organized in a state that so requires, generally do not hold annual meetings and, barring any actions that require a shareholder vote (e.g., change of investment adviser, change in fundamental investment objectives), may often operate for years without a meeting of shareholders.
- b) Closed-end funds, on the other hand, are typically required by the exchange on which they are listed to have an annual meeting of shareholders.
- c) This means that a closed-end fund each year must draft and send to shareholders a proxy statement that, at a minimum, provides for the election of directors.

6. Pricing

- a) Because open-end funds continually buy and sell their shares at a price based on net asset value, the funds have to price at least once each business day.
- b) Closed-end funds, by contrast, do not have to price daily. Most of them price weekly (on Thursday or Friday), so their net asset value (and the trading discount or premium) can be reported in the newspaper. (*But see* Section III. B. below regarding “continuously offered” closed-end funds.)

II. DISTRIBUTION AND REPURCHASE OF CLOSED-END FUND SHARES

A. Distribution of Closed-End Fund Shares

1. Section 23(a) of the 1940 Act

- a) Section 23(a) prohibits closed-end funds from issuing shares for services or for property other than cash or securities, except as a dividend or distribution to its existing shareholders or in connection with a reorganization.

- b) The purpose of this provision is to prevent the dilution of the value of shares held by investors in closed-end funds. For example, a closed-end fund is prohibited from offering stock options to fund officers or affiliates to compensate them for “sweat equity” that they have contributed to the fund.
- c) Similarly, a closed-end fund may not accept property (e.g., real estate) in return for shares of the fund.
- d) The intent of Section 23(a), of course, is to prevent misuse and manipulation of fund resources by officers, directors and affiliates of the fund.

2. **Section 23(b) of the 1940 Act**

- a) Section 23(b) prohibits the sale of shares by a closed-end fund at a price below current net asset value, subject to certain important exceptions. Again, the intent of this section is to prevent the issuance of “cheap stock” to insiders of closed-end funds to the detriment of other shareholders.
- b) The most important exception involves offerings of shares to existing shareholders in the fund. Pursuant to this exception, closed-end funds occasionally make “rights offerings” to existing shareholders permitting them to purchase additional fund shares at or below net asset value.
- c) However, since the “rights” in a rights offering are often transferable by existing shareholders to non-shareholders, this exception has become a vehicle for the sale of closed-end fund shares to the general public.
- d) Such offerings are carefully monitored by the SEC, because they can have the effect of either (i) diluting the aggregate net asset value of the shares owned by shareholders who do not fully exercise their rights, or (ii) coercing existing shareholders into investing more money in the fund to prevent being diluted.
- e) Closed-end fund directors who are considering such a rights offering at below current NAV must make a good faith

determination that the offering will result in a net benefit to existing shareholders, including those who decide not to exercise their rights. (Note that this type of rights offering formed the underlying basis for the *Strougo* case involving the independence of fund directors).

B. Repurchases of Closed-End Fund Shares

1. Section 23(c) of the 1940 Act

- a) Section 23(c) of the 1940 evidences Congress' concern that fund insiders not be given undisclosed opportunities to resell their shares to the fund.
- b) Section 23(c) provides that a closed-end fund may not repurchase its securities except in three circumstances:
 - (1) First, a closed-end fund may repurchase on a securities exchange after adequate notice to its shareholders. Each shareholder thereby has the opportunity to sell his or her shares.
 - (2) Second, a closed-end fund may repurchase pursuant to a tender offer to all shareholders. In such cases, the tender offer rules of the 1934 Act (particularly Rule 13e-4, addressing issuer self-tenders) must be followed.
 - (3) Finally, Section 23(c) permits other repurchases that the SEC specifically exempts pursuant to rulemaking. The SEC has promulgated Rule 23c-1, which sets forth the conditions under which closed-end fund shares may be repurchased, and Rule 23c-2, which governs call and redemption of closed-end fund securities.

2. "Interval" Funds under Rule 23c-3

- a) In 1993, the SEC adopted Rule 23c-3 to permit closed-end funds to make periodic offers to its shareholders to repurchase a specified percentage of its shares at net asset value.

- b) Rule 23c-3 requires a closed-end fund to adopt three-, six- or twelve-month repurchase intervals and to offer to repurchase between 5% and 25% of its outstanding shares in each repurchase offer.
- c) The intent of this rule is to give shareholders in closed-end funds that trade at a discount to NAV the opportunity to resell at least a portion of their shares at NAV.
- d) If such offers are oversubscribed, the fund must prorate purchases equally among shareholders.
- e) Per Rule 23c-3(b)(8), effective September 7, 2004, funds wishing to rely on Rule 23c-3 must comply with fund governance standards on director independence under Rule 0-1(a)(7) as of January 16, 2006.

III. **HOT TOPICS CONCERNING CLOSED-END FUNDS**

A. **Corporate Governance Standards**

1. **Closed-End Funds Excepted from Most Expanded NYSE Standards**

- a) Section 303A of NYSE “Listed Company Manual” imposes new standards and requirements on most companies listing common equity securities.
- b) The standards and requirements are generally not applicable to closed-end and open-end management investment companies registered under 1940 Act due to extensive pre-existing regulation. However, certain provisions of Section 303A do apply to closed-end companies and certain open-end companies (commonly known as Exchange Traded Funds or ETFs).

2. **Compliance Required for Certain NYSE Standards**

- a) Closed-end funds must satisfy certification, notification and some audit committee requirements of Section 303A.
- b) ETFs must also satisfy certain certification, notification and audit committee requirements, though on a more limited basis.

B. “Open-Ending” Closed-End Funds**1. Pressure Arising from Trading Discounts Relative to NAV**

- a) The vast majority of closed-end funds continue to trade at prices below their NAV. When a closed-end fund is trading at such a “discount,” the underlying value of the portfolio securities owned by the fund is higher than its trading price, which (in the absence of a repurchase offer) is the price that shareholders can get if they sell their shares.
- b) These “discounts” typically range from 1% to over 25% of NAV.
- c) Occasionally shareholders (often professional traders who have bought the fund’s shares particularly for this purpose) may object to this trading discount and seek to force the fund’s adviser to “open-end” the fund; that is, to reorganize the fund as an open-end fund.
- d) This has the beneficial short-term effect of automatically raising the price of the fund’s shares to NAV, thereby enhancing shareholders resale value.
- e) However, open-ending may have the negative long-term effect of reducing the flexibility to invest in the types of securities that the closed-end fund was established to take advantage of in the first place (e.g., illiquid securities in developing countries).

2. Shareholder Proposals to Open-End Funds

- a) Activist shareholders have attempted to compel closed-end fund management to submit proposals to shareholders to convert funds into open-end funds.
- b) Fund management typically resists this open-ending pressure by refusing to include shareholder proposals on various grounds or by introducing their own proposals.
- c) The SEC has issued a number of no-action letters addressing such proposals.

C. **“Continuously Offered” Closed-End Funds**

1. **Closed-End Funds that Continuously Offer Shares**

- a) A small but growing number of closed-end funds offer their shares to investors on a continuous basis, just like open-end funds.
- b) These funds, however, do not redeem their shares in the same way that open-end funds do and, accordingly, they are considered closed-end funds.
- c) These funds may be offered on an exchange but, more frequently, provide liquidity to their shareholders through periodic tender offers.
- d) Because they offer their shares continuously, these funds do have to maintain their current 1933 Act registrations and determine their net asset values daily.

Investment Management Compliance, Codes of Ethics

Clair E. Pagnano
George P. Attisano

www.klgates.com

- Rule 206(4)-7 under the Advisers Act – advisers must:
 - Adopt compliance programs reasonably designed to prevent violations of the federal securities laws
 - Review the program annually
 - Designate a chief compliance officer (“CCO”)
- Rule 38a-1 under the 1940 Act — fund boards must:
 - Approve fund and service provider compliance programs
 - Appoint the fund’s CCO and approve the CCO’s compensation
 - Annually review the fund’s program

Compliance Culture

- SEC staff — key aspect of a successful program is “tone at the top”
 - Oversight of compliance
 - Standards, policies and procedures
 - Due diligence in delegating responsibilities
 - Communication, education and training
 - Monitoring and auditing
 - Enforcement and discipline
 - Response, prevention and evaluation

Elements of an Adviser's Compliance Program

- Portfolio management
 - Unfair trade allocation, including IPOs
 - “Dumping” securities from favored clients to other clients
- Trading practices
 - Failure to obtain best execution
 - Inappropriate use of affiliated broker-dealer
- Proprietary and personal trading
 - Market timing, insider trading, front-running
 - Code of ethics violations

Adviser's Compliance Program (continued)

- Disclosure
 - Misleading advertisements
 - Misleading Form ADV or prospectus disclosure
- Safeguarding of client assets
 - Improper access to client assets
 - Unauthorized trading in client accounts
- Books and records
 - Failure to maintain required books and records
 - Failure to protect against unauthorized access

Adviser's Compliance Program (continued)

- Marketing
 - Failure to disclose solicitation arrangements
 - Failure of solicitor to deliver Form ADV, Part II
- Valuation and fees
 - Illiquid assets not valued appropriately
 - Inaccurate fee computation
- Privacy of client information
 - Lack of verification
 - Failure to safeguard the privacy of client information
- Business continuity
 - Failure to test
 - Failure to verify plans of third party providers

- Registered funds
 - Valuation
 - Fund pricing
 - Affiliated transactions
 - Protecting nonpublic portfolio holdings
 - Fund governance
 - Market timing

- The Chief Compliance Officer
 - Must be knowledgeable, competent and empowered
 - Fund CCO may be an employee of the adviser; Rule 38a-1 safeguards:
 - CCO appointment and compensation must be approved by the Board and a majority of independent directors
 - CCO removal requires approval of the Board and a majority of independent directors
 - CCO must present an annual written report to the Board
 - CCO must meet in executive session with the independent directors annually

- Risk Assessments
 - Review existing controls, SEC deficiency letters
 - Risks:
 - operational (inadequate systems)
 - strategic (inadequate business decisions)
 - financial (adviser may be financially unsound)
 - compliance (inadequate resources; inability to resolve conflicts)
 - Conduct risk reviews throughout the year, quarterly or annually, or when the adviser enters a new line of business

- The Annual Review
 - Compliance issues during the year
 - Changes in the adviser's business and regulatory changes
 - Interim review may be necessary
 - Written report not required but recommended for documentation
 - Fund annual review must be written, cover changes to fund and service provider programs, recommendations, issues

- Rule 17j-1 under the 1940 Act — funds, advisers and distributors must adopt a code of ethics to prohibit fraudulent practices and regulate personal securities transactions by access persons
- Rule 204A-1 under the Advisers Act — all advisers must adopt a code of ethics for supervised persons; also regulates personal trades by access persons
- Access Persons
 - Have access to nonpublic information regarding client trades or fund holdings
 - Make or have access to recommendations
 - Directors, officers and partners of the adviser
 - A fund's directors, officers and general partners are presumed to be access persons

- Required Securities Reports
 - Initial and annual holdings reports
 - Quarterly transaction reports
- Exempted Securities
 - Direct U.S. government obligations
 - Money market instruments
 - Money market funds
 - Unaffiliated mutual funds
 - UITs invested solely in unaffiliated mutual funds
- Exceptions
 - Automatic investment plans
 - Accounts that the access person does not influence or control
- Pre-Approval Required of Investments in IPOs and Private Placements

- Independent Directors
 - Not required to file initial or annual holdings reports
 - Not required to file a quarterly trade report, unless the director knew of a trade or recommendation 15 days before or after the trade or recommendation
 - Many advisers refrain from providing portfolio information to independent directors within the 15 day period

- Board Approval
 - Fund board (with a majority of the independent directors) must approve the code of ethics of the fund, the adviser and distributor, and any amendments
- Compliance and Certification Report
 - Funds, advisers and distributors must provide an annual report to the board that:
 - describes any issues and material violations arising under the code since the last report
 - certifies the adoption of procedures reasonably designed to prevent violations of the code

- Exempt Funds
 - Money market funds
 - Funds that invest only in exempted securities
- Disclosure
 - A fund's prospectus or SAI must disclose whether
 - the fund, and its adviser and distributor have adopted codes of ethics
 - the codes permit personal trades, including securities that may be purchased or held by the fund
 - The fund, adviser and distributor codes must be filed as exhibits to the fund's registration statement

- Recordkeeping Requirements
 - Current and past codes of ethics
 - Code violations and corrective actions
 - Access person reports
 - List of all persons subject to, and responsible for reviewing, the code
 - Annual compliance and certification reports
 - Reasons for pre-clearance approvals

**INVESTMENT MANAGEMENT COMPLIANCE, SEC INSPECTION AND
ENFORCEMENT PROGRAMS**

I. COMPLIANCE RESPONSIBILITIES OF REGISTERED ADVISERS AND FUNDS

A. Regulatory Framework

1. Rule 206(4)-7 under the Advisers Act — SEC-registered advisers must:
 - a. Adopt compliance programs reasonably designed to prevent violations of the federal securities laws
 - b. Review the program annually
 - c. Designate a chief compliance officer (“CCO”)
2. Rule 38a-1 under the 1940 Act — fund boards must:
 - a. Approve the compliance programs of the fund and its service providers
 - b. Review the fund’s program
 - c. Appoint the fund’s CCO and approve the CCO’s compensation

B. Compliance Culture

1. SEC staff — key aspect of a successful program is “tone at the top”
 - a. Oversight of Compliance
 - b. Standards, Policies and Procedures
 - c. Due Diligence in Delegating Responsibilities
 - d. Communication, Education and Training
 - e. Monitoring and Auditing
 - f. Enforcement and Discipline
 - g. Response, Prevention and Evaluation

C. Elements of an Adviser's Compliance Program

1. Suggested areas (as relevant)

a. Portfolio management

- (i) Style drift - chasing returns
- (ii) Violation of investment restrictions
- (iii) Window dressing and portfolio pumping
- (iv) Unfair trade allocation, including IPOs
- (v) "Dumping" securities from favored clients to other clients
- (vi) Cherry picking

b. Trading activities and practices

- (i) Failure to obtain best execution
- (ii) Failure to review execution quality
- (iii) Use of brokerage commissions to obtain goods/services outside Section 28(e), without adequate disclosure
- (iv) Unnecessary use of affiliated broker-dealer
- (v) Use of fund commissions to pay for distribution; or use of non-fund client commissions to pay un-disclosed referral fees

c. Proprietary trading of the adviser and personal trading by employees

- (i) Market timing, insider trading, front-running
- (ii) Untimely reporting or failure to report personal trades
- (iii) Codes of ethics violations
- (iv) Failure to monitor trading by all access persons

- d. The accuracy of disclosures
 - (i) Inaccurate or misleading performance numbers
 - (ii) Inadequate documentation for performance claims
 - (iii) Misleading advertisements
 - (iv) Inadequate disclosure of revenue sharing
 - (v) Misleading Form ADV or prospectus disclosure
- e. Safeguarding of client assets from conversion or misuse
 - (i) Improper or inadvertent access to client assets
 - (ii) Unauthorized trading in client accounts
 - (iii) Improper disclosure of client account information
 - (iv) Failure to reconcile discrepancies with the custodian
- f. Creating and maintaining accurate books and records
 - (i) Failure to maintain required books and records
 - (ii) Failure to protect against unauthorized access
 - (iii) Inaccurate books and records
 - (iv) Failure to produce business records
- g. Marketing advisory services, including the use of solicitors
 - (i) Failure to disclose solicitation arrangements
 - (ii) Failure of solicitor to deliver Form ADV, Part II
 - (iii) Failure to disclose payments to employees for referrals
 - (iv) Failure to have written contracts with solicitors
- h. Valuing client holdings and assessing fees
 - (i) Illiquid assets not valued appropriately
 - (ii) Inaccurate fee computation

- i. Creating and protecting the privacy of client information
 - (i) Lack of verification
 - (ii) Data not protected from unauthorized changes
 - (iii) Failure to safeguard the privacy of client information
 - (iv) Failure to notify clients of privacy policies
 - j. Business continuity plans
 - (i) Failure to test
 - (ii) Failure to provide critical personnel and systems
 - (iii) Failure to verify plans of third party providers
 - (iv) Failure to protect records
2. Registered funds — valuation; fund pricing; affiliated transactions; protecting nonpublic portfolio holdings; fund governance; market timing.

D. The Chief Compliance Officer

1. The CCO is expected to be knowledgeable, competent and empowered.
2. A fund CCO may be an employee of the adviser; Rule 38a-1 safeguards:
 - a. The Board, with a majority of independent directors, must approve the CCO and the CCO's compensation
 - b. Approval of the Board, with a majority of independent directors, needed to remove CCO
 - c. CCO must present an annual written report to the Board
 - d. CCO must annually meet separately with the independent directors

3. SEC suggests following CCO duties:
 - a. Advise senior management on an effective culture of compliance.
 - b. Advise senior management on significant compliance matters
 - c. Become the “go-to person” on compliance matters
 - d. Resolve significant compliance issues
 - e. Ensure timeliness of compliance process
 - f. Serve on risk or policy committee
 - g. Ensure that the program is comprehensive, robust, current, and reflects the firm’s business and conflicts of interest
 - h. Ensure that firm observes appropriate management principles: separation of functions, clear duties, benchmarking; reporting
 - i. Ensure competence of compliance personnel
 - j. Test trading to detect exceptions
 - k. Identify repetitive issues as possible compliance gaps
 - l. Evaluate compliance issues
 - m. Ensure that service provider compliance programs are effective
 - n. Establish a compliance calendar.
 - o. Reconcile compliance program interest to disclosures
 - p. Encourage skepticism and “thinking outside the box”
 - q. Manage the adviser’s code of ethics (required by the Advisers Act)
 - r. Conduct required annual review of adviser’s compliance program
 - s. Ensure that recommendations are implemented
 - t. Advocate for appropriate compliance resources
 - u. Stay current on compliance issues
 - v. Train staff
 - w. Active in industry efforts to develop best compliance practices

E. Annual Compliance Review

1. Risk Assessments and Compliance Reviews

- a. Review: existing controls, SEC deficiency letters
- b. Risks:
 - (i) operational (inadequate systems)
 - (ii) strategic (inadequate business decisions)
 - (iii) financial (adviser may be financially unsound)
 - (iv) compliance (inadequate resources; inability to resolve conflicts)
- c. When to conduct risk reviews:
 - (i) throughout the year, quarterly or annually
 - (ii) when the adviser enters a new line of business

2. The Annual Review

- a. Compliance issues during the year
- b. Changes in the adviser's business and changes in the Advisers Act
- c. Interim review may be necessary
- d. Written report not required but recommended for documentation
- e. Goal is to discover if the compliance program is working properly
- f. Fund annual review must be written, cover changes to fund and service provider programs, recommendations, issues
- g. The SEC staff will examine the compliance review:
 - (i) Who conducted the annual review?
 - (ii) What was the scope, and how was it determined
 - (iii) When was it performed?
 - (iv) How was it performed?
 - (v) What were the findings?
 - (vi) What were the recommendations?
 - (vii) Have the recommendations been implemented?
 - (viii) What documentation was created to reflect the work done?
 - (ix) Was senior management involved?

F. Compliance Testing - Protecting the Firm/Avoiding Personal Liability

- 1. *Transactional testing*
- 2. *Periodic testing*
- 3. *Forensic testing*

II. SEC INSPECTIONS OF REGISTERED ADVISERS

A. Introduction

1. Although the SEC has express statutory authority only to examine the books and records of advisers; as a practical matter, the SEC staff also can and does use its inspection authority to gather information.
 - a. Insistence on the statutory limitations likely to result in a subpoena for sworn testimony before the SEC's Enforcement Division.
 - b. The SEC evaluates compliance controls and risk profiles with a view towards preventing future violations.
 - c. All registered advisers should expect periodic SEC inspections.
 - d. The SEC Office of Compliance Inspections and Examinations inspects advisers, funds, brokers, transfer agents
 - e. FINRA inspects broker-dealers

B. OCIE and the Inspection Program

1. Types of Inspections

- a. Routine exams — schedule determined by the time since the last exam and the firm's risk profile
- b. Cause exams — focused on potential specific violations
 - (i) Unlike routine exams, generally unannounced
 - (ii) Require a careful response; experienced enforcement counsel should be retained
- c. Sweep exams seek to determine industry practice

C. The Inspection Process

- 1. Risk-based approach drives the selection of inspection targets
- 2. SEC inspections typically begin with a telephone call or letter that specifies the date the exam is to begin and requests documents inspection
- 3. Examination phases:
 - a. Onsite investigation — (“fieldwork”) starts with an “entrance interview” with the firm's personnel
 - b. Off-site investigation — examiners continue to review documents
 - c. Exit interviews, generally with senior management — permits the firm to react quickly or take prompt corrective action
- 4. Inspection outcomes:
 - a. Deficiency letters (most common); response should address corrective action; required within 30 days (extension possible)
 - b. Letter of no findings — exceedingly good but rare
 - c. Enforcement referral
 - (i) Most likely for fraud, customer abuse, intentional wrongdoing and significant investor losses
 - (ii) Likely to result in an enforcement investigation

D. Handling the Inspection

1. The Essential Prerequisite: An Effective Compliance Program.
 - a. *Generally.*
 - (i) Oversight
 - (ii) Standards, policies and procedures
 - (iii) Due diligence in delegating responsibilities
 - (iv) Communication, education and training;
 - (v) Monitoring and auditing
 - (vi) Response, prevention and evaluation
 - (vii) Enforcement and discipline
 - b. Portfolio management, trading practices, disclosures, safeguarding assets, recordkeeping, fees, privacy and business continuity
 - c. Portfolio valuation, share pricing, affiliated transactions, protection of nonpublic information, market timing, fund governance
 - d. *Tone at the Top* — commit sufficient resources and communicate the consequences of violations
 - e. *Qualified CCO*
 - (i) Level of experience
 - (ii) Ability and authority to effectively administer the program
 - f. *Effective Reporting and Documentation*
 - (i) At a minimum, comply with SEC and other requirements
 - (ii) Prompt production of requested records
 - (iii) A matrix facilitates timely production of requested records.
 - g. *Address Prior Deficiencies* — enforcement more likely if deficiencies not addressed

2. Managing the Process
 - a. Designate a single contact person for the examiners
 - b. Set the right tone and evidence a strong compliance culture
 - c. Make senior management available
 - d. Coordinator should understand the examination process
 - (i) Sufficiently senior to demonstrate the firm's seriousness
 - (ii) Frequently the CCO, general counsel or senior staff
 - e. Beginning the Exam
 - (i) Coordinator should introduce him or herself to the staff
 - (ii) Designate a specific office
3. Employees should be informed of the presence of the examination staff; all conversations should be private
4. Coordinator should inquire about the focus of the examination
 - a. If there is a concern, the coordinator should inform the CCO and the firm's legal counsel
 - b. Consider identifying problem areas at the outset
5. Respond promptly to examiners' requests
 - a. Review documents; do not provide privileged or irrelevant materials
 - b. Confer with counsel before producing sensitive documents
 - (i) Should requested documents be accompanied with appropriate explanations?
 - (ii) Keep copies of all documents that are produced, keep careful notes of all interviews
 - c. While a flat refusal to produce records is unwise, clarify the scope of a request if unclear or requires excessive number of documents

6. Thorough preparation of employees is critical
 - a. CCO or legal counsel should explain the interview process and offer guidance
 - (i) Important to be honest, calm, polite and cooperative
 - (ii) Be responsive, but do not volunteer information
 - b. All interviews of firm employees should be attended by legal or compliance representatives; take careful notes
7. An efficient process is key
 - a. The sooner examiners leave, the sooner the firm can resume business as usual
8. Utmost candor is important
 - a. Issues should be called to the examiners' attention before they are independently discovered.
 - b. Examiners tend to be more understanding when firms discover issues and take corrective steps — consult experienced counsel
 - c. Fulfill commitments made in response to deficiency letters
 - d. Maintain confidentiality
 - (i) Request confidential treatment under FOIA
 - (ii) Request in writing that documents be returned

III. SEC ENFORCEMENT AND PRIVATE ACTIONS

A. Introduction

1. All advisers (whether or not registered) are subject to the antifraud provisions of Section 206 of the Advisers Act and Rule 10b-5 under the Exchange Act
2. SEC enforcement can take the form of administrative cease-and-desist proceedings or judicial injunctive actions
3. Possible sanctions: bar from serving as an adviser, monetary penalties, censure. SEC may work with Justice Department on criminal prosecution
4. All SEC enforcement actions are public
5. Except for emergencies, all enforcement actions are preceded by an extensive, non-public SEC staff investigation
6. Two types of SEC enforcement actions
 - a. Market violations
 - b. Client abuses, e.g., embezzlement, inadequate disclosure

B. Market Violations

1. Insider Trading
 - a. Trading on the basis of material, non-public information acquired directly or indirectly from a confidential source
 - b. Conspiracies to share illegal insider trading profits among brokerage firm personnel and investors, including hedge funds
 - c. Common adviser insider trading — advance tips from an officer of a public company or a broker about a corporate announcement
2. Short Selling
 - a. Rule 105 under Regulation M of the Exchange Act prohibits the use of shares obtained in secondary offerings to cover short sales during restricted periods, usually 5 days before pricing the secondary offering
 - b. Regulation SHO requires brokers to locate shares to be loaned to a customer before executing a short sale

C. Client-Oriented Violations

Most Section 206 actions allege inadequate disclosure of conflicts of interest

1. Performance

- a. Failure to value investments consistent with guidelines; the subprime crisis may result in actions on valuation issues
- b. The use of side pockets to exclude them from the calculation of returns and performance fees

2. Side-by-Side Management

Advisers have an incentive to favor hedge fund clients over accounts that do not pay performance based fees

3. Marketing and Distribution

- a. Market timing — advisers agreed to permit hedge funds to market time funds, contrary to prospectus disclosure, in return for longer term “sticky” investments in the advisers’ other accounts
- b. Revenue sharing — failure to disclose revenue sharing with broker dealers who sold fund shares; failure to disclose sharing of administration fees with advisers

4. Portfolio Transactions

- a. The SEC has made clear that brokerage is a client asset and must be used for the clients’ benefit.
- b. Actions against separate account advisers for failure to disclose allocation of commissions based on client referrals by brokers
- c. Actions against advisers that used client brokerage to generate excessive soft dollar credits
- d. Violation of best execution duty found where a full service broker was used instead of a lower-cost market maker
- e. Adviser misappropriated client investment opportunities

5. Gifts and Entertainment

Action against a broker for providing excessive gifts and entertainment to traders at a large mutual fund adviser

D. Private Civil Actions

1. Usually under Section 36(b) of the Investment Company Act. Most notable case: Gartenberg v. Merrill Lynch Asset Management, Inc. (2d Cir. 1982) — to be guilty of violating Section 36(b), an adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining
2. 2003 and 2004 “late trading” and “market timing” cases
 - a. Late trading — investors were allowed to place trades after the 4 p.m. close of the markets at the funds’ closing price, presumably taking advantage of information from after the close
 - b. Market timing — investors were allowed to engage in short-term trading to take advantage of stale prices of fund portfolio securities
3. Actions against mutual fund advisers for directing fund brokerage to reward brokers for the sale of fund shares — using fund assets (commissions) to pay for distribution outside a Rule 12b-1 plan

CONFLICTS OF INTEREST

I. REGULATION OF AFFILIATED TRANSACTIONS

1940 Act Definition of “Affiliated Person” (One-Way vs. Two-Way Affiliations)

One-Way Affiliations	Two-Way Affiliations
<u>Section 2(a)(3)(D):</u> Officer, director, partner, co-partner, employee <u>Section 2(a)(3)(E):</u> Adviser or member of advisory board of a fund <u>Section 2(a)(3)(F):</u> depositor of a unit investment trust	<u>Section 2(a)(3)(A), (B):</u> 5% share ownership <u>Section 2(a)(3)(C):</u> Controls, is controlled by, is under common control

1. What is “Control”?
 - a. Power to exercise a controlling influence over the management or policies of a company unless such power is solely the result of an official position with such company
 - b. A person who owns more than 25% of a company’s voting shares is presumed to exercise control
 - c. There is a presumption against a natural person being controlled

B. Affiliated Transactions and Exemptions

1. Section 17(a) of the 1940 Act prohibits:
 - a. As principal, buying assets from, or selling assets to, a fund
 - b. As principal, borrowing money or other property from the fund
2. Rule 17(a) Exemption

Cross trades between a fund and other accounts (including funds) with a common adviser, directors and/or officers, provided that:

 - a. Securities trade on a national securities exchange or OTC
 - b. Securities trade at the market price
 - c. No commissions are paid
 - d. The fund board adopts appropriate written procedures

3. Rule 17(a)(8) Exemption

- a. Affiliated funds may merge if each board determines that the merger is in the best interests of the fund and shareholders will not be diluted
- b. Affiliated fund mergers require shareholder approval unless:
 - (1) Both funds' fundamental policies and advisory contracts are materially the same
 - (2) Each fund's board is comprised of a majority of independent directors
 - (3) The surviving fund's 12b-1 fees do not exceed those of the target fund

4. Rule 17a-10 Exemption

- a. Transactions between a sub-adviser and funds in the fund complex that are not advised by the sub-adviser
- b. Transactions between a sub-adviser and discrete portions of the sub-advised fund that the sub-adviser does not manage

5. Rule 12d1-1 Exemption

- a. Permits a fund to invest more than 5% of its assets in money market funds in the same complex
- b. Either no sales charges or service fees are imposed, or the fund's adviser must waive fees to offset these charges
- c. Available for investment in unregistered money funds if:
 - (1) The money fund complies with Rule 2a-7
 - (2) The money fund's adviser is SEC-registered
 - (3) The acquiring fund reasonably believes that the unregistered money fund operates like a 2a-7 fund

6. Section 17(b) Case-by-Case Exemptions

- a. A fund may apply for an exemptive order from the SEC if the proposed transaction is:
 - (1) reasonable and fair and does not involve any overreaching
 - (2) consistent with the policies of the fund and the general purposes of the 1940 Act

7. Rule 17e-1 Exemption

- a. Funds may pay commissions to affiliates if:
 - (1) The commission is reasonable and fair in comparison to what others charge for comparable transactions
 - (2) The fund board adopts appropriate written procedures and determines quarterly that transactions were compliant

8. Joint Transactions.

Section 17(d) and Rule 17d-1 — fund affiliates and the distributor may not enter into joint transactions with a fund

- a. Exclusions — Fund affiliates acting as manager of an underwriting syndicate; the advisory contract between the fund and its adviser
- b. Rule 17d-1 requires SEC exemptive order for joint transactions
- c. Rule 17d-1 Exemptions
 - (1) Profit-sharing
 - (2) Liability insurance policies
 - (3) Merger expenses assumed by the adviser
- d. Trade allocation; bunching of orders
- e. Service contracts with affiliates

9. Rule 10f-3 Exemptions for Purchases During Underwriting

- a. Under certain conditions, a fund may purchase a security in an underwriting in which an affiliate participates
- b. The fund and other accounts managed by the adviser are limited to 25% of the offering
- c. The fund may not purchase directly from the affiliate

II. CODES OF ETHICS

- A. Rule 17j-1 under the 1940 Act requires funds, advisers and distributors must adopt a code of ethics to prohibit fraudulent practices and regulate personal securities transactions by access persons
- B. Rule 204A-1 under the Advisers Act requires all advisers to adopt a code of ethics applicable to supervised persons; also regulates personal trades by access persons
- C. Access Persons
 - 1. A supervised person with access to nonpublic information regarding clients' trades or fund holdings
 - 2. A supervised person involved in making securities recommendations or who has access to nonpublic recommendations
 - 3. Directors, officers and partners of a firm that primarily provides investment advice
 - 4. A fund's directors, officers and general partners are presumed to be access persons

D. Required Reports

Access persons must file reports regarding their securities holdings and transactions

1. Initial holdings report
2. Annual holdings report
3. Quarterly transaction reports

E. Exempted Securities

Access persons must report holdings and trades of all securities other than:

1. Direct U.S. government obligations
2. Money market instruments
3. Money market funds
4. Unaffiliated mutual funds
5. Unit investment trusts invested solely in unaffiliated mutual funds

F. Exceptions from Reporting Requirements

1. Automatic investment plans
2. Accounts over which the access person has no influence or control

G. Pre-Approval Required of Investments in IPOs and Private Placements

H. Personal Trading Procedures

The SEC encourages the following practices:

1. Pre-clearance of all personal securities trades
2. Restricted lists
3. Blackout periods
4. Prohibit short-swing trading and market timing
5. Restrictions on brokers used or number of accounts
6. Duplicate trade confirmations and account statements

I. Independent Directors

1. Not required to file initial or annual holdings reports
2. Not required to file a quarterly transaction report, unless the director knew of a fund trade or adviser recommendation 15 days before or after the trade or recommendation
3. Many advisers refrain from providing portfolio information to independent directors within the 15 day period

J. Board Approval

Rule 17j-1 requires the fund board (with a majority of the independent directors) to approve the code of ethics of the fund, the adviser and distributor, and any amendments

K. Compliance and Certification Report

Rule 17j-1 requires funds, advisers and distributors to provide an annual report to the board that:

1. describes any issues and material violations arising under the code since the last report
2. certifies the adoption of procedures reasonably designed to prevent violations of the code.

L. Exempt Funds

Money market funds

Funds that invest only in exempted securities

M. Disclosure

1. A fund's prospectus or SAI must disclose whether
 - a. the fund, its adviser and distributor have adopted codes of ethics
 - b. the codes permit personal trades, including securities that may be purchased or held by the fund
2. A fund must file its codes of ethics as an exhibit to its registration statement

N. Recordkeeping Requirements

1. The current and past codes of ethics
2. Code violations and corrective actions
3. Access person reports
4. List of all persons subject to, and responsible for reviewing, the code
5. Annual compliance and certification reports
6. Reasons for pre-clearance approvals