Regulatory Issues for Financial Services Firms in a Time of Crisis©

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The credit crisis currently impacting the global economy has caused significant regulatory and compliance concerns to surface in the financial services industry. Investment advisers, broker-dealers and other market participants have all suffered the consequences of the economic downturn as reflected in dramatically decreased securities valuations, shrinking customer accounts and plummeting assets under management resulting in drastically reduced earnings and rising employee layoffs. Despite warnings from the Securities and Exchange Commission's ("SEC") Director of the Office of Compliance Inspections and Examinations ("OCIE") not to allow crisis-induced cost-cutting measures to result in inadequate compliance resources,[1] industry compliance departments have not been immune to staff reductions.

At the same time, the market meltdown has also brought to light some of the most widespread and costly frauds ever perpetrated by industry members.[2] Troubled economic times create incentives for the unscrupulous to engage in activities designed to mislead clients or misappropriate their assets. Ponzi schemes and other fraudulent behavior are often difficult to detect, even by competent compliance professionals. A flawed control environment can provide cover for those with a knack for deception to engage in *sub rosa* activities antithetical to the best interests of their firms, customers or clients. Compliance professionals face a heavy burden to help ensure that their firms, and the third-party service providers upon whom they rely accurately value and describe the securities they issue, market, sell or manage, and that customer or client assets are not misappropriated.

As a result, risk assessment has become a critical part of every firm's compliance program. Regulators, not to mention market conditions, are imposing enhanced risk oversight responsibilities on all industry participants, including advisers, broker-dealers, banks, fund managers and administrators. The level of required "due diligence" by securities firms and professionals has increased dramatically. This article examines critical risk review areas such as disclosure and conflicts of interest and discusses what firms should consider when entering into contracts with service providers. Conflicts of interest in particular have potentially wide-ranging consequences and can affect everything from asset valuation and custody to performance claims. The article also

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briefly addresses what firms need to know about new regulatory expectations, including situations in which a firm or its activities may only be indirectly subject to regulatory oversight. Finally, it considers the potential implications of legislative proposals aimed at increasing the transparency and regulation of hedge funds and their advisers.

Regulatory Lessons from the Credit Crisis

The Sub-prime Debacle

In October 2007, the sub-prime lending industry deteriorated due to several factors, including: (i) softening housing demand which led to a depreciation of house prices; (ii) rising interest rates; (iii) a significant increase in adjustable rate lending to nonprime borrowers; and (iv) a decline in loan underwriting standards.[3] As sub-prime loans collapsed, the value of securities backed by sub-prime loans declined precipitously, the industry contracted rapidly, and defaults and foreclosures rose, resulting in credit and liquidity crises. Originators, syndicators, broker-dealers, insurers and rating agencies involved in the purchase and sale of sub-prime mortgage-backed securities, and structured securitized fund products such as collateralized mortgage obligations ("CMO"), collateralized debt obligations ("CDO"), and collateralized loan obligations ("CLO"), experienced substantial adverse consequences and hurt ancillary markets.[4]

There can be no doubt that the credit crisis has altered the regulatory and compliance landscape for the financial services industry

The collapse of the sub-prime market and, in some cases, significant market participants, led to second-guessing and finger-pointing with respect to underwriting standards, due diligence disclosure adequacy, risk management, and adherence to valuation procedures. Disgruntled investors and regulators filed multiple complaints questioning sub-prime-related disclosures and valuations. The SEC undertook dozens of sub-prime investigations cutting across all types of industry participants, including broker-dealers, advisers, hedge funds, mortgage lenders, banks, insurance companies, and others.[5]

In addition to suits initiated by investors and others, the SEC filed enforcement actions against sub-prime industry members for false and misleading disclosure. For example, the SEC sued Thompson Consulting, Inc., an investment adviser, and three principals alleging that they fraudulently caused two hedge funds they managed to suffer a $54 million loss, nearly the funds' entire assets, due to undisclosed sub-prime and other high-risk investments.[6] They allegedly engaged in riskier trading strategies than those described to investors, several of whom were seniors, and deviated from stated investment policies despite emphasizing the safety of the firm's investment strategy in sales presentations. Within 6 months, the SEC also brought action against WealthWise, LLC, another investment adviser, and its owner, Jeffrey Forrest, for failing to disclose a material conflict of interest when recommending to clients that they should invest in one of the hedge funds managed by Thompson Consulting.[7] A permanent injunction was issued against WealthWise and Forrest on February 4, 2009, and the SEC instituted an administrative proceeding on February 25th.[8]

In addition, the SEC sued two former hedge fund managers from Bear Stearns Asset Management, an investment adviser affiliate of the failed brokerage firm Bear Stearns which was acquired by JPMorgan Chase. The SEC alleged that they fraudulently misrepresented the deteriorating condition and level of investor redemption requests of two hedge funds in order to bring in new money and prevent existing investors and institutional counterparties from withdrawing money. They also allegedly misrepresented the percentage of the funds' investment in sub-prime mortgage-backed securities (approximately 60% versus the 6-8% of each fund's portfolio reported to investors) and mislead investors about their own personal stakes in the funds, while using that as a selling point to potential investors.[9] In addition, the managers are alleged to have used stale valuations for CDOs held by the funds, despite knowing that the market was rapidly deteriorating and the values were no longer accurate.

The Financial Industry Regulatory Authority ("FINRA") is also reportedly investigating various regulated broker-dealer member firms with respect to sales practices and other issues associated with their sub-prime-related securitized products, including valuation, disclosure, suitability, due diligence, conflicts of interest, insider trading and dealings with rating agencies.[10]

The Auction Rate Securities Meltdown

Another market that collapsed amid evidence of inaccurate or inadequate disclosure is the auction rate securities ("ARS") market. ARS include municipal bonds and other highly rated financial instruments with interest rates that reset at periodic Dutch auctions. Despite their usually long-term maturity dates, prior to mid-February 2008, regulators have alleged that ARS were often described to investors as near cash equivalents, akin to money market funds, because they could be liquidated at regularly scheduled auctions. Investment banks and broker-dealers who brought ARS to market apparently ensured the ARS market remained liquid by purchasing unsold units for their own accounts, a practice that was not adequately disclosed or widely understood.

Pressed for capital, the credit crisis led these banks and broker-dealers to abruptly withdraw their support for ARS auctions and the market suddenly froze, leaving holders unable to sell their units. Moreover, these market participants also tried to entice their retail customers to purchase the substantial ARS inventories that had accumulated on their balance sheets. Although some ARS were tied to sub-prime mortgages and lost much of their underlying value, others were tied to highly rated collateral such as student loans issued by SallieMae, Inc., the student loan mortgage association, or closed-end mutual funds with ample backing. Thus, while some ARS continue to pay dividends or interest and others have defaulted, it was the absence of liquidity which caused the entire market to collapse.

In the wake of the auction market meltdown, regulators questioned how ARS were characterized and the adequacy of disclosure about the risks inherent in the auction market. Although initially purchased by sophisticated institutional and corporate buyers aware of their risks, in recent years, the nature of ARS purchasers changed to include individuals. Notwithstanding the fact that the disclosure document pursuant to which ARS was issued typically disclosed the risk that there could be no assurance that a market would always exist for unsold bonds, investors claimed they relied on the oral descriptions of ARS provided by brokers or asset managers that ARS are highly liquid cash equivalents. Investors argued that, but for those assurances, they would not otherwise have purchased or invested in them.

Many broker-dealers have been targeted by regulators for allegedly misrepresenting ARS as cash equivalents or otherwise misleading investors. For the most part, the SEC, FINRA and various states' Attorneys General have reached settlements with these firms concerning their alleged ARS market practices.[11] In each settlement, the firms have agreed to repurchase the ARS they sold to clients, especially individuals, small businesses and charities, as well as several related undertakings. Regulators have no doubt been able to extract this unprecedented relief due to the egregious nature of the alleged misconduct.

Conflicts of Interest

As evidenced by cases like *WealthWise*, the market crisis has had ancillary consequences even for firms not directly involved in the markets that collapsed. In many cases, these consequences are a direct result of failure to perform due diligence, identify relevant red flags, or disclose the conflicts of interest associated with a firm's operational practices, business arrangements and affiliations. OCIE's Director has noted that a major focus area in SEC examinations of registered advisers is "the adviser's compliance program and whether it appears designed to capture and manage that particular adviser's compliance risks" such as conflicts of interest.[12]

Due Diligence and "Red Flags"

Some of the most glaring recent examples of failures to conduct appropriate due diligence and to identify "red flags", or actions which, on their face, indicate something may be amiss, have arisen out of the Madoff Ponzi scheme. The scheme, orchestrated by Bernard L. Madoff and perpetrated through his wholly-owned, dual registrant broker-dealer and investment adviser, Bernard L. Madoff Investment Securities LLC, raised serious red flags and conflicts of interest.[13] As alleged in *Austin Capital*,[14] a recent class action pension fund complaint filed against a registered investment adviser, red flags associated with Madoff's operations included:

- transparency, including Madoff's refusal to disclose his investment strategy;
- lack of abnormally smooth investment returns, with very little volatility, including

only five months of negative returns in the past 12 years;

- other comparable funds using a "split-strike conversion" strategy (which Madoff asserted was his method) could not and did not generate returns in any way comparable to those allegedly earned by Madoff and Madoff Securities;
- firm acted as the fund's own prime broker, while most similar hedge funds use large banks or broker dealers as their prime brokers;
- firm generated revenue only through transaction based commissions, while most similar hedge funds charge investment management fees based on fund performance; and
- firm's and funds' independent auditor, Friehling & Horowitz, consisted of three employees, including a 78 year old living in Florida and a secretary.

On April 1, 2009, the Secretary of the Securities Division of the Commonwealth of Massachusetts filed an administrative complaint against affiliated registered investment advisers of the Fairfield Greenwich group which invested 95% of the $7.2 billion in assets of three hedge funds they managed in the Madoff fund based on claims of extensive due diligence which allegedly was never performed.[15] Various marketing literature and disclosures claimed that due diligence was performed as frequently as daily on Madoff, his trading activity, the fund's valuation, the firm's outside auditor and other matters relating to transparency, compliance and risk management. Despite these claims, the Securities Division alleges that there is no evidence that these due diligence activities were ever performed even though the advisers earned over $100 million per year in performance fees from their hedge funds based on Madoff's purported performance.

The Madoff scheme also identified a significant conflict of interest associated with self-custody of client accounts, as was the case with Madoff, or custody with an affiliate. Although not prohibited by Rule 206(4)-2 ("Custody Rule") under the Investment Advisers Act of 1940, as amended ("Advisers Act"),[16] failure to create adequate checks and balances allowing an adviser's Chief Compliance Officer ("CCO") or designees to examine clients' custodial records is a recipe for disaster. On February 13, 2009, OCIE initiated a sweep exam of advisers who have reported that they have custody of client accounts. In addition, OCIE has publicly announced its intention to seek custody records from advisers' clients and custodians during certain examinations and to compare them against client holdings reported by the advisers.[17]

Current litigation results and regulatory responses provide substantial guidance to regulated entities such as registered advisers and broker-dealers on how to address these situations, but do not always answer questions about the extent to which unregulated or lightly regulated market participants are expected or required to meet the same standards. For example, to what extent must unregistered hedge fund advisers conduct due diligence as to each investment in which their funds invest? Registered advisers are subjected to Advisers Act Rule 206(4)-7, the Compliance Program Rule, which requires due diligence to prevent or detect and correct violations of law. Are unregistered advisers implicitly held to the same standard? In the case of an unregistered fund of funds, must the adviser to the fund of funds perform independent due diligence on the investments being made by the underlying funds? Advisers who merely recommend investment by their clients in third party hedge funds are facing increased regulatory scrutiny regarding both the level of due diligence actually conducted on such funds and statements made to clients about such activities. To what extent must these advisers perform independent due diligence on the third party funds they recommend? What about due diligence on third party funds' service providers, such as accountants, in order to uncover Madoff-like schemes? Similar questions of suitability and due diligence arise when broker-dealers recommend these types of investments to customers.

Further regulatory or legislative guidance addressing due diligence obligations is likely, but for now, all participants in the investment management market should assume that due diligence obligations apply to them regardless of whether such obligations are spelled out by law or regulation. To the extent that further Madoff-type situations arise, both investors and regulators will be quick to point fingers in as many directions as possible based on due diligence shortfalls regardless of whether such due diligence is expressly mandated.

Gifts & Entertainment

OCIE's Director has specifically identified "undisclosed compensation and gifts for business (e.g., to solicitors, fund consultants, and municipal consultants)" as a common conflict of interest and risk area for advisers.[18] Gifts are rife with potential conflicts of interest. Every investment adviser subject to registration ("RIA") with the SEC is required by Advisers Act Rule 204A-1 to adopt and enforce a code of ethics ("Code")[19] that, among other things, includes standards of business conduct expected of "supervised persons,"[20] reflecting the RIA's fiduciary duties and requiring supervised persons to comply with "federal securities laws".[21] Registered investment companies must adopt similar Codes in accordance with Rule 17j-1 under the Investment Company Act of 1940, as amended ("Company Act"). Though not explicitly required, it is generally recommended that advisers and funds adopt gift policies under their Codes.

Broker-dealers are subject to similar ethics requirements under rules adopted by FINRA and approved by the SEC. FINRA Rule 3220 subjects broker-dealers and their associated persons to a $100 per year and per person limit when making gifts and giving gratuities in relation to business of the recipient's employer. The rule also includes certain recordkeeping and supervisory requirements. While a few exceptions apply, this limit is generally applicable to all gifts and entertainment except entertainment in which the firm or an associated person attends the event with the recipient. Many RIAs follow the same $100 limit under their Codes, in part because many are affiliated with a broker-dealer or are dual registrants.

Recent gift-related enforcement actions demonstrate that broker-dealers, investment advisers and the funds they manage have all been affected by the failure to implement and enforce effective gift and entertainment policies. For example, Jefferies, a registered broker-dealer, hired Quinn, a registered representative, to increase brokerage business with FMR Co., Inc., a mutual fund adviser.[22] Quinn sought to obtain additional brokerage business from FMR by giving its equity traders extravagant gifts worth approximately $2 million, which included private chartered jet flights, tickets to sporting events, Broadway shows and concerts, expensive wines and a bachelor party. Jones, Quinn's supervisor, approved these expenditures even though neither the expenditures nor related documentation conformed to Jefferies' policies on travel and entertainment. Jefferies' status as a broker-dealer used by FMR improved substantially after Quinn joined the firm, moving from a third tier "specialized broker" to a first tier "core broker" within 7 months of Quinn's arrival. Jeffries' brokerage with FMR increased from 25.1 million listed/14 million OTC shares to 277.1 million listed/193.6 OTC shares. All were subjected to substantial penalties and consequences. In a related action, NASD (now FINRA) fined Jefferies $5.5 million for improper gifts and entertainment to the employees of the adviser and imposed additional compliance requirements.

Valuation

Valuation of illiquid and hard to value securities also creates conflicts of interet. For example, in an administrative proceeding which began in 2003 and was finally settled in 2008, an RIA, its employees and an affiliated director of a registered fund they managed were found to have worked with an independent pricing service to "smooth" the prices of several municipal bonds in the fund's portfolio that they knew or should have known were incorrectly valued; thus, bringing the prices down gradually to spread their impact on the fund's net asset value over time, resulting in higher advisory fee revenue and higher share prices.[23] As noted above, the Bear Stearns hedge fund portfolio managers are alleged to have fudged the valuation of illiquid sub-prime-related CDO assets held in the two hedge funds they managed in order to keep investors from requesting redemptions of their fund investments. Valuation issues are particularly troublesome in falling markets as it is human nature to avoid giving clients bad news. This tendency can cause advisers and their portfolio managers, whether inadvertently or intentionally, to overvalue illiquid assets. As a result, however, if advisory fees are calculated on the basis of assets under management, such revenue is improperly increased or maintained at the clients' expense.

Valuation and disclosure issues also arose in the context of the ARS market collapse. ARS units typically trade in units of $25,000 and were historically reflected on periodic customer account statements at par. Financial service providers had never confronted the question of how to value the securities once the market collapsed and investors were no longer able to sell their units.[24] Most firms stood pat, and continued to carry the units at par, some adding footnote disclosure that the stated value did not necessarily reflect liquidation value. Fewer firms discounted the value of ARS on customer statements without publicly disclosing the reasons for the discounts. Some have speculated that such discounts were driven by write-downs required on proprietary ARS positions, lest a single firm value the same or similar securities differently in each of its disparate business units.

Even where no conflicts of interest exist, the recent market crisis has highlighted the challenges associated with valuation. For example, investment advisers generally contemplate more than one methodology that may be used in valuing their assets. These methodologies were often disclosed in adviser disclosure materials and, in the case of funds, in the funds' offering documents. Regardless of the approach employed, most valuation processes assume the legitimacy of using prices calculated by third party sources such as pricing services or dealer quotes, or looking at other objective market indicia. Unfortunately, those assumptions have proven inadequate at best. As liquidity and credit evaporated, it became increasingly difficult to value assets which lack readily available market prices, especially alternative or structured assets, using the valuation methodologies articulated in various disclosure documents. This put managers who purchased such assets for their clients in no win situations – forced to choose between valuing assets at zero or deriving valuations based on subjective or other criteria not previously disclosed.

For many hedge fund of funds managers, the situation has been even more challenging. The offering documents of many funds of funds do not adequately address scenarios in which the funds' manager has anecdotal evidence that valuations provided by managers of the underlying third party funds may be higher than warranted by market conditions. Where reports from an underlying fund show no decline in asset value, but the fund of funds' manager nevertheless believes that market conditions justify reductions in valuations, the fund of funds' manager often lacks clear procedures and disclosures as to the circumstances and extent to which it can or must disregard the valuations provided by the underlying funds.

Referral Arrangements

Referral arrangements can also lead to conflicts. In 2008, an RIA's officer agreed to recommend hiring a sub-adviser in exchange for "referral fees" to be paid to the officer's mother if hired without disclosing this arrangement to the RIA. When the sub-adviser was hired, the officer's mother was paid just over $78,000 –more than one-third of the fees paid to the sub-adviser. An anonymous tip uncovered the arrangement, resulting in the officer's firing, as well as a ban on association with any adviser and a civil penalty of $50,000.[25]

The specific examples discussed above are a mere fraction of the potential conflicts of interest that can confront industry participants. Other common examples include conflicts associated with portfolio management, including "cherry picking," or allocating the best trades to proprietary accounts of the adviser or broker-dealer or to accounts of favored customers or clients;[26] misuse of clients' "soft dollars," or the value associated with commissions paid for clients securities transactions;[27] as well as undisclosed payments to affiliates or service providers.[28]

Structural Conflicts of Interest

The ARS market collapse illustrates the inherent conflict of interest that sometimes exists between the proprietary activities of major investment banks and the duties owed to their retail customer base. Regulators have alleged that the finance departments of several major investment banks desperate to raise capital directed sales personnel to promote ARS to their retail customers based on assurances that they were safe investments and that the banks intended to stand behind the products, even after they had decided to do just the opposite.[29] The allegations include assertions that research materials were false and misleading and that objections from retail sales management were disregarded or overruled.

No procedural safeguard can prevent intentional misconduct; but it goes without saying that financial service providers, particularly dual registrants that operate within global financial service supermarkets, must be vigilant to identify and safeguard against risks inherent in their business models to avoid situations where the financial interests of the firm itself may be diametrically opposed to those of their customers. Equally disturbing were allegations in the Bear Stearns case and in the ARS context that a few individuals attempted to place their personal financial interests ahead of those of their clients by taking advantage of their superior knowledge of the firm's intentions or a portfolio's value.

Contracts and Counterparties

The credit crisis has also emphasized how critical it is for investment advisers, funds and other market participants to know their counterparties and understand the terms of counterparty agreements. In times of market instability, counterparty or credit risk can only be fully assessed if (a) contractual agreements clearly identify all parties, (b) all applicable insolvency regimes are fully understood, and (c) signatories understand how applicable insolvency regimes interact with contractual rights. For example, a prime brokerage agreement which appears to create only a direct contractual relationship with just one registered broker-dealer, subject to SEC customer protection rules and protected to a certain extent by SIPC, may also include provisions under which:

- Free credit balances are periodically swept to a money market deposit account with an FDIC-insured bank;
- Securities are lent to, or borrowed from, your account by a non-U.S. affiliate;
- The prime broker may re-hypothecate securities from your account under certain conditions; and
- The prime broker and its affiliates can offset obligations/liabilities you owe to any one or more of such entities.

The failure of Lehman Brothers and others underscored the hidden complexities in many agreements that were previously paid little attention by advisers and funds. While a discussion of how liquidation, bankruptcy, receivership and similar insolvency mechanisms apply to advisers, broker-dealers, banks and non-U.S. firms is beyond the scope of this article, a review of existing agreements and all prospective agreements is recommended to assess potential risks and how such risks might be minimized.

SEC Examinations

All RIA's, registered funds and broker-dealers are subject to examinations conducted by OCIE.[30] Examinations are generally performed on relatively short notice and typically involve production of requested information, interviews and onsite inspections. They may last between two days and several weeks, depending on the size and nature of the firm's business and the findings of the examination. There are typically three possible outcomes: (1) examiners may find only minor deficiencies, which are typically discussed in an exit interview followed by a form letter indicating that the examination process is complete; (2) if more serious deficiencies are found, they are reported to the registrant in a deficiency letter, who must respond to OCIE by detailing the steps it will take to correct the deficiencies and can expect the SEC staff to follow-up on these points in the next examination; and (3) if violations of law are found, OCIE will refer the registrant to the SEC's Enforcement Division for legal action. OCIE may also perform "for cause" inspections without notice if it believes there are ongoing violations of law or may perform "sweep" examinations of all registrants with particular business characteristics, an example of which is the recent "custody sweep" discussed above. Private investment funds managed by RIA's are also subject to these examination requirements.

As a result of the market crisis and the number of Ponzi schemes and other forms of misappropriation uncovered in its wake, several announcements have been made with respect to the examination process. First, current hot areas of examiner concern include disclosure, custody, best execution, sales practices, accuracy of performance claims, and resources provided to support compliance programs.[31] OCIE's Director has also warned the industry that examiners will be expecting prompt responses to examinations and will no longer tolerate dilatory practices, going so far as to suggest that registrants who fail to produce documents timely will be reported to the Enforcement Division for follow-up.[32]

Current litigation results and regulatory responses provide substantial guidance to regulated entities such as registered advisers and broker-dealers on how to address these situations, but do not always answer questions about the extent to which unregulated or lightly regulated market participants are expected or required to meet the same standards.

However, a positive note relating to the examination process is the recent enactment of Rule 502 under the Federal Rules of Evidence ("FRE").[33] FRE 502 limits the circumstances under which inadvertent disclosure of information results in waiver of the attorney-client privilege or work product protection. The rule technically applies to any inadvertent disclosure made "in a Federal proceeding or to a Federal office or agency." However, OCIE is currently applying its conditions for determining whether or not privilege has been waived in the examination process. Rule 502(b) provides that disclosure does not operate as a waiver if: "(1) the disclosure is inadvertent; (2) the holder of the privilege took reasonable steps to prevent disclosure; and (3) the holder promptly took reasonable steps to rectify the error." It is not yet entirely clear what constitutes "reasonable steps" under the second and third conditions, but the federal courts have already begun to decide cases under the new rule.[34]

ERISA Implications

Whenever managed ERISA plans experience significant losses, regardless of whether they are the result of events adversely impacting specific investments or a general market decline, ERISA litigation against investment fiduciaries inevitably increases. The current market crisis is no exception. Several factors contribute to this phenomenon, including the following:

- ERISA imposes a duty on plan fiduciaries to take prudent steps (which may include litigation) to remedy breaches by co-fiduciaries or face possible co-fiduciary liability;[35]
- ERISA remedies to redress fiduciary breaches include a make-whole obligation,[36] so investment losses provide a strong incentive to plan fiduciaries and participants to search for possible ERISA breaches by an investment fiduciary;
- ERISA's heightened standards of care, strict conflict of interest prohibitions, complex prohibited transaction rules, and other technical requirements collectively offer a fertile landscape to mine potential ERISA breach allegations for make-whole claims;
- investments that do not comply (even in an immaterial way) with the governing investment agreement, fund agreement or investment guidelines could, for that reason alone, constitute an ERISA fiduciary breach;[37] and finally,
- any contractual provision that purports to exculpate a fiduciary for ERISA breaches or indemnify a fiduciary from plan assets is void and unenforceable.[38]

Dozens of ERISA fiduciary breach suits have been filed over the past year and a half against investment fiduciaries that are attributable in some way to the market meltdown, seeking recovery for losses arising out of investments in such assets as sub-prime mortgage-backed securities,[39] failed hedge funds,[40] securities lending collateral,[41] and funds and products that are affiliated with the investment fiduciary.[42]

A threshold question in many ERISA fiduciary breach suits is whether the defendant was acting in an ERISA fiduciary capacity with respect to the investment of plan assets in the securities or other assets that gave rise to the loss. The ERISA fiduciary make-whole remedy is available only with respect to a person who is acting as an ERISA fiduciary while engaging in the action that is alleged to constitute an ERISA breach.

Because of ERISA's functional definition of "fiduciary,"[43] fiduciary status is often murky; particularly in the financial services industry, where numerous affiliated and unaffiliated service providers can be involved in the delivery of a single investment product. For example, a consultant who advises a plan fiduciary solely on asset allocation or the selection of investment managers is not a fiduciary under the ERISA definition. Yet, if manager selection involves allocating plan assets to a particular investment fund managed by that manager, the consultant is an ERISA fiduciary with respect to such advice because it relates to the acquisition of a security with plan assets. However, a person is an ERISA fiduciary only to the extent that person performs fiduciary functions. Thus, the consultant's fiduciary status for one purpose does not extend to other, non-fiduciary services, even under the same contract.

The recent flurry of ERISA suits filed against financial institutions evidence an effort to sweep a broad fiduciary net around financial service providers playing various roles with respect to failed investments. For example, in a suit filed against Fidelity by the sponsor of a 401(k) plan for which Fidelity served as a directed trustee, the plaintiff alleged that Fidelity was a fiduciary when it received fees from mutual funds in which the plan invested, in breach of its fiduciary duties.[44] The court ruled that, since Fidelity was directed with respect to the investments, Fidelity was not a fiduciary under ERISA for that purpose.

In another suit, Nationwide served as the investment provider for 401(k) plans with the power to substitute or delete mutual funds from the plans' available investment options. Plan trustees selected the specific funds from among available options on the Nationwide platform. The trustees sued Nationwide under ERISA for revenue sharing payments it received from the mutual funds in which the 401(k) plans invested. Nationwide sought summary judgment on the ground that it was not an ERISA fiduciary merely because it controlled the selection of the funds on its platform since it had no control over the plans' selection of their specific fund options. Summary judgment was denied because plaintiffs presented sufficient evidence to permit a reasonable fact-finder to conclude that Nationwide was an ERISA fiduciary.[45]

The current market turmoil has demonstrated the importance of (i) clearly understanding where the line is drawn under ERISA between fiduciary and non-fiduciary services; (ii) clearly documenting the scope of fiduciary status of the various service providers involved in the delivery of an investment product, and (iii) adopting rules of conduct to preserve the intended status when dealing with ERISA clients. Proposed amendments to U.S. Department of Labor ("DOL") regulations interpreting the statutory exemption for service contracts would require service providers to provide specific disclosures to plans prior to entering into contracts, including disclosing whether the service provider (or an affiliate) will provide any of the services as a fiduciary within the meaning of ERISA or under the Advisers Act.[46]

ERISA suits seeking to recover investment losses are almost always based fundamentally on the imprudence of the decision to invest in failed assets and/or failure to divest failed assets timely. Under ERISA, the two key components of the prudent standard of care are (i) that the fiduciary had the requisite expertise to evaluate the investments involved (known as the "prudent expert standard of care"); and (ii) that the fiduciary engaged in the right level of initial and ongoing due diligence to make an informed investment decision and to monitor the investments on an informed basis (known as "procedural prudence"). Professional investment firms are rarely targets for viable claims that they breached the prudent expert standard of care when investing. Instead, the most fiduciary breach claims against professional managers allege a lapse in the manager's procedural prudence.

For example, the complaint in *Austin Capital*, an ERISA class action suit discussed above,[47] enumerated an array of red flags that plaintiffs allege should have put the adviser on notice that the Madoff fund was a Ponzi scheme. Similarly, DOL has brought action against an adviser managing ERISA plan assets who recommended that the plans invest in hedge funds; alleging, among other things, that the adviser failed to use objective criteria when investing in a hedge fund and failed to investigate the hedge fund's books, performance reports, principals and other relevant information prior to making the investment.[48]

Allegations of procedural imprudence can be countered by good record maintenance, documenting investment decision making and ongoing monitoring of investments, including the frequency of evaluations and the information considered in connection with the evaluation. These records are not to enable a court to second-guess whether the investment or retention decision was, in fact, the best decision; but merely to demonstrate that active monitoring occurred; *i.e.* the fiduciary was not "asleep at the switch". Procedural imprudence claims bear a heavy burden to succeed, even in the wake of substantial investment losses, because ERISA cases are clear that investment prudence is measured prospectively based on the information available to the fiduciary at the time the investment is made; not retroactively with the benefit of hindsight. This principle was well-articulated in a suit involving Black Monday losses where the court, ruling in favor of the investment fiduciary, declared that the "fiduciary duty of care requires prudence, not prescience."[49]

For this reason, ERISA make-whole complaints often pair claims of imprudence with allegations that the fiduciary was improperly motivated by some personal interest, in breach of ERISA's duty of loyalty.[50] For example in a suit filed against Wells Fargo by a participant in a Wells Fargo 401(k) plan,[51] the plaintiff alleged that investment of the plan in mutual funds managed by its affiliates was imprudent and was motivated by the bank's desire to generate revenue. A suite of complaints filed in connection with securities lending collateral losses typically include allegations that the fact that the securities lending agent shared in returns from the investment of collateral gave it an incentive to invest in riskier assets than were prudent.[52]

Given the broad range of services offered by large financial institutions and the complexity of investment products, investment fiduciaries who otherwise invested prudently and, at least prior to the market collapse, profitably for their investors may find their ability to zealously defend themselves compromised by conflict of interest allegations. ERISA fiduciaries cannot cure potential conflicts of interest through disclosure or even consent. A variety of administrative and statutory exemptions are available for many investment arrangements that are typical in the financial services industry, but would otherwise involve potentially prohibited conflicts of interest for ERISA accounts. However, exemptive relief has not kept pace with the increasing complexity of financial products and the increased potential for affiliate conflicts resulting from the consolidation of the financial services industry.

Proposed Hedge Fund Transparency Act

On January 29, 2009, "The Hedge Fund Transparency Act"[53] ("Transparency Act") was introduced in the U.S. Senate by Senators Levin and Grassley which, if enacted, would require most private investment funds, including hedge funds, private equity funds, real estate funds, securitization vehicles and family offices, with $50 million or more in assets or assets under management, to, among other things, register with the SEC as investment companies[54] (though subject to less-than-usual regulation) and make certain public disclosures. Although passage of the Transparency Act is by no means guaranteed, there appears to be substantial support for this or similar legislation in the current economic environment.[55]

Its stated purpose is to remove the "cloak of secrecy" under which private funds have operated in the past. The bill's sponsors believe that lack of transparency contributed to the existing economic crisis and that requiring private investment funds to register will increase market transparency. As such, the bill was drafted broadly to cover *all* vehicles which rely on the language of Company Act Section 3(c)(1) or 3(c)(7) to avoid registration, regardless of what they may be called.[56] These two provisions allow certain funds to be excluded from the definition of an "investment company" under the Company Act.[57]

The Transparency Act would transform Company Act Sections 3(c)(1) and 3(c)(7) into new Sections 6(a)(6) and 6(a)(7), respectively, and impose certain conditions on the private funds that rely on them.[58] As a result, private funds would no longer be considered excluded from the definition of "investment company."[59] Rather, they would be investment companies which are exempt from many Company Act requirements.[60]

The Transparency Act distinguishes between private funds with assets or assets under management of $50 million or more ("Private Funds)" and those with less than $50 million ("Small Private Funds"). Private Funds would be required to register with the SEC, maintain certain books and records, cooperate with SEC requests for information or examination; and, at least annually, file an Information Form which would be made publicly available.[61]

The Information Form would require disclosure of the following:

1) the name and address of each individual who is a beneficial owner of the Private Fund;
2) the name and address of any company with an ownership interest in the Private Fund;
3) information regarding the structure of ownership interests of the Private Fund;
4) any affiliations the Private Fund has with other financial institutions;
5) the name and address of the Private Fund's primary accountant and primary broker;
6) any minimum investment commitment required of a limited partner, member, or investor;
7) the total number of current limited partners, members, or other investors; and
8) the Private Fund's current assets or assets under management.

While not specifically referenced in the Transparency Act, it is possible that existing antifraud provisions will apply to misstatements or omissions made in these public filings. Clearly, however, Advisers Act Rule 206(4)-8, which imposes antifraud liability on advisers to Section 3(c)(1) and 3(c)(7) funds, would continue to apply to Private Funds' advisers. This rule prohibits all advisers, whether or not registered, from making false and misleading statements to, or otherwise engaging in conduct that is fraudulent, deceptive or manipulative with respect to investors and prospective investors in certain pooled investment vehicles. It prohibits false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to requests for proposals. The rule applies regardless of whether a pooled investment vehicle is offering, selling, or redeeming securities.

Anti-Money Laundering Requirements

The Transparency Act would require all private funds to establish anti-money laundering ("AML") programs and report suspicious transactions under the Bank Secrecy Act. The Treasury Secretary, in consultation with the SEC and Commodity Futures Trading Commission, would be required to establish a rule within 180 days of enactment establishing minimum policies, procedures and controls required for the AML programs. Unlike AML requirements currently applicable to registered investment companies, the new rule must require all private funds to "use risk-based due diligence policies, procedures, and controls that are reasonably designed to ascertain the identity of and evaluate any *foreign* person ... that supplies funds or plans to supply funds to be invested with the advice or assistance of such investment company."[62] The rule must also require such funds to comply with the same requirements as other financial institutions for producing records requested by a federal bank regulator no later than 120 hours after receiving such request.[63] If a final rule is not issued by Treasury, the AML requirements would take effect one year after the Transparency Act is enacted.

To the extent that hedge funds already retain third party service providers subject to their own AML requirements, such as broker-dealers or banks, to serve as fund administrators or fund custodians, it is possible that the Transparency Act's AML requirements would not represent a significant change in their procedures even though the funds are not currently subject to AML requirements themselves. Further, some jurisdictions in which hedge funds solicit potential investors already require general evidence of AML compliance by such funds.

Implications for Advier Registration

The Transparency Act does not specifically address registration under either the Advisers Act or state law by investment advisers to any of the affected funds. Currently, many advisers to private investment funds avoid SEC registration by reliance on Advisers Act Section 203(b)(3), which exempts from registration any adviser with fewer than 15 clients not holding itself out to the public as an investment adviser, and not providing advice to any investment company "registered" under the Company Act.[64] Advisers not otherwise exempt from registration are required to register with the SEC or state regulatory authorities. Since the Transparency Act would specifically require Private Funds to register under the Company Act, it is unlikely that advisers to Private Funds would be able to continue to rely on that exemption post-enactment.[65] If Private Fund advisers are required to register with the SEC, they would be subject to Advisers Act Rule 206(4)-7, the Compliance Programs Rule, which requires a full-scale compliance program with written policies and procedures accompanied by annual reviews.

Conclusion

There can be no doubt that the credit crisis has altered the regulatory and compliance landscape for the financial services industry. What remains to be seen is how dramatically things will change going forward. The President, his administration, and Congressional leaders are actively discussing and recommending significant revisions with respect to the federal agencies that oversee this industry. Existing regulatory agencies have already recommended proposed rules and rule amendments to address the plethora of misleading or otherwise fraudulent activities that were revealed by the market crisis. Industry participants should anticipate, at a minimum, greater information sharing between relevant market regulators as well as the serious likelihood that some federal agency, whether new or already extant, will be authorized to oversee systemic market risks associated with the activities of all regulated entities. Hedge funds and other entities which currently operate in a largely unregulated environment should not be surprised to see dramatic changes, at least with respect to the imposition of additional disclosure and reporting requirements to improve transparency. In all, the market crisis is expected to usher in an era of re-regulation to prevent systemic risk and increase customer protection.

ENDNOTES

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Pat S. Conti, a partner in Mayer Brown's Washington DC office, focuses his practice on securities regulation, enforcement, compliance and litigation. He represents a wide range of clients in investigations by the SEC, the US Department of Justice, the Financial Industry Regulatory Authority (FINRA) and other self-regulatory organizations.

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Jerome J. Roche, a partner in Mayer Brown's Washington DC office, is a corporate adviser and transactional attorney whose practice is especially focused on financial services regulatory matters. Jerome counsels registered broker-dealers, investment advisers and banks.

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1 *See* "Open Letter to CEOs of SEC-Registered Firms," (Dec. 2, 2008), from OCIE Director Lori A. Richards, available at http://www.sec.gov/about/offices/ocie/ceoletter.htm. *See also* "Compliance Through Crisis: Focus Areas for SEC Examiners and Compliance Professionals," Lori A. Richards, OCIE Director, Speech for the National Society of Compliance Professionals, National Meeting, Philadelphia, PA (Oct. 21, 2008).

2 *See* BNA Daily Report for Executives, (Apri1 2, 2009), quoting SEC Enforcement Director Robert Khuzami's statement that the SEC "has halted more than 75 Ponzi-related schemes in the past two years and charged more than 300 individuals since 2002 in such enforcement actions." These include the now-notorious Madoff scandal in which Bernard Madoff and his eponymous securities firm for years ran a Ponzi scheme resulting in investor losses estimated at $65 billion.

3 *See* 39 BNA Securities Regulation & Law Report No. 37, 1455, "*Subprime Mortgage Lending: Possible Securities Litigation Exposure*," Stephen J. Crimmins, Andrew J. Morris & Daniel T. Brown (Sept. 24, 2007).

4 *See* NERA Economic Consulting, Insight Series Part III, "Subprime Securities Litigation: Key Players, Rising Stakes, and Emerging Trends, Dr. Faten Sabry, Anmol Sinha & Sungi Lee (July 3, 2008).

5 *See, e.g.,* BNA Daily Report for Executives: Federal Tax & Accounting, No. 28, "SEC Pursuing Dozens of Investigations Regarding Subprime Mortgage Industry," (Feb. 15, 2008) (The SEC is looking into "who knew what when and what did they disclose to the marketplace along the way.").

6 *See Securities and Exchange Commission v. Thompson Consulting, Inc.,* 2:08-cv-00171 (D.Ut. filed March 4, 2008); *SEC Litigation Release* No. 20475 (March 4, 2008).

7 *See Securities and Exchange Commission v. WealthWise, LLC and Jeffrey A. Forrest,* CV 08-06278 GAF (SSx) (C.D.CA. filed September 24, 2008); *SEC Litigation Release* No. 20737 (September 24, 2008) (failed to disclose a side agreement under which WealthWise received a portion of performance fee hedge fund paid Thompson Consulting for all WealthWise assets invested in fund).

8 *See In the Matter of WealthWise, LLC and Jeffrey A. Forrest,* Rel. No. IA-2846, Admin. Proc. File No. 3-13381 (Feb. 25, 2009).

9 *See SEC v. Ralph R. Cioffi and Matthew M. Tannin*, Civil Action No. 08 2457 (FB) (E.D.N.Y. June 19, 2008) and SEC Lit. Rel. 20625, *available at* http://www.sec.gov/litigation/litreleases/2008/lr20625.htm. Cioffi allegedly redeemed more than one-third of his personal investment in the funds while touting his holdings.

10 *See* "*New FINRA Task Force is Investigating Nine Regulated Firms For Subprime Misdeeds*," BNA 40 Sec. Reg. & L. Rep. 857 (June 2, 2008).

11 The SEC has settled with virtually all of the major ARS underwriters including, for example, Citigroup, UBS, Wachovia and Merrill Lynch. *See, e.g.,* SEC Press Release Nos. 2008-168 (Aug. 7, 2008) (Citigroup), 2008-171 (Aug. 8, 2008) (UBS), 2008-176 (Aug. 15, 2008) (Wachovia), and 2008-181 (Aug. 22, 2008) (Merrill Lynch). With respect to the states, see, for example, Financial Times, "UBS To Buy Back $19 billion of ARS Debt," Joanna Chung (Aug. 8, 2008) (UBS settlement with SEC also settled Massachusetts and New York proceedings).

12 "Focus Areas in SEC Examinations of Investment Advisers: the Top 10," Lori A. Richards, OCIE Director, Best Practices Summit 2008, IA Week and the Investment Adviser Association Washington, DC (March 20, 2008).

13 *See* companion criminal and civil complaints, *United States v. Bernard L. Madoff,* and *SEC v. Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC*, S.D.N.Y. (December 11, 2008).

14 See class action complaint in *Pension Fund For Hospital and Health Care Employees – Philadelphia and Vicinity; and Henry Nicholas v. Austin Capital Management Ltd.*, Civ. Act. No. 2:09-cv-00615-PBT (E.D. PA) filed Feb. 12, 2009 ("*Austin Capital*").

15 See administrative complaint, "In the Matter of Fairfield Greenwich Advisors LLC and Fairfield Greenwich (Bermuda) LTD, Docket No. 2009-0028 (Apr. 1, 2009).

16 The Custody Rule allows registered advisers to use any "qualified custodian," whether affiliated with the adviser or not. Indeed, registered advisers that are themselves qualified custodians, such as dual registrant broker-dealer/advisers, may maintain their own clients' funds and securities subject to certain account statement requirements under the Custody Rule.

17 See *Compliance Reporter*, "IAA Recommends Revision to Custody Rule," (published March 13, 2009) stating that OCIE "told the [Investment Advisers Association] in a March 9 letter that its staff will begin requesting independent, third-party verifications of client assets during examinations." As used in the letter, "third-party verification" includes clients and auditors.

18 *Id*.

19 *Investment Adviser Code of Ethics*, Rel. No. IA-2256 (July 2, 2004) ("Code Release"). This rule was adopted under Advisers Act Section 204A, which requires RIAs to "establish, maintain and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information." An RIA's Code "should set out ideals for ethical conduct premised on fundamental principals of openness, integrity, honesty and trust." *Id*.

20 A "supervised person" is "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser." Advisers Act §202(a)(25).

21 Rule 204A-1(a)(2). The term "federal securities laws" is defined in Rule 204A-1 the same as in Rule 38a-1 under the Investment Company Act of 1940, as amended ("Company Act"), which includes: (1) the Securities Act of 1933, as amended; (2) the Securities Exchange Act of 1934, as amended; (3) the Sarbanes-Oxley Act of 2002; (4) the Company Act; (5) the Advisers Act; (6) Title V of the Gramm-Leach-Bliley Act of 1999; (7) any rules adopted by the SEC under any of these statutes; (8) the Bank Secrecy Act as it applies to funds and investment advisers, and (9) any rules adopted thereunder by the SEC or the Department of the Treasury. This requirement is broader than Advisers Act Rule 206(4)-7, the Compliance Programs Rule, which only requires that an RIA's compliance procedures be rea-

sonably designed to prevent violations of the Advisers Act.

22 *See In the Matter of Jefferies & Co., Inc. and Scott Jones*, Rel. No. 34-54861; *In re Kevin Quinn*, Rel. No. 34-54862 (Dec. 1, 2006). *See also In the Matter of Fidelity Management & Research Company and FMR Co., Inc*., Rel. No. IA-2713 (March 5, 2008) (Fidelity employees, including some executives, improperly accepted gifts and entertainment from brokerage firms that sought and obtained business from Fidelity, including tickets to the Superbowl and other sporting events and concerts, a raucous bachelor party, illegal drugs and gambling. Fidelity failed to create and implement policies and procedures designed to avoid conflicts of interest resulting from the receipt of gifts, and failed to monitor whether the gifts were affecting traders' decision-making in seeking best execution. Fidelity also failed to keep records of electronic messages sent between Fidelity traders and brokers over the Bloomberg electronic messaging network. Fidelity paid an $8 million civil money penalty, as well as numerous fines paid by each of the involved employees and executives.); and *In the Matter of Lazard Capital Markets LLC*, IA Rel. No. 58880 (October 30, 2008) (administrative proceedings against B-D and brokers who gave improper gifts to Fidelity traders in exchange for or to solicit brokerage).

23 *See In the Matter of Heartland Advisors, Inc., et al.*, Rel. Nos. 33-8884, et al. (January 25, 2008) (RIA and employees fined over $4 million; employees suspended and fund director ordered to cease-and-desist).

24 A niche secondary market emerged after mid-February 2008, but transactions reportedly took place at fire sale prices deemed not to be reflective of the value of ARS, particularly those that had not defaulted and continued to pay interest or dividends, sometimes at higher rates.

25 *See In the Matter of Michael R. Donnell*, Rel. No. IA-2718 (March 11, 2008).

26 *See, e.g, Securities And Exchange Commission v. K.W. Brown And Company, 21st Century Advisors, Inc., K.W. Brown Investments, Inc., Kenneth Brown, Wendy Brown, And Michael Cimilluca, Jr.*, Civ. Act. No. 05-80367-Civ-Johnson (U.S.D.C. SD FL, Dec. 19, 2007); *In the Matter of K.W. Brown & Company, et. al.*, Rel. No. IA-2690 (Jan. 4, 2008) (RIA and affiliated B-D engaged in illegal cherry-picking scheme, netting $4.5 million while passing more than $9 million of losses onto unsuspecting advisory clients); *In the Matter of Gerson Asset Management, Inc. and Seth Gerson*, Rel. Nos. 34-52880, IA-2457 (Dec. 2, 2005) (RIA allocated profitable trades to personal account and unprofitable trades to client accounts by transacting securities in omnibus account and delaying allocation until later or by selling appreciated securities, allocating profits to personal account and then buying back same security for clients later, but at higher price); *In re Melhado, Flynn & Associates, Inc., George M. Motz and Jeanne McCarthy,* Rel. No. IA-2593 (Feb. 26, 2007) (RIA fraudulently engaged in trade allocations that benefited proprietary trading account and hedge fund client at expense of other clients, without disclosure to disadvantaged clients).

27 *See, e.g., In the Matter of Schultze Asset Management LLC and George Schultze*, IA. Rel. 2633 (Aug. 15, 2007) (RIA misrepresented and certified 3 times to client that it used soft dollars only for research when it actually used client assets to pay for operating expenses, including principal's salary, health insurance and rent).

28 *See, e.g., In the Matter of Smith Barney Fund Management LLC and Citigroup Global Markets,* Rel. Nos. 34-51761, IA-2390 (May 31, 2005) (RIA to registered funds failed to disclose to fund directors scheme to use affiliated transfer agent at funds' expense, by subcontracting work to unaffiliated transfer agent at lower rate than affiliated transfer agent charged funds and pocketing the difference). *In The Matter of BISYS Fund Services, Inc*., Rel. Nos. 33-8742; 34-54513; IA-2554; IC-27500 (Sept. 26, 2006) (fund administrator aided and abetted 27 mutual fund advisers in defrauding fund investors by entering into undisclosed side agreements which obligated it to rebate a portion of its fund administration fees to the advisers in exchange for continuing to recommend administrator to the funds' boards without disclosing arrangement to the boards).

29 *See, e.g., In the Matter of UBS Securities, LLC and UBS Financial Services, Inc.*, Admin. Complaint (June 26, 2008), Commonwealth of Massachusetts, Office of the Secretary of the Commonwealth, Securities Division (Docket No. 2008-0045); *In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Incorporated,* Admin. Complaint (July 31, 2008), Cmwlth. of Massachusetts, Office of the Secretary of the Commonwealth, Securities Division (Docket No. 2008-0058); Press Release: *Securities Regulators Announce Settlement with Citigroup in Auction Rate Securities Investigation*, North American Securities Administrators Association (Aug. 7, 2008).

30 *See, e.g.,* "Office of Compliance Inspections and Examinations Investment Adviser Examinations: Core Initial Request for Information" (available at http://www.sec.gov/info/cco/requestlist-core1108.htm) for information on what the SEC staff expects to see during an RIA examination.

31 *See* "Compliance in Today's Environment: Step Up to the Challenge," Lori A. Richards, OCIE Director, Speech before the IA Compliance Best Practices Summit 2009, IA Week and the Investment Adviser Association, Washington, DC (March 12, 2009).

32 *See* Ignites, "SEC Director Seeks to Speed Document Production" (published Feb. 10, 2009) (quoting OCIE Director Lori Richards at the Practicing Law Institute's conference "The SEC Speaks in 2009", as saying: "We are going to be working with our colleagues in the Division of Enforcement to create policy with respect to the production of documents and information . . . The agency wants examiners to know when they should refer matters to the enforcement division because document production has not been timely or a firm has not fully cooperated with examiners."). *Cf.* Ignites, "SEC Examiners Step Up E-Mail Requests" (published March 3, 2009) (quoting Gene Golhke, OCIE Deputy Director, as saying: "we generally expect information to be provided promptly.").

33 Rule 502 was enacted on September 19, 2008, when President Bush signed into law S.2450.

34 *See, e.g., Relion, Inc. v. Hydra Fuel Cell Corp.*, 2009 WL 5122828 (D. Or. 2008) (attorney-client privilege was waived under amended FRE 502 when privileged materials were produced because of disclosing party's careless privilege review).

35 A plan fiduciary may incur ERISA liability as a result of actions of a co-fiduciary if it is determined that the first fiduciary enabled the co-fiduciary's breach by imprudent retention or monitoring of the co-fiduciary; or, if it is determined that the first fiduciary either participated in, or had knowledge of, the co-fiduciary's breach and failed to make reasonable efforts under the circumstances to remedy the breach. ERISA § 405(a), 29 U.S.C. § 1105(a) (2000).

36 Breach of an ERISA fiduciary duty could render a manager and other persons who are deemed, by virtue of their control over plan investments, to be fiduciaries, liable (a) to disgorge any profits made by such fiduciary as a result of the breach, and (b) to restore any losses suffered by the ERISA investors as a result of the breach. In addition, if a breach involves a prohibited conflict of interest or a prohibited transaction, an excise tax of 15% per year of the amount involved in the transaction is imposed on the party in interest in the transaction. ERISA § 409(a), 29 U.S.C. § 1109(a) (2000).

37 Section 404(a)(1)(D) requires a fiduciary to discharge its duties with respect to a plan in accordance with the documents and instruments governing the plan.

38 *See* ERISA § 410(a), 29 U.S.C. § 1110 (2000), 29 C.F.R. § 2509.75-4 (2006), 40 Fed. Reg. 31599 (Jul. 28, 1975).

39 *See, e.g., In re State Street Bank & Trust Co. ERISA Litigation*, 579 F. Supp. 2d 512 (S.D.N.Y. 2008) (seeking recovery of $80 million in losses attributable to alleged overly risky and highly leveraged mortgage-based financial derivatives); *Apogee Enterprises, Inc. v. State Street Bank and Trust Company*, S.D.N.Y. No. 09-cv-00170-DSD-FLN (investments in securities backed by sub-prime mortgage loans and other "high risk" assets inappropriate for a fund represented to be a stable, risk-controlled and well-diversified enhanced bond index fund).

40 *See, e.g., Austin Capital*, at n. 14, *supra*; *Chao v. Zenith Capital LLC*, N.D. Cal., No. C-08-0454 ("*Chao*").

[41] *See, e.g.*, *FedEx Corporation v. The Northern Trust Company*, W.D. Tenn., No. 2:08-cv-082; *BP Corporation North America Inc. Savings Plan Investment Oversight Committee v. The Northern Trust Investments, N.A*, N.D. Ill., No. 08-cv-6029; *Board of Trustees of the AFTRA Retirement Fund v. JPMorgan Chase Bank, N.A*, S.D.N.Y., 09-cv-00686; *Diebold v. Northern Trust Investments, N.A.*, S.D. Ill., 1:09-cv-01934; *Fishman v. State Street Corporation*, D. Mass, 09-cv-10533; *Board of Trustees of the Imperial County Employees' Retirement System v. JPMorgan Chase Bank, N.A.*, S.D.N.Y., 09-cv-3020.

[42] *See, e.g., Gibson v. Wells Fargo & Co*., D. Minn., No. 08-cv-04546 ("*Gibson*").

[43] "Fiduciary" is defined to include any person who renders investment advice to a plan for a fee and any person who has control respecting management or disposition of plan assets. *See* ERISA § 3(21)(A), 29 U.S.C. § 1002 (21)(A) (2000). Regulations provide that investment advice can relate to the value of, or the advisability of investing in, securities or property, and if a person does not have discretionary authority or control, that person will be deemed to be rendering investment advice only if the person:
(i) renders advice on a regular basis pursuant to a mutual agreement, arrangement or understanding that such advice will be a primary basis for investment decisions with respect to plan assets, and
(ii) will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as investment policies or strategy, overall portfolio composition or diversification. *See* 29 C.F.R. § 2510.3-21(c).

[44] *See Columbia Air Services, Inc. v. Fidelity Management Trust Company*, 2008 WL 4457861.

[45] *See Haddock, et al. v. Nationwide Fin. Serv. Inc.*, et al., 2006 WL 616629 (D. Conn. 2006).

[46] *See* 72 Fed Reg. 70988 (Dec. 13, 2007).

[47] *See* n. 14, *supra*.

[48] *See Chao*, n. 40, *supra*.

[49] *De Bruyne v. Equitable Life Assurance Soc*., 720 F. Supp. 1342, 1347-49 (N.D. Ill. 1989), aff'd, 920 F.2d 457 (7th Cir. 1990).

[50] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) (2000), requires a plan fiduciary to act "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of . . . providing benefits to participants and their beneficiaries [and] defraying reasonable expenses of administering the plan."

[51] *See Gibson*, n. 42, *supra*.

[52] *See* cases cited at n. 39, *supra*.

[53] *See* The Hedge Fund Transparency Act, S. 344, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/z?c111:S.344:). *See also* Sen. Grassley's related Statement released Jan. 29, 2009 (available at http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=19024).

[54] Unlike the SEC rule directed at hedge fund advisers, "Registration Under the Advisers Act of Certain Hedge Fund Advisers," (SEC Rel. No. IA-2333 (Dec. 2, 2004) (available at http://sec.gov/rules/final/ia-2333.pdf)) which was vacated by a federal appellate court in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the Transparency Act would compel registration of the funds.

[55] *See, e.g.,* testimony of Mary Shapiro, SEC Chairman, before the Senate Banking Committee on March 26, 2009, http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=3085f397-be90-4d34-89b6-e46031d8b3a3; and of Timothy Geithner, Secretary of the Federal Reserve, before the House Financial Services Committee at http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf on the same date in support of registration and regulation of private funds. *See also* Letter from Representatives Capuano and Castle to Barney Frank, Chairman of the House Financial Services Committee, urging the Chairman to continue action on the package of House and Senate bills seeking to regulate hedge funds, available at http://www.castle.house.gov/UploadedFiles/Capuano-Castle_Hedge_Fund_letter.pdf.

[56] Contrast with the hedge fund adviser registration rule, discussed in n. 34 above, which targeted specific hedge fund advisers based on the types of investment pools managed and the ease with which investors could withdraw their assets. The rule imposed a bright line between advisers to any investment pool with a lockup period of less than two years (covered) and advisers solely to pools with lockups of two years or more (exempt).

[57] Section 3(c)(1) excludes any fund the outstanding securities of which are beneficially owned by not more than 100 beneficial owners, and that is not making or proposing to make a public offering of its securities. Section 3(c)(7) excludes any fund the outstanding securities of which are owned exclusively by "qualified purchasers" (generally, individuals owning not less than $5 million, and entities owning not less than $25 million, of certain investments), and that is not making or proposing to make a public offering of its securities.

[58] Some private funds currently rely on exclusions from investment company status other than or in addition to Section 3(c)(1) or 3(c)(7). For example, real estate funds may also be excluded under Company Act Section 3(c)(5)(C), which generally exempts funds not issuing redeemable securities that are primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Similarly, many securitization vehicles also rely on Company Act Rule 3a-7. It is unclear whether a private fund that chooses to use Section 6(a)(6) or 6(a)(7) as a back-up exception to another exclusion would be required to register and otherwise comply with those provisions from fund inception or only from the fund's date of reliance on them.

[59] Although generally excluded from the definition of "investment company," such funds are already treated as investment companies for certain purposes under Company Act Section 12 which would not be changed by the Transparency Act.

[60] By complying with Section 6(a)(6) or 6(a)(7), private funds would not be required to comply with some of the more onerous requirements of the Company Act, such as statutory limits on margin and borrowing, independent directors and approval of advisory agreements by fund shareholders.

[61] This form would be filed electronically with the SEC and be publicly available on IDEA (formerly "EDGAR").

[62] Under current regulations, registered investment companies must implement an AML program that includes, among other things, written compliance policies, appointment of an AML Officer, annual testing and certification, customer identification procedures and suspicious activity reporting.

[63] *See* Section 319 of the USA PATRIOT Act (available at http://www.law.cornell.edu/uscode/31/5318.html).

[64] Advisers Act Section 203(b)(3).

[65] A recently introduced House bill would remove Advisers Act Section 203(b)(3) in its entirety. If removed, any adviser with at least one client not qualifying for another exemption would be required to register with the SEC under the Advisers Act or with applicable state securities regulators. *See* Hedge Fund Adviser Registration Act of 2009, H.R. 711, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.711:). Another recent House bill would require the President's Working Group on Financial Markets (the "PWG") to conduct a study on the hedge fund industry and issue a report recommending any regulatory or disclosure requirements the PWG believes should be imposed on hedge funds. *See* Hedge Fund Study Act, H.R. 713, 111th Cong. (2009) (available at http://thomas.loc.gov/cgi-bin/query/ z?c111:H.R.713:).