

## Financial Reform on Final Stretch

House and Senate conferees were busy the fourth week of June rushing to pass a financial reform bill before President Obama met with the Group of 20 nations in Toronto the weekend of June 26 to continue talks on global financial reform.

Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee, and Sen. Chris Dodd (D-Conn.), chairman of the Senate Banking Committee, led negotiations in the House-Senate Wall Street Reform and Consumer Protection Act Conference.

Investment Adviser Association (IAA) Executive Director David Tittsworth gave Frank high marks in leading the committee's reconciliation, calling it "the most transparent process I've ever seen." Still, the IAA's biggest issue with the bill — the standard of care for advisers and broker-dealers — did not exactly come out as the IAA would have preferred. It was a compromise between the starkly diverging House and Senate proposals. Assuming enactment of the bill, the debate, Tittsworth said, now moves to the SEC. The bill would require a six-month study of the issue and would give the commission rulemaking authority over it. The IAA, he vowed, will stay on task as the action shifts from the Hill to the SEC. **Page 2**

## SEC Releases More Q&A Guidance On Custody Rule

The SEC added eight new questions and answers to its list of frequently asked questions (FAQs) May 20, marking the third time it has updated the guidance since publishing the revised custody rule last December. Although industry representatives have called for relief — or at least more detailed guidance — for advisers acting as trustees for their clients, the SEC offered no new FAQs addressing that area. The SEC added several questions and answers pertaining to hedge funds. **Page 4**

## Proposed SEC Rules Would Apply to TDF Marketing Materials

Investors would have new information available to help them better understand target date funds (TDFs) under new rules the SEC proposed. The proposed rules are designed to help clarify the meaning of a date in a TDF's name.

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- ¶273 — Updated section on surprise examinations under the Custody Rule with discussion on third party verification and added in Fig. 273-A.
- App. IV — Replaced Staff Responses to Questions About the Custody Rule (FAQs) with version updated May 20 by the SEC.

## News Alerts

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— The Editors

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# Financial Overhaul Moves Toward Finish Line

Following months of wrangling, lawmakers in Washington reconciled monumental financial reform bills from both sides of Capitol Hill into one final proposal that would be, if signed into law, the most extensive rewrite of American financial markets regulation since the Great Depression. As of press time, the resulting bill faced full votes in both chambers of Congress, expected to take place some time the week of June 28. The announcement that the sides had reached an agreement on merging the House bill — passed in December — with the May 20 Senate bill culminated a marathon negotiating session on Capitol Hill at 5:29 a.m., Friday, June 25.

Lawmakers dubbed the 2,319-page bill the “Dodd-Frank Act,” after its two chief architects, Senate Banking Committee Chairman Chris Dodd (D-Conn.) and House Financial Services Committee Chairman Barney Frank (D-Mass.).

Many of the provisions that will affect investment advisers appear in Title IX of the bill. The bill also calls for SEC registration of advisers to hedge funds in Title IV. (See *Finding out More*, p.3, for how to access the full text of the conference report.)

## Standard of Care for Investment Professionals

A contentious issue during debate on the legislation was whether to impose a fiduciary duty — and if so, exactly what kind — on broker-dealers that provide investment advice to individual investors. The fiduciary

issue has been particularly important to the investment adviser community. It views its members as beholden to a higher standard of care than other professionals — primarily broker-dealers — that are not subject to the Investment Advisers Act of 1940 (Advisers Act), the law that imposes the fiduciary standard; that is, that advisers place clients’ interests ahead of their own. The Investment Adviser Association (IAA) led efforts to impose the fiduciary standard of the Advisers Act on all professionals that give individual investment advice. While the IAA expressed some dissatisfaction with the versions of a financial bill from both sides of Capitol Hill, the version that ultimately came out of the Senate especially displeased the IAA because it called for a yearlong study of the issue, prompting the IAA and other groups to label it as a delaying tactic (see June newsletter, p. 2).

Before markups in the Senate Banking Committee, Dodd’s version of the bill eliminated the broker-dealer exemption from the Advisers Act, effectively subjecting them to the same fiduciary standard as registered investment advisers — a provision that met with support from the IAA. However, Sen. Tim Johnson (D-S.D.) succeeded with an amendment that gutted that proposal and replaced it with the yearlong study requirement, prompting an outcry from the IAA, Consumer Federation of America and other groups (see April newsletter, p. 2). The IAA has said in the past that the House bill’s answer to the fiduciary issue — a call for the SEC to write rules

See *Finance Reform*, p. 3

## Money Manager’s Compliance Guide

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The *Money Manager’s Compliance Guide* (USPS 012-974) is published monthly by Thompson Publishing Group, Inc., 805 15th St. NW, 3rd Floor, Washington, DC 20005. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices.

**POSTMASTER:** Send address changes to: *Money Manager’s Compliance Guide*, Thompson Publishing Group, Inc., 5201 W. Kennedy Blvd., Suite 215, Tampa, FL 33609-1823.

This newsletter for the *Money Manager’s Compliance Guide* includes a looseleaf update to the *Guide*. For subscription service, call 800 677-3789. For editorial information, call 202 872-4000. Please allow four to six weeks for all address changes.

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## Finance Reform (continued from p. 2)

on a uniform standard of care, but providing no guarantees that the result would be uniform application of the Advisers Act, was its second choice compared with the original Senate version before the Johnson amendment.

The conference bill is a compromise. The Dodd-Frank proposal calls for a shorter study period — six months — and gives the SEC the authority to write rules that would harmonize the standard of care for investment advisers and broker-dealers. It states that the SEC may write rules setting the standard of conduct for broker-dealers and investment advisers providing “personalized advice” to “retail customers.” (See sidebar, right, for wording.)

IAA Executive Director David Tittsworth said lawmakers changed the Senate version’s “shall” to “may” in referring to the SEC’s rulemaking authority over the standard of conduct issue. “Assuming the bill becomes law, the debate will shift from Capitol Hill to the SEC. We expect to be active participants in the SEC study and any subsequent rulemakings,” he said.

“The conferees essentially ‘stapled’ major parts of the Senate study with major parts of the House rulemaking provision,” Tittsworth said. “It includes many of the Senate provisions requiring the SEC to conduct a study of broker-dealer and investment adviser regulation.”

Tittsworth gave Frank high marks in leading the committee’s reconciliation, calling it “the most transparent process I’ve ever seen.”


### Hedge Funds

The bill would amend the Advisers Act to require advisers to hedge funds with at least \$150 million in assets under management (AUM) to register with the SEC. A summary released by Frank’s office June 28, said the bill “ends the ‘shadow’ financial system by requiring hedge funds and private equity advisers to register with the SEC as investment advisers and provide information about their trades and portfolios necessary to assess systemic risk.” Under the proposal, the SEC would share the data with the new systemic risk regulator created by the bill, and will report to Congress annually on how it uses the information to protect investors and market integrity.

The bill would raise the assets threshold for federal regulation of investment advisers from \$30 million AUM to \$100 million AUM, in a move that lawmakers expect to “significantly increase” the number of advisers under state supervision. “States have proven to be strong regulators in

this area and subjecting more entities to state supervision will allow the SEC to focus its resources on newly registered hedge funds,” the summary said.

### Finding out More

For the full text of the conference committee report, go to [http://financialservices.house.gov/Key\\_Issues/Financial\\_Regulatory\\_Reform/Financial\\_Regulatory\\_Reform062410.html?dbk](http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/Financial_Regulatory_Reform062410.html?dbk). 

### Text of the Frank-Dodd Provision on Standard of Conduct

“(1) IN GENERAL.—The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 206(1) and (2) of this Act when providing personalized investment advice about securities, except the Commission shall not ascribe a meaning to the term ‘customer’ that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser.

The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser.

*Source:* Conference Report, House-Senate Wall Street Reform and Consumer Protection Act Conference, section 901, June 28, 2010.

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# SEC Releases More Q&A Guidance on Custody Rule

The SEC added eight new questions and answers to its list of frequently asked questions (FAQ) May 20, marking the third time it has updated the guidance since publishing the revised custody rule last December. The FAQs are reprinted in their entirety in App. IV of the *Guide*.

## Fee Deductions

The FAQs are grouped by subject area, such as definition of “custody”/scope of rule — which saw the addition of three new FAQs — and “Fee Deduction,” to which the SEC added the following question and answer:

***Q. A client has instructed its custodian to debit the client's account for advisory fees each quarter. The custodian makes all fee calculations, based on the advisory contract. The adviser does not calculate the fee, nor does it send a bill. Does the adviser have custody?***

**A.** If the qualified custodian is not a related person of the adviser, the adviser does not have custody. Under these circumstances, the custodian is acting only as agent for the client, and the adviser does not have access to the client's funds. (FAQ III.1)

## Trustees

Although industry representatives have called for relief — or at least more detailed guidance — for advisers acting as trustees for their clients, the SEC offered no new FAQs addressing that area. Valerie Baruch, assistant general counsel of the Investment Adviser Association (IAA), confirmed in a June 21 phone conversation that the revised rule's impact on trustees remains a top concern for the IAA, which represents registered investment advisers. The IAA expressed concern in recent months, and Baruch reconfirmed, that advisers providing trustee services — often as a courtesy to their clients — will walk away from that role because of the cost of the surprise examination to which they would be exposed under the revised rule by acting in such a capacity.

Baruch said clients likely will be forced to get those services from professionals not as versed in the Investment Advisers Act of 1940 (Advisers Act) and the Investment Company Act of 1940 (1940 Act). She pointed out, however, that when the SEC adopted the revised rule in December 2009, it promised to study the issue of trustees over the ensuing year. In the December rule release, the SEC stated it would “evaluate the impact of the surprise examination on smaller advisers that have the authority to obtain possession of client funds or securities and whose client assets are maintained by an independent qualified custodian.” (See February newsletter, p. 2.) When the SEC updated the custody rule FAQs last

March, Baruch commented that the new guidance provided very limited relief to advisers serving as trustees, calling for a broader exemption. (See April newsletter, p. 3.)

Baruch said that some advisers have indeed stopped providing trustee services to clients because of the revised rule. However, she noted that the IAA will know more when it gets the 400 to 500 responses it expects to an annual survey it conducts with the consulting firm ACA Insights and London-based asset management firm Old Mutual.

## Authority to Order Address Change

An adviser does not have custody of client funds just because it may instruct the qualified custodian maintaining a client's account to remit funds or securities from the account to the client at his or her address of record, if the adviser can show written permission of the client to do so, and so long as the adviser does not have the authority to open an account on behalf of the client nor the authority to designate or change the client's address of record with the qualified custodian. (FAQ II.5)

## Possessing ID Number and Password to Account

SEC staff would deem an adviser to have custody if the adviser has the ability to withdraw funds or securities or transfer them to an account not in the client's name at a qualified custodian. The mere possession by an adviser of the login identification name and password to a client's account — say, for the purposes of rebalancing and adjusting investments in a pension fund account — is not enough to trigger a presumption of custody. (FAQ II.6)

## Pooled Investment Vehicles

Certain limited partnerships — including hedge funds, for example — can take advantage of the “audit provision” of the custody rule, which would exempt them from the annual surprise audit requirement under certain conditions, including that they get an annual audit by a PCAOB-certified accountant. (See Rule 206(4)-2(b)(4) in App. I.) One of the newly added FAQs addresses how an investment adviser to a pooled investment vehicle may comply with the custody rule if it does not use the so-called audit provision, or “audit approach.” The new FAQ states:

If the financial statements of the pooled investment vehicle are not audited and distributed to investors in accordance with paragraph (b)(4) of the rule, the exceptions provided in that paragraph will not be available to the adviser. As a

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See *Custody Rule*, p. 6

# Washington Watch

## House Bill Would Require New Disclosures About 401(k) Plan Fees and Expenses

The House on May 28 passed a bill that would require 401(k) plans to provide more information to plan participants about retirement plan fees. The measure would place new disclosure obligations on 401(k) service providers as well. The bill — the American Jobs and Closing Tax Loopholes Act, H.R. 4213 — also would provide relief to single-employer defined benefit (DB) plans struggling to meet minimum funding requirements.

Reaction to the bill was mixed. The U.S. Department of Labor (DOL) is preparing its own disclosure rules for 401(k)-style plans, and some in the retirement plan industry said they were concerned the House bill would conflict with the DOL's rules.

### Fee Disclosures

Under the House bill, plan administrators would be required to provide workers in 401(k)-type plans with a range of information about available investments and plan fees. Before an employee becomes eligible to participate in a plan, the administrator would have to provide the employee with a notice describing the plan and key characteristics of each investment option in the plan, including information about the risks, objectives and fees of the investment options.

Plan participants also would receive quarterly statements from plan administrators. The bill approved by the House would require these statements to list total contributions, earnings, closing account balances, net returns and all fees subtracted from the employees' accounts.

Federal law does not require the disclosure of fees taken out of workers' 401(k) accounts. But hidden fees can make a big difference in retirement savings, proponents of the bill maintain. The Government Accountability Office found that a 1-percentage point difference in fees could cut retirement savings by nearly 20 percent.

"Guaranteeing complete and simple disclosure of fees will help give Americans a fighting change to strengthen their retirement and increase our nation's future economic security," said House Education and Labor Committee Chairman George Miller (D-Calif.).

The House bill would place new obligations on 401(k) service providers, too. Before entering into a contract with a plan, service providers would be required to provide a written statement to the plan administrator describing the services to be provided and the total an-

nual revenue to be collected by the service provider in connection with the plan.

Service providers would be required to disclose to plan sponsors all fees assessed against participant accounts, broken down into the following categories:

- plan administration and recordkeeping fees;
- investment management fees; and
- all other fees.

The fee-disclosure requirements included in the House version of H.R. 4213 are based on the 401(k) Fair Disclosure and Pension Security Act, H.R. 1984, which the Education and Labor Committee approved in 2009.

### Funding Relief

The House bill would give employers that sponsor DB plans more time to make up the losses their pension plans suffered when the stock market plummeted in the fall of 2008. A single-employer plan could elect a nine-year amortization period and pay interest only in the first two years. Or the plan sponsor could elect a 15-year amortization period instead.

The provision generally would allow a plan sponsor to elect relief for up to two plan years during the period 2008-2011. A plan's funding obligation for a plan year would increase if the plan sponsor made excessive employee or shareholder payments.

Sponsors of the relief provision estimate that it would free up \$129 billion over the next seven years that companies could use to preserve or create new jobs. "We've seen some significant improvements in the national economy, but many employers are still struggling to recover," remarked Rep. Earl Pomeroy (D-N.D.). "This legislation will give them some solid relief so they can focus on creating jobs and getting our economy back on track."

Earlier this year, the Senate passed a version of the bill that included funding relief for DB plans, but not fee-disclosure requirements for 401(k) plans. Now the House and Senate versions will have to be reconciled. In addition to the retirement plan provisions, the bill contains a host of other provisions, including business tax cuts and an extension of unemployment insurance benefits.

The House initially passed the bill on Dec. 9, 2009; the Senate did so on March 10. On May 28, the House agreed to Senate amendments to the measure, but further amended it; the bill is now back before the Senate. 🏠

# Proposed SEC Rules Would Apply to Target Date Fund Marketing Materials

Investors would have new information available to help them better understand target date funds (TDFs) under new rules proposed by the SEC. The proposed rules are designed to help clarify the meaning of a date in a TDF's name.

TDFs are structured to make investing for retirement more convenient by automatically changing an investor's investments to a more conservative mix as the investor nears retirement. This automatic asset allocation has been referred to as a fund's "glide path."

The name of a TDF often refers to its target date, which generally represents the year in which the investor intends to retire. But TDFs that share the same target date have been shown to have very different investment strategies or risks, as well as varying fees.


The rules proposed by the SEC would give investors more information about a fund's anticipated investment glide path and risk profile. For example, they would require a TDF's marketing materials to include a prominent table, chart or graph that depicts the how the fund's asset allocation changes over the life of the fund.

The rules also would require the materials to include a written statement explaining that the fund's investment mix changes over time and that the asset allocation eventually stops changing. The statement would explain

when — how many years after the target date — the asset allocation becomes final and what the final investment mix would hold.

"These proposed rule changes would help clarify the meaning of the date in a target date fund and improve the information provided when these funds are advertised and marketed to investors," commented SEC Chairman Mary L. Shapiro.

Under the SEC's proposed rules, marketing materials for a TDF that includes a target date in its name would need to break down the fund's holdings in different types of investments — such as equity securities, fixed income securities or cash. The types of investments would need to appear with the fund's name the first time the name is used. The SEC's proposal would require TDF marketing materials to include a warning to potential TDF investors that they could lose money by investing in the fund, even after the target date.

The SEC voted unanimously on June 16 to propose the new rules, which would amend the Securities Act and the Investment Company Act. The SEC is seeking public comment for a period of 60 days following their publication in the *Federal Register*. In May, the SEC and the Department of Labor issued an investor bulletin explaining aspects of TDFs investors should consider before investing in one. 


## **Custody Rule** (continued from p. 4)

consequence, the adviser, among other things, must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends quarterly account statements to each investor in the pool and must obtain an annual surprise examination with respect to the pool's assets. We note that, because the privately offered securities exception provided in paragraph (b)(2) is not available with respect to assets of an unaudited pool, the adviser must maintain privately offered securities owned by the pool with a qualified custodian. (FAQ VI.1)

Another FAQ clarifies that when a qualified custodian is required to send account statements directly to investors in a pooled investment vehicle, each account statement should be a statement of funds and securities held by the entire pool and transactions entered into by the

pool, rather than a statement of each individual investor's ownership interest.

### **Finding out More**

The full text of the updated FAQs can be found at [http://www.sec.gov/divisions/investment/custody\\_faq\\_030510.htm](http://www.sec.gov/divisions/investment/custody_faq_030510.htm), and in App. IV of the *Guide*. 

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# FBAR Filing Requirements for Plan Fiduciaries and Related Persons

*IRS Issues Filing Relief, but Certain Filing Obligations Remain*

*By Karen A. Simonsen, Todd A. Solomon and James G. Isaac*

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The IRS recently issued several pieces of guidance related to the filing of the Report of Foreign Bank and Financial Accounts, IRS Form TD F 90-22.1 (FBAR), by pension plan sponsors. While the IRS has relieved some of the filing obligations, most notably the requirement for plans to file for foreign hedge fund investments for 2009 and prior years, certain filing obligations remain. Plan sponsors with foreign financial accounts should be aware of their FBAR filing obligations and should be gearing up to make filings before June 30, 2011. (In some cases, the deadline was June 30, 2010.) The following discussion is intended to provide plan sponsors and related individuals with a better understanding of the IRS's position on FBAR requirements and how this position may affect their filing obligations.

## **Who Is Generally Required to File an FBAR?**

Under IRS rules, U.S. persons with a financial interest in, or signature or other authority over, financial accounts in a foreign country that have an aggregate value exceeding \$10,000 at any time during the calendar year are required to file the FBAR by June 30 of the following year (subject to limited exceptions). Although this filing requirement is not new, the IRS recently made clear that its scope is much broader than previously understood.

## **Are There Consequences for Not Filing an FBAR?**

Yes. Criminal penalties for the willful violation of FBAR requirements can, if connected with the violation of another law or if part of a pattern of illegal activity, reach \$500,000 and imprisonment for 10 years. Civil penalties can be up to \$10,000 for each non-willful violation.

## **Are Plan Sponsors and Related Individuals Subject to the FBAR Filing Requirements?**

In short, the answer may be "yes." The IRS has indicated that the FBAR filing requirements may extend to employee benefit pension plans and trusts, plan sponsors, plan trustees, investment managers — including invest-

ment advisers and brokers — and plan service providers (collectively, plan filers). This is because a pension plan, for example, will often invest in offshore investment vehicles. These foreign investments may fall within FBAR's use of the term "foreign financial accounts." Most defined contribution plans do not hold foreign financial accounts (for example, most "international" mutual funds are U.S.-based funds that hold international securities and thus do not constitute foreign financial accounts). However, many defined benefit plans hold foreign mutual funds, which are treated as a foreign financial account, or offshore hedge funds and private equity funds, which — subject to the recent guidance discussed below — can be treated as a foreign financial account.

ERISA requires every plan to have a "named fiduciary" responsible for the management and administration of the plan. Named fiduciaries have the power to dispose of a plan's assets. Under FBAR's instructions, such persons will generally have "signature or other authority" over the assets invested in the offshore investment vehicles mentioned above and would need to file.

Depending on the identity of a plan's "named fiduciary," the plan sponsor's directors, officers, investment committee members and a number of other employees may have the authority to engage in transactions on behalf of the plan. Arguably, this power could fall within the definition of "signature or other authority" over the plan's foreign accounts, and thus require each of these individuals — whose normal job duties may be only tenuously related to a plan — to file an FBAR as well.

If covered, plan filers face burdensome reporting obligations. For example, a plan filer with signature authority over a foreign financial account is required to list the maximum value of the foreign financial account during the calendar year reported, the account number and the name of the financial institution holding the account for

**See FBAR, p. 8**

# SEC Enforcement

## SEC CHARGES N.Y. ADVISER WITH FRAUDULENT MANAGEMENT OF CDOs


Last October, SEC Office of Investigations and Examinations (OCIE) Acting Director John Walsh testified to Congress that advisers would see more sweep examinations and that the OCIE would be working more closely with the commission's Enforcement Division in the aftermath of the Bernard Madoff and other fraud cases. June 21 brought forth results from the stepped-up efforts when the SEC charged New York-based ICP Asset Management LLC with defrauding four multi-billion-dollar collateralized debt obligations (CDO) called the Triaxx CDOs. The complaint alleged that ICP and its president, Thomas Priore, directed more than \$1 billion of trades for the Triaxx CDOs at what they knew to be inflated prices.

"ICP and Priore repeatedly put themselves ahead of their clients," said SEC Enforcement Division Director Robert Khuzami. "Instead of acting as fiduciaries, they took advantage of a distressed market to line their own pockets."

The complaint alleges ICP and Priore caused the CDOs to make numerous prohibited investments — at intentionally inflated prices to allow ICP to collect

millions of dollars in advisory fees — without obtaining necessary approvals, and later misrepresented the investments to trustees and investors. George Canellos, director of the SEC's New York Regional Office said, "The CDOs were complex but the lesson is simple: collateral managers bear the same responsibilities to their clients as every other investment adviser. When they violate their clients' trust, we will hold them accountable." Canellos said during a June 19 briefing with reporters that the charges against ICP came out of an earlier sweep examination of about 50 investment advisers related to CDOs. SEC Chairman Mary Schapiro announced the sweep in a Jan. 26 seminar at the SEC, saying that it "focuses on the manner in which investment advisers that manage CDOs, hedge funds and other vehicles that hold asset-backed securities and other structured products have managed those assets under the ongoing stresses of the credit market."

### Finding out More

The SEC announced the charges in Litigation Release No. 21563. The full text of the SEC's complaint can be found at <http://www.sec.gov/litigation/complaints/2010/comp21563.pdf>. 

## FBAR (continued from p. 7)

each foreign financial account over which the filer has such signature authority.

### Does Recent IRS Guidance Clarify Plan Filer FBAR Obligations?

Although several issues remain unresolved, recent guidance has clarified some important points. For example:

- Plan filers with signature authority over, but no financial interest in, a foreign financial account have received a one-year extension of their filing deadline until June 30, 2011. Examples of this type of plan filer might include investment committee members and in-house investment officers who are authorized to move money for the plan's trust.
- However, plan filers with a financial interest in a foreign account, such as a foreign mutual fund, must still file an FBAR for 2009 by June 30, 2010. Examples of this type of plan filer might include the plan or the plan's trustee(s).
- Plan filers with either a financial interest in, or signature or other authority over, a foreign commingled fund other than a foreign mutual fund are not required to file an FBAR for 2009 and prior

years. This would include interests in offshore hedge funds and private equity funds.

- The recent FBAR guidance specifically does not exempt pension plans from filing requirements, which means the FBAR requirements for foreign accounts, including commingled accounts such as foreign hedge funds, are likely here to stay.

### What Key Issues Remain Involved?

As mentioned previously, plan filers with either a financial interest in, or signature or other authority over, a foreign commingled account other than a foreign mutual fund are not required to file an FBAR for 2009 and prior years. Notably, however, the recent guidance does not resolve the important issue of whether foreign hedge fund and private equity investments must be reported in the future. Thus, as of today, this means that plan filers who have only signature authority over, but no financial interest in, a foreign hedge fund or foreign private equity fund (such as pension plan investment committee members and plan sponsor employees) have a filing obligation beginning June 30, 2011.

Any additional guidance on FBAR will be forthcoming as the IRS makes it available. 