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## Financial Services Europe and International Update Regulatory Developments

This update summarises current regulatory developments in the European Union and the UK, focussing on the investment funds and asset management and related sectors, in the last three weeks.

### EU Regulatory Developments

#### The AIFM Directive

The European Securities and Markets Authority ("ESMA") published on 2 August 2011 the agenda for an open hearing on its draft technical advice to the European Commission on possible implementing measures for the Alternative Investment Fund Managers Directive (2011/61/EU) (the "AIFM Directive").

The open hearing will be held in Paris on 2 September 2011 and the agenda includes Article 3 of the AIFM Directive, general operating conditions, depositaries and the calculation of leverage and transparency requirements.

The Financial Services Authority of the UK (the "FSA") published an update on 3 August 2011 on the AIFM Directive, which includes an implementation timetable and which indicates that the FSA and HM Treasury will publish two consultations in 2012 and a policy statement in 2013 relating to the Directive.

#### Draft Regulation Released Proposing EU-wide Freezing Orders

At the end of July 2011, the European Commission released the proposed European Account Preservation Order ("EAPO") Regulation, which had been submitted for consideration by the European Parliament and the Council of the EU. Whilst it is likely to be

several years before the EAPO Regulation comes into force, it is likely that the infrastructure which will be required in order to administer the regime within the UK will be set up in the near future.

The regime introduces a new and additional type of bank freezing order which is intended to be available throughout the European Union. The regime, if it is adopted in the UK, will impose new requirements on the infrastructure of the court system and will materially change the way banks do business in relation to requests to search and freeze accounts. Given that it is intended to be available in the courts of any EU Member State, it is reasonable to expect increased demands being made on banks in consequence.

The EAPO is a procedural device available to creditors which, when implemented, freezes some or all of the funds within any bank accounts held by a debtor which are located within the EU. "Bank account" is defined to include accounts containing cash or financial instruments, including transferable securities, options, futures, swaps and units in collective investment undertakings. A creditor is entitled to freeze funds up to the value of its debt plus interest on the debt and (if it is a judgment creditor) costs. Once the EAPO attaches to a bank account, the bank is not permitted to withdraw or transfer funds from the bank account although if not all of the funds in the account are frozen, the surplus funds remain at the disposal of the debtor.

In contrast to an English freezing order, which operates *in personam* and has the effect of restraining a debtor's conduct (and therefore any breach by the debtor constitutes contempt of court), an EAPO operates *in rem* and the obligations attach only to the property or the debtor held by the bank. Unlike a freezing order, an EAPO does not give a creditor the right to obtain disclosure from the defendant of information relating to the defendant's assets.

The EAPO regime will apply to all pecuniary claims in all cross-border civil and commercial matters, but excluding arbitration and insolvency. Accordingly, any creditor can apply for an EAPO provided there is a cross-border element to the dispute.

**Comment:** The UK Government has until 24 October 2011 to elect whether to opt in. The UK has traditionally opted into all regulations regarding civil justice, and in the absence of significant lobbying against the draft regulation, it is likely that the UK will do so with the EAPO, despite the cost to government of establishing a central register or search facility of all UK bank accounts.

Financial institutions should consider taking the opportunity to formulate proposals as to how the regulation can be implemented with minimal disruption and at least cost to them.

### Short Selling Bans

Belgium, France, Italy and Spain announced the introduction of new bans on short selling on 12 August 2011. In light of this, ESMA updated its table of measures adopted by EU securities regulators and has announced that it will continue to update the table, which was originally published on 22 September 2008, and last updated on 9 February 2011 and 9 August 2011.

## UK Regulatory Developments

### FSA Consults on Further Amendments to Client Assets Sourcebook

At the end of July 2011, the FSA published a consultation on proposals to amend its Client Assets sourcebook ("CASS") regarding custody liens and title transfer collateral arrangements ("TTCAs") (CP11/15).

- **Custody liens:** the FSA consulted on proposals to enhance CASS in a consultation paper published in March 2010 (CP10/9). Final rules were set out in a policy statement

published in October 2010 (PS10/16). One of the proposals in CP10/9 involved prohibiting firms from granting inappropriate general liens over their clients' assets and client money derived from those assets. The final rules (which have applied to new agreements since 1 March 2011 and which will come into force for other agreements on 1 October 2011) took account of responses received to CP10/9, but technical issues with those rules have since been raised. In broad terms, these issues relate to the rule concerning liens over assets held in overseas jurisdictions, and the fact that firms need to change their current business models where assets are generally held in omnibus client accounts and liens are taken over the assets in those accounts.

To address these issues, the FSA now proposes to:

- apply interim relief from the effect of the existing rules for the period 1 October 2011 to 31 March 2012;
- amend the rules to provide for the taking of certain liens or rights over omnibus client accounts; and
- amend the rules in relation to liens or rights over assets held in overseas jurisdictions.

(The text of the proposed amendments is contained in two draft Handbook instruments which are reproduced in Annexes to CP11/15.)

- **TTCAs:** the FSA consulted on proposals to amend CASS, including prohibiting the use of TTCAs with retail clients in all circumstances in Quarterly Consultation Paper No. 25 (CP10/15) published in July 2010. The final rules came into force on 1 December 2010.

TTCAs are arrangements by which a client transfers to a firm full ownership of monies or assets to secure or cover existing or future obligations. They have the effect of removing the monies or assets of the client from the protections afforded by CASS.

Following consultation in CP10/15, the FSA ultimately implemented rules which prohibited the use of TTCAs with retail clients in relation only to certain products, namely spread betting and other contracts for differences. The FSA now proposes to extend the prohibition to include rolling spot forex contracts offered to retail clients. This means that retail clients providing client money or assets to firms in relation to rolling spot forex

contracts will receive the full protection available under CASS.

### FSA Reports on Findings of Hedge Fund Surveys

Also at the end of July 2011, the FSA published a report assessing the possible sources of systemic risk from hedge funds.

The report sets out the results of the FSA's latest hedge fund survey ("HFS"), which was conducted in March 2011, and hedge fund as counterparty survey ("HFACS"), which was conducted in April 2011. The HFS and HFACS are voluntary surveys, conducted every six months as part of the FSA's work to assess risks to financial stability arising from outside the prudential regulatory perimeter. In general, such risks could crystallise through two potential channels:

- **the Market channel:** that is, market dislocations disrupting liquidity and pricing. Data from the HFS are used to assess potential threats through this channel.
- **the Credit channel:** that is, losses in hedge funds leading to losses by banking and other counterparties. Data from both the HFS and the HFACS are used to assess potential threats through this channel.

The latest results of the HFS and HFACS indicate that the leverage of hedge funds surveyed by the FSA for these purposes remains largely unchanged in aggregate. Hedge funds continue to have a modest presence within most markets. This means that current risks to financial stability through the market channel appear to be limited. Counterparty credit exposures to hedge funds remain concentrated amongst a small number of banks. The FSA notes that, since the financial crisis, counterparties have increased margining requirements and tightened other conditions on their exposures to hedge funds, thereby increasing their resilience to hedge fund defaults.

However, the report makes clear that risks may change rapidly according to market conditions and that some potential risks to hedge funds remain. Although hedge funds appear to have extended the term of their financing recently, there is still a risk of a sudden withdrawal of liabilities during a stressed market environment that could potentially result in forced asset sales. If this were to occur across a number of funds, or in one large and highly leveraged fund, it might exacerbate pressure on market liquidity and efficient pricing.

The FSA intends to repeat the HFS in September 2011 and the HFACS in October 2011. In respect of the HFS, the FSA will continue to work closely with IOSCO and other national regulators to help achieve a clearer identification of global risks through a consistent and proportionate international approach to systemic risk data collection from hedge funds.

### ISA Bulletins Nos 34 and 35

HMRC issued ISA Bulletin 34 at the end of July 2011 to keep ISA managers informed of new developments relating to the ISA scheme. It contains articles on:

- Junior ISA – regulation changes
- Guidance Notes for ISA Managers

The ISA regulations (*S.I. 1998 No. 1870*) have been amended to allow for the creation of Junior ISAs. The amendment regulations take effect from 1 November 2011.

On 4 August 2011, HMRC issued ISA Bulletin 35 which contains guidance on cancellation rights in respect of Junior ISAs.

### FSA Policy Statement on Delivering the RDR and Other Issues for Platforms and Nominee-Related Services

The FSA published on 1 August 2011 a policy statement on delivering the retail distribution review (the "RDR") and other issues for platforms and nominee-related services (PS11/9).

PS11/9 reports on the feedback the FSA received to its November 2010 consultation on the RDR and platforms (CP10/29) and includes details about the definition of a platform service, adviser charging, independent advice, payments from product providers to platforms, cash rebates and re-registration.

Changes to the FSA Handbook to implement the new rules and guidance are set out in the Retail Distribution Review (Platforms) Instrument 2011 (FSA 2011/47) included as an appendix to PS11/9.

The following are the significant points contained in the policy statement:

- **Defining a platform:** the FSA is introducing a definition for a "platform service", but it does not include a description of its primary or core functions. The FSA has confirmed that the definition does not include product

providers such as life companies, the activities of authorised fund managers or self-invested personal pension operators.

- **Adviser charging:** the FSA is amending its Conduct of Business sourcebook (COBS) to ensure platforms face the same requirements as product providers if they facilitate payment of adviser charges. The requirement means that the firm facilitating the payment of the adviser charge must be satisfied that the client has agreed to the payment of the adviser charge and how this is to be carried out.
- **Independent advice:** the FSA will require platform firms to present their products in an unbiased manner and expects independent advisers to be able to demonstrate why using a particular platform is suitable for an individual client, which will involve not just looking at one platform over another, but also looking 'off platform' when it is appropriate to do so.
- **Payments from product providers to platforms:** the FSA considers that it would be desirable, in principle, to ban payments by product providers to platforms, although it acknowledges that it needs to consider how this move would impact on platforms' existing business models and how long they might need to adapt to this change. (Any rule changes the FSA makes in this area will not come into force before 31 December 2012.)
- **Cash rebates:** the FSA has decided that it would ultimately like to move to a position where cash rebates from platforms to consumers are banned and will undertake further research on this (and again, any rule changes will again not come into force before 31 December 2012.)
- **Re-registration:** the FSA is to require authorised nominee companies, including platforms, which hold products on behalf of consumers, to transfer these investments to another nominee, when requested to do so, within a reasonable time.
- **Investing in authorised funds through nominees:** the FSA is to require platforms and other nominees to pass on fund information to end investors (i.e., beneficial owners). They will also be required to inform end investors where there is an event that requires an extraordinary resolution at which unitholders must vote in order to accept an alteration to a fund.

The changes to the FSA Handbook to implement the new rules and guidance set out in the Retail

Distribution Review (Platforms) Instrument 2011 will come into force on 31 December 2012.

### **FSA Defers Introduction of New Capital Rules for Personal Investment Firms**

Also on 1 August 2011, the FSA, in relation to its review of the prudential regime for personal investment firms ("PIFs"), announced that it had deferred the introduction of new capital resources requirements for PIFs for two years.

The phasing in of the new rules for PIFs will now commence on 31 December 2013, with the full requirements in place by the end of 2015. (The FSA believes this will give firms more time to build up their capital resources to the required levels).

### **FSA Finalised Guidance on Derivative Risk-Management Practices in Investment Management Industry**

The FSA published on 2 August 2011 final guidance on derivative risk-management practices across the investment management industry (FG11/10).

The FSA consulted on this guidance in December 2010 and its final guidance appears to be in broadly the same form as the draft version.

The guidance sets out the FSA's expectations relating to the Collective Investment Schemes sourcebook (COLL) requirement that authorised fund managers use a risk-management process, which enables them to monitor and measure as frequently as appropriate the risk of a fund's positions and their contribution to the overall risk profile of the fund.

### **Hedge Funds Strategy Board Consultation on Internationalising and Strengthening Its Standards**

The Hedge Fund Standards Board ("HFSB") published on 4 August 2011 a consultation on internationalising and strengthening its Hedge Fund Standards (CP3/2011).

The standards were originally published in 2008 in the context of the UK regulatory environment. They were created with the aim of setting out good practice in the hedge fund industry to complement statutory rules and regulation. However, international interest in the standards has grown and the HFSB wishes to modify the standards to ensure they are relevant to non-UK hedge fund managers and are not perceived as being tied to a particular national regulatory regime. Accordingly,

the HFSB proposes to delete references to the FSA's Principles for Businesses (PRIN) from its standards.

A particular focus of the consultation is on ensuring that the standards are appropriate for US managers. For example, the HFSB is proposing that where a fund does not have an independent governing body in place to protect investors' interests, there should be an obligation to ask for investor approval before key actions may be taken which may involve a potential conflict of interest between a manager and investors.

The consultation also includes proposals to strengthen the standards in the light of lessons learned from the financial crisis, and in particular, there are proposed amendments to:

- strengthen disclosure to investors;
- improve risk management;
- ensure consistency in valuation; and
- ensure policies are in place to prevent market abuse.

A document containing the standards with proposed amendments has been published by the HFSB alongside the consultation paper, (which closes for responses on 28 October 2011).

### **FSA Finalised Guidance on Remuneration Code**

The FSA published on 5 August 2011 finalised guidance on its remuneration code (FG11/11) following its April 2011 consultation (GC11.09).

The guidance provides tools to help firms comply with the code and gives information about the operation of the code in key areas. It consists of:

- guidance on retention periods;
- guidance on guaranteed variable remuneration;
- frequently asked questions on the remuneration code;
- a template to help firms in proportionality tier 2 to complete a remuneration policy statement (RPS). An annex containing a code staff list for tier two firms has also been published. This is in the form of a spreadsheet template in which firms can record code staff, remuneration structures and any guarantees given to employees; and

- a template to help firms in proportionality tiers 3 and 4 to complete an RPS. An annex containing a code staff list for tier three and four firms has also been published.

(The FSA also published a guidance consultation on issues relating to remuneration on 5 August 2011 noted below).

### **FSA Guidance Consultation on Issues Relating to Remuneration**

The FSA also published on 5 August 2011 two proposed "Dear CEO" letters providing guidance on issues relating to remuneration as part of a guidance consultation (GC11.19), together with a related webpage.

The proposed guidance relates to the FSA's remuneration code in chapter 19A of the Senior Management, Systems and Controls sourcebook (SYSC). A revised version of the code came into force on 1 January 2011. The proposed letters set out the FSA's plans for monitoring implementation of the code up to and during the 2011/12 annual remuneration review. They also outline what the FSA expects firms to do.

One is for firms in proportionality tier 1. This letter sets out the FSA's detailed approach to monitoring how these firms have implemented the code. Among other things, it outlines the need for firms to submit a remuneration policy statement ("RPS") within a given timeframe. The FSA has also published a draft RPS template and a code staff list for tier 1 firms (to be completed and returned with the RPS).

The letter is for firms in tiers 2, 3 and 4. This letter sets out the FSA's less onerous approach to monitoring these firms. The RPS template for these firms has already been consulted on and has been published in final form. For a small number of tier 2 firms, supervisors are likely to tailor the assessment approach more closely to the firm, taking account of its business model and risk profile.

The letters are also designed to provide guidance (set out in an Annex to each letter) on a number of policy areas:

- **the definition of "code staff"**: this guidance focuses on how to identify staff whose remuneration falls into the "same bracket" as senior management, control staff and risk-takers, and who have a material impact on a firm's risk profile;
- **long-term incentive plans ("LTIPs")**: this guidance is designed to provide clarity on

what the FSA would expect to see in an LTIP that is used to pay part of variable remuneration; and

- **structure of alternative investments:** this guidance provides clarity on what the FSA would expect to see in relation to firms that cannot or do not wish to pay part of variable remuneration in shares.

(Comments on the draft letters, the draft RPS template and the proposed guidance in the Annexes to the letters can be made until 2 September 2011.)

- **Comment:** Whilst this FSA guidance in the form of draft “Dear CEO” letters is helpful in providing the steps that the FSA will take to

review the implementation of the Remuneration Code for FY2011, overall the letters and guidance do not represent a departure from the principles and guidance previously issued by the FSA. In due course, firms will need further clarification on the types of alternative instruments that might be acceptable. They will also need more details about the process to collect information for high earners and how this is to be submitted to the European Banking Authority.



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