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A legal update from Dechert's Financial Services Group

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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 focusing on the investment funds and asset management sectors, during the past three weeks.

EU Regulatory Developments

IOSCO Report on Trading of OTC Derivatives

On 25 January 2012, the International Organisation of Securities Commission ("IOSCO") published an analysis to its February 2011 report on trading of over-the counter ("OTC") derivatives (IOSCO delivered a February 2011 report to the Financial Stability Board in April 2011 and was requested to undertake further analysis on the current use of multi- and single-dealer platforms).

The latest IOSCO report:

- describes the different types of trading platform currently available for the execution of OTC derivatives transactions in IOSCO member jurisdictions;
- highlights the different approaches global regulators are taking (or envisage taking) to mandate the use of organised platforms for trading OTC derivatives; and
- aims to assist regulators and policy makers when developing or implementing derivatives trading policy proposals.

Short Selling: ESMA Consults Action on Draft Technical Standards on the EU Regulation on Short Selling and Certain Aspects of Credit Default Swaps

On 24 January 2012, ESMA published a consultation paper regarding draft technical standards on the EU regulation on short selling and certain aspects of credit default swaps covering the following:

- information on net short positions to be notified to competent authorities and disclosed to the public, and means by which such information may be disclosed to the public;
- information on net short positions in shares and sovereign debt to be provided to ESMA by competent authorities on a quarterly basis;
- types of agreements, arrangements and measures that adequately ensure that, in the case of short sales, the shares or sovereign debt will be available for settlement; and
- the method for calculating turnover to determine the principal venue for the trading of a share (as, where the principal trading venue is outside the EU, exemptions from disclosure apply).

The deadline for responding to this consultation is 13 February 2012.

EMIR Update

On 24 January 2012, the Council of the EU published further details of the proposed European Market Infrastructure Regulation ("EMIR") following a meeting of ECOFIN.

The press release indicates that the Council has adjusted its position in negotiations on

EMIR with the European Parliament. The adjustment aims to "facilitate rapid agreement", so as to enable EMIR to be adopted by the European Parliament at first reading.

The main change to the general approach agreed in October 2011 relates to the procedure for authorising central counterparties ("CCPs"). The October 2011 approach specified that a CPP authorisation by a regulator could only be blocked by a negative opinion of the college of supervisors supported by an unanimity minus one vote (i.e. all the members of the college, excluding the home member state regulator). However, the Council has now approved a proposal that would introduce two additional safeguards:

- following a negative opinion of the college of supervisors, with unanimity minus one, the home member state can refer the matter to the European Securities and Markets Authority ("ESMA") for binding mediation.
- when a "sufficient" majority in the college of supervisors oppose authorisation of a CCP, this majority may then decide to send the issue to ESMA for binding mediation. ("Sufficient" is defined as two-thirds of college members, with votes in the college limited to two per member state for colleges of up to and including 12 members, and three for colleges above that size).

The Council also mentions two other compromises:

- pension schemes will be exempt from a clearing obligation for a period of three years, extendable by another two years, and then another year, subject to reports justifying the deferrals; and
- CCPs from third countries will only be recognised in the EU if the legal regime of the relevant third country provides for an effective equivalent system for the recognition of CCPs authorised under foreign legal regimes.

Stop Press: After nearly four months of trialogue meetings, agreement has finally been reached on the EMIR. A full report will appear in the next issue of this On Point.

EVCA Consultation Handbook of Professional Standards

On 19 January 2012, the European Private Equity and Venture Capital Association (the "EVCA") published for consultation a revised draft of its handbook of professional standards on which it had originally consulted in June 2011.

The handbook brings together certain existing EVCA professional standards (i.e. the code of conduct, governing principles and corporate governance guidelines) with the aim of providing accessible, clear and practical guidance on the principles which should govern the professional relationships between managers, investors, portfolio companies and others engaged in the European private equity and venture capital industry.

New sections have now been added on:

- general partner communication and transparency;
- limited partner ("LP") conflicts of interest;
- LP advisory committees;
- keyman provision; and
- secondary transactions.

The final version of the handbook will now also include the International Private Equity and Venture Capital valuation guidelines as well as new reporting guidelines.

This consultation closes on 30 March 2012.

ESMA Consultation on Future Regulatory Framework for ETFs and Other UCITS Issues

The European Securities and Markets Authority ("ESMA") published on 30 January 2012 a consultation paper (ESMA/2012/44) setting out future guidelines on UCITS Exchange-Traded Funds ("UCITS/ETFs") and other UCITS-related issues. The proposals cover both synthetic and physical UCITS/ETFs and describe future obligations for UCITS/ETFs, index-tracking UCITS, efficient portfolio management techniques, total return swaps and strategy indices for UCITS. In the summer of 2010 ESMA started looking into the operation of UCITS making use of the new investment freedoms introduced by the UCITS III Directive and the Eligible Assets Directive (2007/16/EC) in order to identify the possible impact on investor protection and market integrity. As part of this work, ESMA published a discussion paper on policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS on 22 July 2011 (ESMA/2011/220), responses to which were due by 22 September 2011. These latest proposals represent the next step in the development of ESMA guidelines in this area.

ESMA's proposals go wider than simply ETFs, however. They cover both synthetic and physical UCITS/EFTs and detail the proposed obligations for the UCITS/ETFs, index-tracking UCITS, efficient portfolio management techniques, total return swaps (in relation to collateral), securities lending and strategy indices for UCITS. The consultation also proposes a tightening of the eligibility criteria of such indices.

In addition, ESMA's proposals include placing an obligation on UCITS/ETFs to use an identifier and facilitate the ability of investors to redeem their shares directly with the ETF provider.

Comments in response to this consultation can be made until 30 March 2012.

ESMA will finalise these guidelines for adoption in Q2 of 2012.

Comment: The question remains whether some of these funds should be reclassified as "complex" products. That issue will be determined by the European Commission as part of its review of MiFID.

Central Rating Repository

On 2 February 2012, ESMA announced the launch of the Central Rating Repository (the "CEREP").

The CEREP will provide information on credit ratings issued by credit rating agencies ("CRAs") that are registered or certified in the EU. The data provided by CEREP will be based on historical credit ratings submitted by CRAs on a semi-annual basis calculated in a standardised manner.

CEREP will be a platform for investors to assess the performance and reliability of credit ratings on different types of ratings, asset classes and geographical regions over specified time periods.

Article 11(2) of the CRA Regulation (Regulation 1060/2009) required the Committee of European Securities Regulators, ESMA's predecessor, to establish this central repository.

UK Regulatory Developments

New Accounting Rules for UK Limited Partnerships

Under the Partnership (Accounts) Regulations 2008, a limited partnership established under the law of any part of the United Kingdom must prepare and file accounts as if it were a company if each of its partners is either a limited company, an unlimited company, or a Scottish partnership each of whose members is a limited company (a "qualifying partner"). (Many private equity limited partnerships will currently avoid these rules because at least one of the partners falls outside of these categories of qualifying partner). However, HM Government has recently produced draft regulations ("the Partnership Accounts rules") which are due to come into effect for accounting periods beginning on or after April 2012.

Under the Partnership Accounts rules a UK limited partnership will be required to meet the accounting and disclosure standards which apply to a UK limited company if the partnership's general partner is a qualifying partner. This change will bring most private equity limited partnerships with a single corporate general partner back within the Partnership Account rules. The result of this would be that the funds concerned may have to disclose potentially sensitive information, which may include carried interest allocations and valuations of investments of the fund, for example. In order to avoid this, affected funds could replace their corporate general partner with a limited liability partnership (a "LLP"), or insert a LLP as a second general partner (although the VAT implications of that approach need to be considered).

When establishing a new fund, it should be borne in mind that the Partnership Accounts rules only apply to partnerships established under UK law and will not apply to limited partnerships established offshore.

Publication of Financial Services Bill 2010-12

On 27 January 2012, the text of the Financial Services Bill 2010-12 (the "FS Bill"), together with explanatory notes, was published. The Bill, having had its first reading in the House of Commons on 26 January 2012 is likely to receive its second reading on 6 February 2012.

HM Treasury has also published a policy paper to accompany publication of the FS Bill containing details of key policy decisions recently taken on the new regulatory structure including:

- the FS Bill will give the Chancellor of the Exchequer new powers to direct the Bank of England (the "Bank") in financial crises where public money is at risk;
- the term of the governor of the Bank will be changed to a single eight-year term, rather than two five-year terms.

- the FS Bill will contain provisions enabling the Government to transfer responsibility for the regulation of consumer credit to the new Financial Conduct Authority (the "FCA") from the Office of Fair Trading, (The Government reserves the option, however, of retaining the existing Consumer Credit Act 1974 regime, if an appropriate model for consumer credit regulation under the Financial Services and Markets Act 2000 and the FCA cannot be determined).

The Government intends to complete the parliamentary passage of the FS Bill by the end of 2012 and to implement the changes to be made by the FS Bill early in 2013.

Guidance on Unfair Contract Terms

On 30 January 2012, the FSA published final guidance on the above (FG12/2) which provides a commentary on the types of contract term that the FSA commonly finds to be of concern under the Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083) (the "UTCCRs").

The guidance provides the FSA's commentary on terms that give a firm:

- The right to vary the contract unilaterally: the FSA provides guidance on its interpretation on the concepts of "valid reasons", "notice" and "freedom to dissolve the contract" relevant to determining whether a unilateral variation term is unfair.
- The right to terminate the contract: the FSA considers this issue in respect of both contracts of determinate duration, such as annual insurance contracts and mortgage contracts, and in respect of contracts of indeterminate duration.
- Discretion to exercise contractual powers: the FSA provides guidance on when firms have given themselves excessive discretion to exercise contractual powers.
- The right to transfer its obligations under the contract: the FSA expects firms to address the risk that a transfer of a firm's obligations may reduce the consumer's rights under the contract.

The guidance also sets out the FSA's views on terms that are not in plain and intelligible language. (In the FSA's view, words and expressions such as "indemnity", "tort", "lien", "consequential loss" and "time is of the essence" have a specific legal or technical meanings that are not readily understood by the average consumer.)

The FSA expects all firms to take positive and proactive actions to ensure that their contract terms are clear and fair under the UTCCRs. This includes ensuring that they have adequate systems and controls in place to achieve this.

Counterparty Credit Risk Management by CCPs

On 31 January 2012, the FSA published its final guidance on its review of counterparty credit risk management by central counterparties ("CCPs") (FG12/3).

The FSA consulted on the guidance in July 2011 and updated its guidance to reflect the views of respondents where appropriate.

The guidance provides details of the process by which the FSA undertakes reviews of counterparty credit risk ("CCR") management by CCPs under the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995) (the "Recognition Requirements Regulations"). The guidance provides details on the FSA's approach to certain high-level areas that it typically focuses on in its reviews.

The guidance is also designed to be consistent with the Committee on Payment and Settlement Systems and the IOSCO principles for financial market infrastructures, and may be revised when these principles are finalised. The guidance will also be further revised in order to be consistent with the technical standards for CCP requirements to be defined when the EMIR is finalised.

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(Certain of the summaries of developments contained above have been based on the daily and weekly Financial Services updates provided by Practical Law Company Limited.)

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