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A legal update from Dechert's Financial Services Group

Financial Services Europe and International Update

Regulatory Developments

This update summarises current regulatory developments in the European Union, the UK and internationally, focussing on the investment funds and a set manager and related sectors, during the past three weeks.

European Union and International Regulatory Developments

The EU's Transparency Directive: European Commission Proposal for an Amending Directive

At the end of October 2011, the European Commission published the provisional text of a proposal for a directive to amend the Transparency Directive.

The proposed Directive makes a number of changes to the regime for the notification of major holdings, including that the regime be extended to include direct and indirect holdings of financial instruments with economic effects similar to holdings of shares and entitlements to acquire shares whether or not they give right to a physical settlement. Other proposals include the removal of the requirement to publish interim management statements and enhanced powers for competent authorities to impose sanctions and measures for breaches of the transparency regime.

BCBS Consultation on Capitalisation of Exposures to CCPs

On 2 November 2011, the Basel Committee on Banking Supervision ("the Basel Committee") published a second consultation on the capitalisation of bank exposures to central counterparties ("CCPs") (BCBS206).

The proposals developed by the Basel Committee require banks to more appropriately capitalise their exposure to OTC derivatives and create incentives for banks to increase their use of CCPs. This includes efforts to ensure that the exposure of banks to CCPs are adequately capitalised. The proposals cover both capital requirements for default fund exposures and trade-related exposures to CCPs.

The Basel Committee carried out an initial consultation on this topic in December 2010. Its second consultation takes account of the responses received to the earlier consultation, as well as the results of various impact assessments. The Committee also consulted closely with the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions (IOSCO).

The Basel Committee seeks comments on the proposed rules text by 25 November 2011. It then aims to finalise the rules and to publish the results of its quantitative impact studies at the end of 2011 and expects that the rules will be implemented in its member jurisdictions by January 2013.

Financial Stability Board Recommendations on Shadow Banking

At the end of October 2011, the Financial Stability Board (the "FSB") published a report setting out its recommendations on strengthening the oversight and regulation of

shadow banking. In November 2010 the G20 had called for the FSB to provide these recommendations and in April 2011, the FSB published a background note setting out its initial thinking.

This report now sets out the FSB's recommendations and high-level principles relating to:

- the approach that authorities should take towards monitoring the shadow banking system and, in particular, identifying shadow banking activities that may cause systemic risks; and
- the design and implementation of regulatory measures intended to address the risks posed by the shadow banking system.

The report also provides details of future work on the regulation of shadow banking which the FSB, the Basel Committee and IOSCO will carry out during 2012.

For the purposes of monitoring shadow banking activities, the FSB recommends that national supervisory authorities should cast the net wide and consider all non-bank credit intermediation to ensure that all areas are monitored where shadow banking-related risks to the financial system might arise. Once this has been done the authorities should narrow their focus for policy purposes to the sub-set of non-bank credit intermediation where there are:

- developments that increase systemic risk involving four key risk factors:
  - maturity transformation,
  - liquidity transformation,
  - imperfect credit risk transfers; and/or
  - leverage; or
- indications of regulatory arbitrage undermining the benefits of financial regulation.

The FSB's report also sets out high-level principles on which authorities should base their monitoring frameworks. It intends to conduct annual monitoring exercises to assess global trends and risks in shadow banking, with the results reported annually to the G20 and at the FSB's plenary sessions.

The FSB also recommends high-level principles that regulators should apply when designing and implementing regulatory measures for shadow banking to address the risks identified in the monitoring process and details the initial recommendations for further work on specific measures for regulating the shadow banking system, which include:

- Regulation of banks' interactions with shadow banking entities: the Basel Committee on Banking Supervision will examine enhanced consolidation for prudential regulatory proposes, concentration limits and large exposure rules, risk weights for banks' exposures to shadow banking entities and the treatment of implicit support and will provide a report to the FSB with policy recommendations by July 2012.
- Regulatory reform of money market funds ("MMF"s): IOSCO will examine regulatory action relating to MMFs and will provide a report to the FSB with policy recommendations by July 2012, following a consultation in Q1 of 2012.
- Regulation of other shadow banking entities: the FSB will assess the regulation of other shadow banking entities such as structured investment vehicles, finance companies, mortgage insurance companies and credit hedge funds and will develop policy recommendations by September 2012.
- Regulation of securitisation: IOSCO, in co-ordination with the Basel Committee, will examine retention requirements and measures that enhance transparency and standardisation of securitisation products and IOSCO will provide a report to the FSB with policy recommendations by July 2012.
- Regulation of securities lending and repurchase agreements ("repos"): the FSB will examine the role of securities lending and repos and will develop policy recommendations by the end of 2012.

BCBS Adopts Basel Capital Framework Changes Relating to Trade Finance

At the end of October 2011, the Basel Committee on Banking Supervision ("the BCBS") published a report (BCBS205) on the treatment of trade finance under the Basel capital framework.

The BCBS has adopted two changes to the treatment of trade finance in the Basel II and III capital adequacy frameworks:

- waiving the one-year maturity floor for certain trade finance instruments (issued and confirmed letters of credit) under the

advanced internal ratings-based approach for credit risk; and

- waiving the sovereign floor for certain trade finance related claims on banks using the standardised approach for credit risk.

The BCBS also considered whether the 100 per cent credit conversion factor for contingent trade finance products used to calculate the leverage ratio is too high, disadvantaging banks that specialise in trade finance. However, it decided not to change the CCF for calculating this ratio.

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The BCBS carried out an initial consultation on this topic in December 2010. Its second consultation takes account of the responses received to the earlier consultation, as well as the results of various impact assessments. The Committee also consulted closely with the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions ("IOSCO").

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EU Developments in the Fund Management Sector

On 2 November 2011, the FSA published a speech given by Sheila Nicoll, FSA Director of Conduct Policy, on EU regulatory developments in the fund management sector.

Amongst other things, in her speech, Ms Nicoll commented on the Alternative Investment Fund Managers Directive (2011/61/EU) and some of the details of the regime that have yet to be finalised, one of the most important being the implementing measures. Following the consultation by the European Securities and Markets Authority ("ESMA") over the summer, ESMA is due to provide its advice to the European Commission on implementing measures by 16 November 2011. The FSA has spent time with ESMA reviewing responses to the consultation, and considering the themes that have emerged. The most contentious issues relate to:

- depositaries, particularly the liabilities of depositaries in the event of the loss of assets;
- the definition and use of leverage; and
- the treatment of third country funds and fund managers.

Ms Nicoll explained that although ESMA's advice will not represent the final rules, and there may well be significant changes to ESMA's proposals, its advice will provide firms with "at least the direction of travel".

Ms Nicoll also referred to the recent EU legislative proposals to amend the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID"), (now commonly known as "MiFID II"). Points of interest include the following:

- MiFID II will impact on some of the matters the FSA has been dealing with through its retail distribution review ("RDR"), such as investment adviser independence and the risk of commission-biased advice. The FSA is pleased to note the similarities between MiFID II and some of the RDR requirements and it considers that the RDR requirements are compatible with MiFID II;
- MiFID II will extend the scope of MiFID to catch a wider range of instruments and types of trading system. One of the challenges will be to ensure that the different elements of the marketplace are defined properly, to avoid unintended consequences. The FSA supports the proposal for robust risk controls to be put in place by firms involved in algorithmic trading, or which provide sponsored access to automated traders;
- the FSA broadly agrees with the proposals to broaden and re-categorise trading venues with a new organised trading facility (OTF) definition, but it is concerned that the definition is too broad in its scope, and there is a significant risk that it will catch methods of trading that are not truly organised or venue-like.

ESAs' Joint Board of Appeal

On 3 November 2011, the European Securities and Markets Authority, the European Insurance and Occupational Pensions Authority and the European Banking Authority (together known as the European Supervisory Authorities ("ESAs")) jointly announced the appointment of members and alternates of their joint Board of Appeal (including Mr Justice Blair from the United Kingdom). The Board comprises six members and six alternates appointed for a term of five years, extendable once and those appointed are experts in banking, insurance, occupational pensions, securities markets or other financial services.

The Board will hear appeals from certain decisions taken by the ESAs.

G20 Cannes Summit: Financial Services Issues

On 4 November 2011, after the photocalls and political posturing were over, the G20 published a final declaration following the G20 leaders' summit held in Cannes on 3 and 4 November 2011. Amongst other things, the declaration sets out agreement reached by the G20 relating to the following issues:

- reforming the OTC derivatives markets;
- compensation practices;
- over-reliance on external credit ratings;
- addressing the "too big to fail" issue;
- shadow banking;
- market integrity and efficiency;
- commodity market regulation;
- consumer protection; and
- anti-money laundering and counter terrorist financing.

The G20 also agreed to reforms intended to strengthen the capacity, resources, and governance of the Financial Stability Board, giving it legal personality and greater financial autonomy.

Briefing Notes on CRD IV

On 7 November 2011, the Association for Financial Markets in Europe (the "AFME") published five briefing notes on CRD IV (i.e., the package of reforms forming part of a sequence of major amendments to the Capital Requirements Directive (*2006/48/EC and 2006/49/EC*)) as follows:

- CRD IV: overview;
- CRD IV: leverage;
- CRD IV: counterparty credit risk;
- CRD IV: liquidity; and
- CRD IV: capital and capital buffers.

The European Commission published its CRD IV legislative proposals on 20 July 2011. Prior to this, in June 2011, the AFME had published a pack of explanatory materials on CRD IV and Basel III.

UK Regulatory Developments

FSA Guidance Consultation on Proportionality and Remuneration

At the end of October 2011, the FSA published a guidance consultation on proportionality and remuneration (GC11/25).

The FSA is currently consulting on changing its December 2010 general guidance on proportionality which focuses on the remuneration code in Chapter 19A of the Senior Management Arrangements, Systems and Controls sourcebook (SYSC) and the requirement to make Pillar 3 disclosures relating to remuneration (in accordance with Chapter 11 of the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU).

The FSA is of the view that banks and building societies with capital resources between £50m and £100m present a sufficiently low remuneration risk as to warrant tier 3 proportionality treatment. The FSA is therefore proposing a change to the boundary between tiers 2 and 3 for banks and building societies. The consultation recommends that this boundary is raised from £50m to £100m for banks and building societies. This aligns it with the corresponding boundary for BIPRU 730K firms (i.e., full scope BIPRU investment firms).

The guidance consultation closes on 28 November 2011.

FSA Policy Statement on Remaining CRD III Amendments

On 3 November 2011, the FSA published a policy statement: "Strengthening Capital Standards –

Feedback and Final Rules for CRD3" (PS11/12).

CRD III (2010/76/EU) was one of a sequence of directives amending the Capital Requirements Directive (2006/48/EC and 2006/49/EC). PS11/12 relates to amendments to the FSA Handbook implementing provisions in CRD III that must be implemented by 31 December 2011, principally those relating to the trading book and securitisations. (The FSA consulted on these amendments in CP11/9 published in May 2011).

PS11/12 sets out the FSA's policy and final rules relating to the following issues, consulted on in CP11/9:

- certain aspects of the CRD III trading book requirements;
- CRD III requirements relating to securitisation in the non-trading book; and
- guidelines published by the Committee of European Banking Supervisors ("CEBS") in December 2010 on Article 122a of Directive 2006/48/EC.

PS11/12 also includes details of the FSA's policy on a number of other CRD III-related changes, including Pillar 3 disclosure requirements, prudent valuation and certain technical amendments.

In CP11/9, the FSA also consulted on CEBS' October 2010 guidelines on the management of operational risks in market-related activities but published its final rules relating to those guidelines in August 2011.

Changes to the FSA Handbook rules to implement the relevant amendments are set out in the Capital Requirements Directive (Handbook Amendments No 4) Instrument 2011 (FSA 2011/66), which comes into force on 31 December 2011.

Legal Uncertainty in CASS and Arising from the Lehman Brothers Litigation

The respected Financial Markets Law Committee sponsored by the Bank of England has published a paper, dated October 2011, containing an analysis of legal uncertainty in the FSA's Client Assets Sourcebook (CASS) and arising from judicial decisions relating to the administration of Lehman Brothers International (Europe).

The FMLC explains that the High Court's decision in *Lehman Brothers International (Europe) v CRC Credit Fund Ltd and others* [2009] EWHC 3228 (Ch) and the Court of Appeal's decision in *CRC Credit Fund Ltd v GLG Investments Sub-Fund* [2010] EWCA Civ 917 ("the Lehman case") have highlighted issues surrounding the nature and effect of the statutory trust created under CASS when a FSA authorised firm fails to segregate properly the monies that it receives from its clients. The FMLC considers that these issues give rise to material legal uncertainty in the financial markets.

In response to the financial crisis, it will be recalled that the FSA amended CASS. During the consultation period, it participated in the Court of Appeal hearing in the Lehman case and tried to ensure that the hearing would not adversely affect the policies it had proposed. However, the FSA will only undertake a comprehensive review of the CASS regime once the appeal to the Supreme Court in the Lehman case has been decided later in 2011 or early in 2012.

The FMLC has therefore prepared this paper for the FSA in its consideration of CASS. In particular, the paper seeks to deal with:

- the uncertainties highlighted in the High Court's decision in *Lehman Brothers International (Europe) v CRC Credit Fund Ltd and Others* and the Court of Appeal's decision in the Lehman case surrounding the point at which the statutory trust created under CASS arises;
- the uncertainties in relation to the nature of the assets and claims forming part of the statutory trust and the remedies available to the holders of the beneficial interests under the statutory trust where a firm has failed to segregate monies in the client account; and
- some policy solutions for addressing the above uncertainties, including the power to transfer unsegregated monies from the "house" account to the "client" account and the power to treat a claim for client monies as an expense of a firm's administration in cases where the statutory trust and/or proprietary remedies fail.

First Investment Firm to Enter the New Special Administration Regime

On 31 October 2011, MF Global UK Limited, an insolvent investment broker, became the first investment firm to enter the special administration regime (the "SAR") created by the Investment Bank Special Administration Regulations 2011 (SI 2011/245).

The SAR was adopted in February 2011 following the collapse of Lehman Brothers and has the advantage over ordinary corporate administration in that it sets special objectives for the administrator and this is the first time the SAR has been used. The SAR sets three objectives for a special administrator:

- to ensure the return of client assets as soon as practicable;
- to ensure timely engagement with market infrastructure bodies and the authorities; and
- either to rescue the firm as a going concern or wind it up in the best interests of the creditors.

(In an ordinary corporate administration proceeding only the third objective would apply.)

The FSA can direct the special administrator to prioritise one or more of these objectives if it deems that to be necessary on UK financial stability grounds but before it does so it must consult HM Treasury and the Bank of England.

The special administrator can direct any suppliers to continue to provide key services to the entity in the SAR in order to facilitate an orderly resolution.

For further details of the SAR, please refer to our August 2011 *DechertOnPoint* "The New UK Insolvency Regime for Investment Firms".

Structured Products: FSA Review Findings and Guidance Consultation on Retail Product Development and Governance

On 2 November 2011, the FSA published a guidance consultation that sets out the findings of its review of how firms are designing structured products and contains proposed guidance on retail product development and governance (GC11/27).

In outline, GC11/27 sets out that firms should, going forward:

- identify the target audience and then design products that meet the target audience's needs, rather than merely contributing towards the firms' bottom line;
- stress-test new products to ensure they are capable of delivering fair outcomes for the target audience;
- ensure a robust product approval process for new products and be clear about what is a "new" product; and
- monitor the progress of a product through to the end of its life cycle.

GC11/27 also contains:

- guidance on the Unfair Terms in Consumer Contracts Regulations 1999 (*SI 1999/2083*) (UTCCRs), which takes effect immediately;
- a cost benefit analysis; and
- proposed guidance on the Prospectus Rules.

The deadline for comments is 11 January 2012.

FSA Policy Statement on Product Disclosure

On 8 November 2011, the FSA published a policy statement on product disclosure (PS11/14) as part of its work on the retail distribution review (the "RDR"). PS11/14 follows the FSA's February 2011 consultation paper on product disclosure (CP11/3) and also sets out the FSA's feedback on responses to its proposals to:

- change the key features illustrations ("KFIs") that firms must give to their clients, arising from the RDR rules on adviser and consultancy charging; and
- replace monetary projections by inflation-adjusted projections for personal and stakeholder pensions (both individual and group).

In the light of responses to the first issue listed above, and following discussions with trade bodies and firms, the FSA has made some changes to the rules it consulted on, outlined in Chapter 2 of PS11/14. In relation to the second issue listed above, the FSA has drawn up revised KFIs for consumer testing. It expects to report the results of the testing to the market at the same time as it consults on the changes.

The new product disclosure rules are set out in the Retail Distribution Review (Key Features Illustrations) Instrument 2011 (*FSA 2011/55*). These new rules will come into force on 31 December 2012, at the same time as the RDR rules. (A transitional rule is available that allows firms to take advantage, from 1 October 2012, of a rule for generic key features illustrations for groups or sub-groups of employees in a group personal pension scheme.)

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This update was prepared by Martin Day (+44 20 7184 7564; martin.day@dechert.com) and edited by Richard Frase (+44 20 7184 7692; richard.frase@dechert.com).

Certain of the summaries of developments which it contains have been based on those contained in the Financial Services daily and weekly know-how services of Practical Law Company Limited.

Practice group contacts

For more information, please contact the author, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

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Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

Peter D. Astleford
London
+44 20 7184 7860
peter.astleford@dechert.com

Gus Black
London
+44 20 7184 7380
gus.black@dechert.com

Martin Day
London
+44 20 7184 7565
martin.day@dechert.com

Peter Draper
London
+44 20 7184 7614
peter.draper@dechert.com

Olivier Dumas
Paris
+33 1 57 57 80 09
olivier.dumas@dechert.com

Richard Frase
London
+44 20 7184 7692
richard.frase@dechert.com

John Gordon
London
+44 20 7184 7524
john.gordon@dechert.com

Andrew Hougie
London
+44 20 7184 7373
andrew.hougie@dechert.com

Angelo Lercara
Munich
+49 89 21 21 63 22
angelo.lercara@dechert.com

Angelyn Lim
Hong Kong
+852 3518 4718
angelyn.lim@dechert.com

Stuart Martin
London
+44 20 7184 7542
stuart.martin@dechert.com

Michelle Moran
Dublin
+353 1 436 8511
michelle.moran@dechert.com

Antonios Nezeritis
Luxembourg
+352 45 62 62 27
antonios.nezeritis@dechert.com

Declan O'Sullivan
Dublin
+353 1 436 8510
declan.osullivan@dechert.com

Achim Pütz
Munich
+49 89 21 21 63 34
achim.puetz@dechert.com

Marc Seimetz
Luxembourg
+352 45 62 62 23
marc.seimetz@dechert.com

Hans Stamm
Munich
+49 89 21 21 63 42
hans.stamm@dechert.com

Mark Stapleton
London
+44 20 7184 7591
mark.stapleton@dechert.com

James Waddington
London
+44 20 7184 7645
james.waddington@dechert.com

Jennifer Wood
London
+44 20 7184 7403
jennifer.wood@dechert.com

Dechert
LLP

www.dechert.com