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Financial Services Europe and International Update

Regulatory Developments

This *DechertOnPoint* summarises current regulatory developments in the European Union and the UK and certain other EU member states in the investment funds and asset management sectors in the past three weeks.

EU and Supranational Regulatory Developments

Hungarian Presidency's EMIR Compromise Proposal

Derivatives were brought to the forefront of regulatory concerns as the financial crisis developed, from the near-collapse of Bear Stearns to the default of Lehman Brother's and the bail-out of AIG. In October 2009, the Commission published a Communication outlining the range of legislative measures that it has now published as a draft regulation. On 15 September 2010 the Commission issued its formal Proposal for a Regulation on OTC Derivatives, central counterparties and trade repositories.

On 3 May 2011, the Hungarian Presidency of the Council of the EU published a compromise proposal dated 29 April 2011, relating to the proposed European Market Infrastructure Regulation ("EMIR") to be considered at a meeting of the Council's working party on financial services this month. The compromise proposal follows earlier compromise proposals previously published by the Presidency.

However, three particular aspects that are noteworthy are:

- the continued consideration as to whether the scope should cover only OTC derivatives or be extended to all derivatives;
- an increasing emphasis on the reliability of central bank liquidity compared with that provided by commercial banks; and
- an EU limitation has been placed on the definition of an intra-group derivatives contract for financial counterparties.

Short Selling: EU Set to Ban 'Speculative' Sovereign Debt Trades

On 6 May 2011, EU member states gave initial backing to a ban on naked selling of sovereign debt.

The current EU presidency, Hungary, has said that under the deal it brokered that week a ban on naked government debt selling could only be lifted temporarily under strict criteria to be worked out later. (A naked sale is where the asset is not owned or borrowed when sold, in the hope that market prices will have fallen by the time the asset is needed for settlement).

Hedge funds and other investors have been accused of speculating on falls in government bond prices, which exacerbated difficulties for Greece last year (which had to be bailed out by the EU and International Monetary Fund).

Under the Hungarian presidency's deal proposed, a member state can ask for the ban to be lifted temporarily if liquidity in its sovereign debt falls below a set threshold.

The European Parliament, which has joint decision-making powers with member states, voted overwhelmingly in committee in March

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2011 to go further than the Commission text and back a ban on naked selling of sovereign credit default swaps.

The Hungarian presidency's compromise is expected to receive a final first reading in June or July 2011 at the latest. The UK, which believes the deal gives the European Securities and Markets Authority too much power, already appears to have been outvoted on this.

According to a note issue by AIMA on 18 May 2011, at the ECOFIN meeting held the previous day, agreement has now been reached on the Hungarian Presidency's compromise text in relation to the EC's Short Selling Regulation. This was an important stage in the legislative process as it means that both the European Parliament (through its ECON Committee) and the Council of Ministers have now finalised their preferred versions of the European Commission's Original Proposal. Later this month the Council, Parliament and Commission will commence the trialogue process and these negotiations should, in due course, lead to a single text being agreed, which the European institutions will then formally adopt.

Neither the ECON Text nor the Council Text is perfect, but between them, they provide scope for a compromise which could be sensible and effective.

Whilst the Parliament, for example, seeks to impose a ban on uncovered sovereign CDSs, it would also provide for public reporting of significant net short positions in shares to be done on a anonymised basis. On the other hand, the Council has to date resisted any move to include restrictions in respect of sovereign CDSs and it would still require public reporting to be done on a 'name and shame' basis.

EFAMA Papers on External Governance and Responsible Investment

On 9 May 2011, the European Fund and Asset Management Association ("EFAMA") published the following two papers:

- *Code for external governance*: EFAMA recognises that good standards of governance are critical to ensuring confidence in the EU capital markets. The purpose of the code is to provide a framework of high-level principles and best practice recommendations for the investment management industry to follow when they exercise ownership rights in investee companies. EFAMA considers that the code will act as a catalyst for engagement between investment management companies and the companies in which they invest. The principles are designed to enhance the quality of the communication with investee companies, and to foster the creation of value to investors by dealing effectively with concerns over companies' performance. EFAMA considers that compliance with the code will help to support interaction between the industry and the companies it invests in, and ensure a strong link between governance and the investment process. EFAMA calls on the industry to publicly confirm their adherence to the code (for example, on websites or in annual financial statements).
- *Report on responsible investment ("RI")*: EFAMA recognises that RI is an important feature of the investment management industry, with an increasing investor demand in many markets. The report describes recent developments in RI, establishes EFAMA's position on RI and suggests some actions moving forward. Having considered the RI developments in member states, EFAMA has concluded that there are a variety of approaches to RI. This lack of standardisation is an issue that cannot be easily resolved. EFAMA considers that when an investment management company provides RI products, it should commit to an adequate amount of transparency regarding its processes so that investors are able to evaluate and compare how the product meets the RI requirements. EFAMA would welcome universal standards in this area. These could be facilitated by EU industry guidance on transparency, to which EFAMA is committed to contributing.

(In a press release published with these papers, EFAMA point out that EFAMA recognises that corporate governance and RI are both issues that are now high on the European Commission's agenda.)

AIFM Directive: AIMA's Report on Developments

The Alternative Investment Funds Managers Association ("AIMA") reported on 11 May 2011 that work was on the Level 2 implementing measures of the Alternative Investment Funds Directive ('the AIFM Directive') is now well advanced. Given that the official publication of the final Level 1 text has been delayed and is only expected to take place in June 2011, it seems that the European Securities and Markets Authority ("ESMA") will now be given more time to develop its advice. Currently, it is expected to finish its work in November 2011 (which should provide it with roughly two extra months to finalise its technical advice.

ESMA has divided the work into four separate sub-groups or taskforces: depositaries; scope and types of AIFM; general operating conditions; and transparency/leverage/risk/liquidity. All taskforces

are autonomous, but share a common deadline for the publication of the draft technical advice, which will should most likely come out in June or July (originally mid-May) for a two-month public consultation period.

The taskforce on depositaries, chaired by French regulator (the AMF), is proceeding at a pace. The AMF has been provided with a great deal of information from AIMA and the hedge fund industry to assist with its work. Among the issues it is addressing are the scope of the depositary's custody obligation in a counterparty relationship; the treatment of cash; the definition of 'financial instruments' that can be maintained by the depositary; the definition of loss; and the scope of depositary liability.

The taskforce on scope, chaired by the Central Bank of Ireland, is working on the issue of typology of hedge funds and other alternative investment funds. The Commission has indicated that it wishes to have some form of typology underpinning the Directive, though others have indicated they would prefer there to be no hard and fast categorisation.

The most difficult topics in the taskforce on general operating conditions (chaired by German regulator BaFin) relate to the issue of own funds and delegation. The work in the other areas is very likely to draw heavily on many existing UCITS and/or Mifid provisions. The key issue in the delegation area revolves around the definition of a letterbox entity and whether the fund manager is obliged to carry out the activity of portfolio and risk management itself or whether these activities can be outsourced in their entirety to third parties, with the manager maintaining full control and oversight.

On the issue of own funds, the main difficulties relate to the determination of the extent additional capital and/or professional indemnity insurance must be held in order to cover potential professional liability risks resulting from the activities of the fund manager.

On leverage, it appears that the FSA-chaired taskforce is seeking to work on a structure which makes use of several methods of leverage calculation, including the commitment method which is used in the UCITS context. The taskforce has embarked on a search for yet another method of leverage calculation which would not have the obvious drawbacks of the commitment approach (i.e. exaggeration of leverage by using notional exposures for derivatives). A number of meetings have taken place between AIMA and the FSA and examples provided of ways different fund managers approach calculation of leverage depending on their strategies. (Suffice it to say there is no single method that can be applied universally).

Revised AIFM Directive Text

On 15 May 2011, the Council of the European Union published the long awaited revised text (dated 13 May 2011) of the Alternative Investment Fund Managers Directive (the "AIFM Directive").

The European Parliament adopted the AIFM Directive at its plenary session on 11 November 2010. The text agreed in November 2010 however, was to be scrutinised by EU legal and linguistic experts before the official version was finalised and the revised text reflects the work of these experts.

EFAMA Report on 'Newcits'

On 16 May 2011, the EFAMA published a report, *The evolving investment strategies of UCITS*, on the development of certain UCITS using a wide range of techniques and instruments to manage the trade-off between risk and return. (The term 'Newcits' has been used to describe these UCITS, in particular those funds that use derivative techniques to generate absolute returns to investors.)

The increasing use of Newcits in recent years has led to concerns from regulators about the nature of these UCITS, which have included the extent of derivative use and the sophistication of their investment strategies.

The report analyses:

- the reasons behind the evolving strategies of UCITS including the amendments to the original UCITS Directive (*85/611/EEC*) permitting the use of derivatives for investment purposes;
- the challenges that Newcits pose for firms providing UCITS platform services and for depositaries, as well as issues concerning transparency for investors and distribution; and
- how the UCITS regulatory framework addresses these challenges.

EFAMA concludes that the term Newcits is not helpful, and should not be adopted by regulators, as these funds are not new products nor any new category of fund. It suggests that the existing UCITS regulatory framework, particularly the framework in force from 1 July 2011 under UCITS IV (*2009/65/EC*) should be sufficient to encompass the changing nature of UCITS, provided that

framework is enforced by ESMA and the national regulators.

UK Regulatory Developments

Bribery Act: Risk Assessments Should Be Well Underway

The Bribery Act 2010, which comes into force on 1 July 2011, creates a new offence under section 7 which can be committed by commercial organisations which fail to prevent persons associated with them from bribing another person on their behalf.

An organisation that can prove it has adequate procedures in place to prevent persons associated with it from bribing will have a defence to the section 7 offence. To this end, the Ministry of Justice has now published a 45-page guidance document and a 7-page quick start document to help commercial organisations of all sizes and sectors understand what sorts of procedures they can put in place to prevent bribery.

FSA: Publication of Guidance on Individual Liquidity Systems Assessment

The FSA has published its finalised guidance on its Individual Liquidity Systems Assessment ("ILSA") for simplified Individual Liquidity Adequacy Standards ("ILAS") BIPRU firms.

ILSA's aim is to help firms ensure they act in accordance with, and meet, the overall liquidity adequacy rule. ILSA also enables the FSA to assess firms' compliance with this rule more effectively.

The guidance firsts sets out what the FSA expects from ILSA. In general, ILSA:

- must be proportional to a firm's size, business model and risk appetite;
- should take into account all sources of liquidity;
- must include a firm's own assessment and evaluation of its compliance with the systems and control requirements of BIPRU 12.3 and 12.4, and the simplified quantitative requirements of BIPRU 12.6.

Further, the guidance states that firms should conduct an ILSA at least annually, or more frequently if any changes suggest that the level of and access to liquidity resources are no longer adequate. However firms must only submit their ILSA to the FSA when it requests it. This will usually be part of the FSA's ongoing supervisory process.

The guidance also sets out that the ILSA is used to:

- inform a firm's governing body of the firm's ongoing assessment of its compliance with liquidity risk management systems and controls, as required by BIPRU 12.3 and 12.4, including the results of the stress tests required by BIPRU 12.4; and
- inform a firm's governing body of how the firm calculates and meets the simplified liquidity buffer requirements as set out in BIPRU 12.6.9R ̃ 12.6.18R.

The guidance also sets out that although the ILSA may be based on, and incorporate, a firm's existing internal documentation (e.g. existing liquidity policies), the FSA will expect a firm's governing body to require a bespoke ILSA document to be prepared. As the ILSA is a statement of how a firm complies with the FSA's liquidity risk management systems and controls requirements, the FSA also expects a firm's governing body to have formally approved its contents.

The guidance finally sets out the structure and format that an ILSA should follow, and individual liquidity guidance and regulatory intervention points for simplified ILAS BIPRU firms.

Offshore Funds (Tax) (Amendment) Regulations 2011

The Offshore Funds (Tax) (Amendment) Regulations 2011 (*SI/2011/1211*) (the "Amendment Regulations") were made on 4 May 2011. They have amended the Offshore Funds (Tax) Regulations 2009 (*SI 2009/3001*), which govern the tax rules on reporting funds. The Amendment Regulations largely reflect the February 2011 consultation draft but do contain some substantive changes including:

- revised provisions about amending disclosures concerning equalisation arrangements;
- the inclusion, in certain circumstances, of listed companies in the exemption for investments in unlisted trading companies; and
- treating offshore funds that are transparent funds but not unit trusts as if such funds were unit trusts for chargeable gains taxation purposes.

Subject to transitional provisions, the Amendment Regulations have effect, for income tax and

corporation tax purposes, for distributions made (or treated as made) on or after 27 May 2011 and, for the purposes of chargeable gains taxation, for disposals made on or after that date.

FSA Code of Practice for External Auditors and Supervisors

On 6 May 2011, the FSA published final guidance setting out a code of practice for the relationship between external auditors and supervisors (FG11/09). (The FSA consulted on the draft code in February 2011.)

The final guidance appears to be in broadly the same form as the draft version subject to one substantive addition. The introduction to the guidance now makes it clear that the nature of the relationship and information sharing between the FSA and audit firms should be considered not only in the context of the respective roles and responsibilities of auditors and a firm's management, but also of those charged with the governance of a firm. The finalised guidance explains that 'as part of its governance structure, a firm's audit committee is charged with holding management to account for internal control and financial reporting, overseeing the external audit process and appointing external auditors'.

The Companies Acts 2006 (Consequential Amendments and Transitional Provisions) Order 2011: Financial Services Implications

On 13 May 2011, the *Companies Act 2006 (Consequential Amendments and Transitional Provisions) Order 2011 (SI 2011/1265)* was published.

The Order, which was made on 11 May 2011 and came into force on 12 May 2011, brings Northern Ireland open-ended investment companies (OEICs) within the scope of the Financial Services and Markets Act 2000. It also makes consequential amendments to the UK primary and secondary legislation relating to financial services which contain references to provisions of earlier legislation which the Companies Act 2006 has superseded, repealed or revoked.

FSA Publishes First Decision Notices for Enforcement Decisions

On 12 May 2011, the FSA published a press release announcing that it has, for the first time, published decision notices for enforcement decisions that have been referred to the Upper Tribunal.

Both individuals named have referred their cases to the Tribunal. The date for the hearings will be set in due course.

The FSA has published these decision notices under new powers it has under section 391 of the Financial Services and Markets Act 2000 (as amended by section 13 of the Financial Services Act 2010), which came into force in October 2010. (Its approach to publishing decision notices was explained in a February 2011 policy statement (PS11/3).

Comment

Announcing disciplinary action to warn the public of enforcement measures before the appeals process is complete is not without controversy. Such appeals used to be secret, but last year Parliament gave the FSA the power to make cases public once its regulatory decisions committee hands down a decision notice.

The move is part of the FSA's broader 'credible deterrence' agenda, which claims that tough, well-publicised enforcement will help reduce financial crime.

The Coalition Government now appears to want even greater transparency and is proposing to give the FSA power to tell the public of 'warning notices'—the stage at which the FSA lays out its accusations, but before it gives any decision. These notices will constitute a landmark for the FSA and regulated firms and individuals will want to assurance that the FSA will be using these powers consistently.

Both of these developments have drawn criticism from commentators, who consider that early publicity could tarnish reputations unfairly. However, the FSA points out the US regulatory system and criminal prosecutors in the UK make charges public before they are sustained. The FSA also points out that the vast majority of warning notices lead to regulatory findings. In 2010 for example, only three of the fifty four warning notices issued failed to lead to a decision (although the Tribunal has on occasions modified the penalties imposed by the FSA).

The effect of these changes could be relatively modest because most cases settle before coming to the regulatory decisions committee. In the 2010-11 for example, the FSA settled 89 per cent of cases against firms and 61 per cent of cases against individuals. However, the FSA has acknowledged there may be reputational costs. It nevertheless considers that as the number of enforcement decisions overturned is small and those costs are of

minimal significance because they are likely to be outweighed by ensuring earlier deterrence.

Nevertheless, it is arguable that the new processes will breach the rights of individuals subjected to them which stem from the Magna Carta. In addition, unless it can be shown that the FSA has been acting in bad faith, those subject to these procedures who are subsequently found to be guiltless may have little or no chance of obtaining any compensation from the FSA, notwithstanding that the adverse publicity the FSA generated may have caused their businesses to fail.

FSA Consultation on Remaining CRD 3 Amendments

On 11 May 2011, the FSA published a consultation paper, *Strengthening Capital Standards 3 - further consultation on CRD3 (CP11/9)*.

CRD 3 (*2010/76/EU*) was one of a sequence of directives amending the Capital Requirements Directive (*2006/48/EC* and *2006/49/EC*) (the 'CRD'). CP11/9 focuses on amendments to the FSA Handbook implementing those provisions in CRD 3 which must be implemented by 31 December 2011, primarily those relating to the trading book and securitisations.

The FSA originally consulted on these provisions in December 2009 in CP09/29 and set out feedback on CRD 3 issues in July 2010 in CP10/17, but did not provide final rules.

Issues on which the FSA is now consulting in CP11/9 include:

- certain aspects of the CRD 3 trading book requirements;
- CRD 3 requirements relating to securitisation in the non-trading book;
- guidelines published by the Committee of European Banking Supervisors (CEBS) in December 2010 on Article 122a of Directive 2006/48/EC. (These guidelines reflect amendments made by CRD 2 concerning securitisation practices;
- CEBS' October 2010 guidelines on the management of operational risks in market-related activities; and
- reporting requirements relating to market risk, and securitisation in the trading book and the non-trading book.

CP11/9 also includes summaries of the feedback provided on those CRD 3 issues considered in CP10/17 where the FSA's policy approach has remained unchanged.

With the exception of the proposals relating to the CEBS' operational risk guidelines, the deadline for comments on the proposals is 11 July 2011. The FSA intends to publish a policy statement with final rules in Q3 of 2011. The deadline for comments on the CEBS' operational risk guidelines themselves is 11 June 2011 and the FSA intends to issue feedback in its July 2011 Handbook Notice.

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