DechertOnPoint

Third Quarter 2012

Financial Services Quarterly Report

In this issue

Commodity Pool Operators and Commodity Trading Advisers: Practical Advice for Fund Managers Outside the United States
p. 1

Recent Developments in the Regulatory Framework of the PRC Investment Funds Industry
p. 6

Upcoming and Recent Events
p. 9

Implementation of the AIFM Directive: The German Approach
p. 9

Luxembourg Developments
p. 13

ESMA's Draft Guidance on the Remuneration Principles of the AIFMD
p.18

Russian Developments
p. 22

French Tax Developments
p. 24

The U.S. Consumer Financial Protection Bureau at Its First Anniversary
p. 29

Dechert LLP

Commodity Pool Operators and Commodity Trading Advisers: Practical Advice for Fund Managers Outside the United States

by **Karl J. Paulson Egbert** and **Kylee Zhu***

The Need For Registration

Recent changes to U.S. Commodity Futures Trading Commission (CFTC) regulations mean that many fund managers must register with the CFTC before 31 December 2012. The reach of these regulations is extensive and may catch non-U.S. managers off-guard. If a fund uses derivatives[1] and is offered or sold to U.S. persons, the CFTC will assert jurisdiction even if the fund is domiciled or regulated outside of the United States.[2] While there are limited exemptions,[3] it is expected that some fund managers, who are otherwise exempt from SEC registration, will now be required to register with the CFTC.

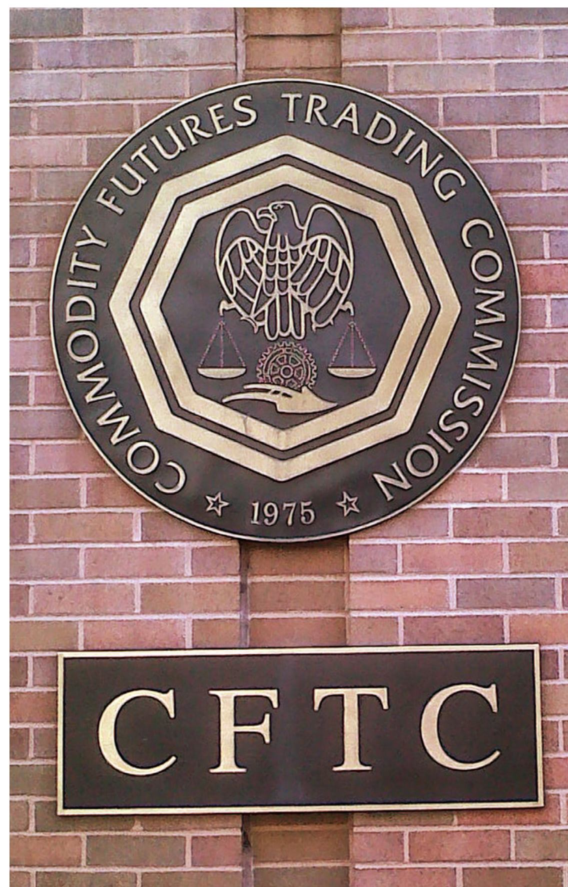
If a fund uses derivatives and is offered or sold to U.S. persons, the CFTC will assert jurisdiction even if the fund is domiciled or regulated outside of the United States.

This article reviews the basic application of CFTC regulatory concepts in a number of jurisdictions where funds are commonly organized: Ireland, Luxembourg, Germany, Dubai, Hong Kong and Singapore.

Commodity Pool Operators and Commodity Trading Advisers

The type of CFTC registration required depends on what activities an entity undertakes. There are two categories particularly useful for fund managers:

- An entity that advises others on derivatives trading is required to register as a commodity trading adviser (CTA).



- An entity that: (a) operates a "commodity pool" (the CFTC's term for collective investment schemes or vehicles); (b) can "hire and fire" the CTA; or (iii) markets the pool to U.S. investors would be required to register as a commodity pool operator (CPO).

Difficulties arise when applying these categories to non-U.S. fund structures. In some cases, there will be more than one CPO, triggering two separate registration requirements. While advisers and sponsors are frequently CPOs, for funds that are organized as corporations, each member of the board of directors is also a CPO. In the case of a limited partnership, the general partner is a CPO. In a trust structure, the trustee is deemed to be a CPO. This does not present an issue when, for example, the trustee is also the fund manager (as with most German collective investment schemes organized as *Sondervermögen*). But, in other cases, the presence of a board, general partner or trustee in addition to a fund manager will give rise to more than one requirement to register as a CPO. Subject to certain conditions, such a result can frequently be avoided by delegating the board/general partner/trustee's CPO functions to the fund manager.

While there are limited exemptions, it is expected that some fund managers, who are otherwise exempt from SEC registration, will now be required to register with the CFTC.

Germany: Most collective investment schemes (*Sondervermögen*) are sponsored and managed by a single entity (a management company — *Kapitalanlagegesellschaft*). Such a management company is likely to be both the CPO and CTA. However, in the case of investment vehicles with external, unaffiliated advisers, the analysis is more complex. If the external adviser gives advice only to the management company and has no authority to make investment decisions, it is not a CPO and may not even be a CTA. Where the management company instead delegates portfolio management to the external adviser, the external adviser is likely to be a CTA. In all cases, because the management company retains the right to hire and fire any external adviser, it is likely to be a CPO.

Ireland: Irish unit trusts, common contractual funds and investment limited partnerships all have managers that are responsible for the business and affairs of the scheme. The manager will appoint an investment manager with discretion to manage the scheme's portfolio of investments. The manager is likely to be a CPO and the investment manager a CTA.

Difficulties arise when applying these categories to non-U.S. fund structures.

Irish self-managed investment companies are corporate vehicles managed by a board of directors that will delegate investment duties to an investment manager. As noted above, each individual director of a board of directors is likely to be a CPO. While a board of directors can, subject to certain requirements, delegate CPO responsibilities to a manager, that may not be possible if the board wishes to retain greater oversight over the scheme's operations.

For Irish umbrella funds with sub-funds managed by distinct investment managers, the analysis will be highly fact sensitive. Each of the investment managers is likely to be a CTA on the basis that they are advising on a portfolio of investments that includes commodity interests. If these investment managers market their own sub-funds, this may trigger both CPO and CTA registration requirements.

Luxembourg: Funds in Luxembourg are organized either as investment companies (a corporate structure) or common funds (a contractual structure). Such funds must be represented by a management company. Funds may further delegate to an investment adviser. In the latter case, managers are likely to be CPOs and the investment advisers are likely to be CTAs. Note that any promotional activities by an investment adviser can prompt CPO registration requirements as well.

Dubai International Financial Centre (DIFC): Funds domiciled in the DIFC can take the form of a corporation, limited partnership or investment trust, constituted under the applicable laws in the DIFC. Due to DIFC regulations, most DIFC funds appoint an existing DIFC-domiciled "Fund Manager" (who has regulatory responsibility and the required DIFC regulatory permissions) to establish and operate funds. The fund board may be charged with making

the investment decisions, although it often appoints another fund manager outside of the DIFC. Promotion and marketing of funds, as well as implementation of the fund investment policy, could take place at the level of the DIFC investment manager, board or even an external investment adviser. Both CPO and CTA functions can be performed in any of those entities.

Fingerprinting — A surprising aspect of CFTC registration is the requirement that each of a CPO's or CTA's "principals" and associated persons submit fingerprint cards on a Federal Bureau of Investigation form.

Hong Kong and Singapore: In Hong Kong and Singapore, the use of a two-tier management structure is common. A Cayman Islands entity typically serves as an offshore manager, while a Hong Kong or Singapore entity acts as an onshore adviser/sub-manager. The onshore adviser is staffed with trading personnel who advise on derivatives trading. As a result, the onshore adviser will often be a CTA. But if personnel of the onshore adviser also market the fund to U.S. persons, this gives rise to a possible CPO registration requirement. The status of a Cayman manager is unclear and will depend on a case-by-case evaluation of the manager's operations — an offshore manager generally retains the ability to hire and fire the onshore adviser, but it may not otherwise act as a CPO.

Ultimately, the determination of CPO/CPA status is fact sensitive. Where a particular entity does not have employees or other covered functions, it may be possible (or even required) to disregard such entity for CFTC registration purposes. Alternatively, subject to certain conditions, a manager may delegate all of its covered CPO/CTA functions to the adviser (or vice versa) in order to reduce the number of registrations required. The principal goal of such delegations should be to have to register only one entity as a CPO. CTA registration is comparatively easier to manage — useful exemptions still exist[4] and the process of adding CTA registration to an entity's CPO registration is simple. In either case, however, managers should consider whether the registration options chosen accurately reflect the managers' operations.

Registration is itself only a first step — new CPOs and CTAs must put into place additional compliance policies and procedures and make ongoing disclosure filings with the CFTC.

Registration as a CPO and/or CTA: The Application Process

Managers should allot up to four months to complete the entire process to register as a CPO and/or CTA, although this can be completed in less time if all goes well.

But delays can occur even before the application is filed — all of the CPO/CTA's "associated persons"[5] must pass the National Commodity Futures Examination Series 3.[6] The exam covers both theoretical and practical aspects of futures trading. While examinations are regularly scheduled, a large number of test-takers is expected in response to the CFTC's new requirements — as a result, it may be necessary to book a seat days or weeks in advance. Furthermore, if a test-taker fails, he or she must wait a minimum of 30 days before scheduling the next examination. Information in relation to the test centers can be found on the FINRA website at http://apps.finra.org/TestCenter/1/locations.aspx.

The basic registration application form, Form 7-R, can be submitted electronically on the National

Dechert LLP

Futures Association (NFA) website. The form requests standard identifying information and disclosure of any disciplinary issues. Related forms must be filed for each of the CPO's principals and associated persons.[7]

Fingerprinting

A surprising aspect of CFTC registration is the requirement that each of a CPO's or CTA's "principals"[8] and associated persons submit fingerprint cards on a Federal Bureau of Investigation form. A number of prospective CFTC registrants have found it difficult to locate officially-accepted methods to comply with this requirement.

The table below sets out the process of obtaining officially-accepted fingerprint cards in various jurisdictions.

Information Regarding Fingerprinting Services

JURISDICTION	Germany	Luxembourg	Dubai	Hong Kong	Singapore
Location	In Frankfurt: Polizeipräsidium Frankfurt am Main K 33 - Erkennungsdienst Adickesallee 70 60322 Frankfurt am Main Outside Frankfurt: Managers should contact the local police station to see if it provides this service.	Both local police and the U.S. Embassy have confirmed that they can provide a fingerprinting service in connection with CFTC registration.	The Government Services Office in the DIFC has indicated it will provide finger printing services to those individuals who hold a DIFC-sponsored Residency Visa.	Certificate of No Criminal Conviction and Criminal Conviction Data Office 14/F., Arsenal House Police Headquarters 1 Arsenal Street Wan Chai Hong Kong Telephone: +852 2396 5351	Criminal Investigation Department 391 New Bridge Road Police Cantonment Complex, Block C Singapore 088762 Telephone: +65 6435 0000
Appointment			Required.	Not necessary.	Not necessary.
Documents to Provide			Passport (including residency visa), UAE National Identity Card and DIFC Identity Card.	Passport or Hong Kong Identity Card and FBI standard fingerprint form FD 258. Applicants will also be asked to complete a form (which includes name, HKID card number, employer and other identifying information) before their fingerprints are taken.	Passport and Singapore Identity Card, evidence of the requirement of the fingerprint card,[10] and FBI standard fingerprint form FD 258.
Fees			Confirmation of any fees payable should be sought when making the appointment.	This service is provided free of charge.	A fee of S$15 will be charged per set of fingerprints made.

Conclusion

While the paperwork associated with CPO and CTA registration is generally straight-forward, the process can be distracting and time-consuming. Registration is itself only a first step — new CPOs and CTAs must put into place additional compliance policies and procedures and make ongoing disclosure filings with the CFTC. But strategies to lessen these burdens exist — evaluating options now is the key to reducing compliance headaches before the CFTC's 31 December deadline.

---

* The authors appreciate the contributions of Conor Durkin (Dublin, +353 1 436 8520; conor.durkin@dechert.com), Sebastian Göricke (Munich, +49 89 21 21 63 62; sebastian.goericke@dechert.com), Chris Harran (Dubai, +971 4 425 6329; chris.harran@dechert.com) and David Heinen (Luxembourg, +352 45 62 62 30; david.heinen@dechert.com).

1 Certain instruments are carved out from the CFTC's jurisdiction, such as (1) options on single stocks and equity indices and (2) swaps that reference a single security or index comprised of nine or fewer securities (i.e., a "narrow-based" index). In addition, there is a formal proposal to exempt physically settled foreign exchange swaps and forwards from CFTC regulation. The status of that proposal is unclear, and funds using foreign exchange derivatives should plan to go ahead with CFTC registration. For a more detailed discussion of existing CFTC exemptions, please see *DechertOnPoint* "CFTC Changes Rules Affecting Public and Private Funds".

2 Note that while this article discusses the situation of funds offered or sold to U.S. persons, the CFTC also can require registration of non-U.S. fund managers that use U.S. derivatives markets. Such managers typically can use one of several exemptions.

3 For example, Rule 4.13(a)(3) provides an exemption from registration as a CPO for entities engaged in a de minimis amount of derivatives trading. Also, Rule 30.5 provides an exemption from registration to a foreign CTA or CPO that files with the NFA an agreement designating an agent for service of process in the United States. Rule 30.5 may have an impact on what counterparties a fund can use to execute swaps. As a result, it may be not be an attractive option for many funds.

4 A dual CPO/CTA fund manager that advises only investment funds exempted under Rule 4.13(a)(3) can be exempted from registration as a CTA pursuant to Rule 4.14(a)(5), if its commodity interest trading advice is directed solely to, and for the sole use of, the investment funds for which it is exempt as a CPO. Rule 4.14(a)(10) provides an exemption from CTA registration for any CTA who had no more than 15 clients (a fund is generally regarded as one client) during the preceding 12 months and does not hold itself out to the public as a CTA.

5 An "associated person" is a person who solicits participants in a commodity pool or separately managed account or supervises solicitation. Solicitation may include providing certain investor-related or investor relations services. Any principal in the supervisory chain-of-command of associated persons must also be registered as an associated person. For more information, refer to the NFA's guidance on who must register as an associated person, at http://www.nfa.futures.org/NFA-registration/registration-advisories/advisory-09-24-07.HTML.

6 A guide on the process for signing up for the exams and information about the exams themselves can be found at http://www.nfa.futures.org/NFA-registration/study-outlines/SO-Entire.pdf.

7 Various fees are associated with CPO registration, including various application fees for associated persons, principals and the CPO itself. Additionally, all registered CPOs engaged in retail off-exchange foreign exchange activities are required to apply to become a foreign exchange firm and pay USD2,500 for CPO foreign exchange firm membership dues.

8 This would include: all directors of the applicant, its president, CEO, CFO, CCO, COO and the head of a business unit conducting commodity interest trading. Direct and indirect ownership of an entity can also make an entity or individual a principal. For more information, refer to the rule and guidance regarding who is a "principal", at http://www.nfa.futures.org/NFA-registration/principal/index.HTML.

9 FBI standard fingerprint form FD 258 (which can be obtained from the FBI website, at http://www.fbi.gov/about-us/cjis/background-checks/standard-fingerprint-form-fd-258.

10 It appears that the Singapore police will accept a copy of the information provided on the NFA website, at http://www.nfa.futures.org/nfa-registration/fingerprint-cards.HTML.

11 For a discussion of these disclosure obligations, please see *DechertOnPoint* "CFTC Changes Rules Affecting Public and Private Funds".

Karl J. Paulson Egbert
Hong Kong
+852 3518 4738
karl.egbert@dechert.com

Kylee Zhu
Hong Kong
+852 3518 4708
kylee.zhu@dechert.com

Recent Developments in the Regulatory Framework of the PRC Investment Funds Industry

by **Angelyn Lim** and **Jessica Shao***

Background

In the last decade, there has been a dramatic increase in the total assets under management (AUM) of local fund management companies in the PRC — from RMB 260 billion (approximately USD41 billion) as of December 2003 to RMB 2.2 trillion (approximately USD 345 billion) as of December 2011, complemented by the boom in qualified foreign institutional investors (QFII), with a total investment quota of USD28.5 billion granted as at the end of July 2012.

In response to industry demand, Chinese central legislators recently published two sets of regulations — *Circular on Certain Issues Regarding The Implementation of Administrative Measures on Domestic Securities Investment by Qualified Foreign Institutional Investors* (关于实施《合格境外机构投资者境内证券投资管理办法》有关问题的规定) (the QFII Circular) issued on 27 July 2012 and *the Proposed Amended Securities Investment Fund Law* (证券投资基金法（修订草案）) (Proposed Fund Law) issued on 6 July 2012. These regulations have the general effect of enhancing the current regulatory regime governing foreign and domestic investors, respectively. There have been similar initiatives at the provincial level as well — it is widely expected that the Shanghai municipal government will shortly launch a qualified domestic limited partner (QDLP) program that will allow foreign asset managers to form RMB-denominated private funds for investment in overseas markets. In addition, on 27 August 2012, the Shanghai Securities Exchange (SSE) announced that it was considering drafting rules to allow so-called "sunshine" private trust funds (hitherto the PRC's answer to hedge funds) to trade interests in the funds on the SSE.

QFII Circular

Since 2002, the QFII program has allowed foreign investors to buy and sell RMB-denominated shares listed on the Shanghai and Shenzhen stock exchanges. The QFII Circular effectively relaxed a number of key aspects of the existing QFII regime.

Minimum AUM: As had been widely anticipated by the industry, the financial threshold requirements for QFII applicants have been significantly eased — the minimum AUM requirements for all categories of QFII applicants (i.e., asset managers, commercial banks, securities firms and other financial institutions) have been lowered. As an example, the minimum AUM requirement for QFII asset manager applicants is now only USD500 million instead of USD5 billion, which is a significant reduction and opens the gates to many more potential applicants. QFII applicants are also now required to submit audited reports of only the preceding one year instead of the preceding three years.

Segregated Accounts: QFIIs may now establish segregated accounts for each client's investments. Previously, only "open-ended China A funds" managed by QFIIs were permitted to maintain separate accounts

of their own. This development will afford segregation and protection of different clients' assets and help mitigate risk of comingled assets. This will clearly be attractive to more sophisticated clients of QFII applicants. QFIIs may also maintain multiple trading accounts with different brokers, whereas previously each QFII was limited to working with only one broker with respect to each stock exchange.

One of the most significant amendments proposed by the legislature is to extend the existing Law on Securities Investment Funds to the private fund industry (which is currently not covered by the domestic regulatory framework).

Investments: QFIIs are permitted to invest in the interbank bond market as well as stock index futures in China, and the maximum aggregated shareholding of QFIIs in any one PRC-listed company has been increased from 20% to 30%.

Proposed Fund Law

Separate efforts are also being made to improve the regulatory environment for domestic participants. On 6 July 2012, the National People's Congress published the Proposed Fund Law for public consultation.

The QDLP program, although initiated only in Shanghai, will (if it is successfully launched) provide a new channel for foreign asset managers to attract RMB-denominated subscriptions.

One of the most significant amendments proposed by the legislature is to extend the existing Law on Securities Investment Funds to the private fund industry (which is currently not covered by the domestic regulatory framework). The Proposed Fund Law introduces a registration system for private fund managers and private funds. Private funds may only be offered to qualified investors who have a specified minimum threshold level of income or asset holdings (details of which are to be determined by the China Securities Regulatory Commission) and who are able to understand and bear the potential risks that may arise from an investment in a private fund.

The Proposed Fund Law also introduces a new fund structure to public funds — the board of administration form (which is more akin to a mutual fund corporation structure) — in addition to the traditional contract-form public fund (which is more akin to a unit trust). The board of administration-form public funds may delegate certain powers and duties to the board of administration (which is established through a holders' general meeting).

Certain regulations and restrictions on fund management companies have been extended to their shareholders and *de facto* controllers. As the Proposed Fund Law does not distinguish between joint venture fund management companies (between foreign and domestic parties) and purely domestic fund management companies, foreign shareholders of joint venture fund management companies will, presumably, also be subject to such enhanced supervision.

QDLP Program

Noting the lack of a national regulation that governs the distribution of offshore private funds in the PRC, the Shanghai municipal government has taken the initiative to invite qualified foreign asset managers to establish private RMB-denominated funds in Shanghai.

While there is uncertainty as to the actual rules applicable to the establishment and operation of such structures (the detailed QDLP rules are yet to be published and be publicly available), the industry seems to expect that the program will set high financial asset net worth and minimum investment threshold amounts for the high net worth domestic individuals and institutional investors who will be permitted to invest in such funds. Additionally, there will likely be qualification requirements applicable to the foreign asset managers permitted to establish such RMB-denominated funds.

Given the lack of publicly available direction in this area, interested potential QDLP participants are now engaging directly in discussions with the Shanghai municipal government or local industry participants in a bid to determine a leading edge.

Listing of Sunshine Private Trust Funds on the SSE

Another initiative that has recently come under the spotlight is the SSE's announcement to consider a plan to list so-called "sunshine" private trust funds on the SSE in order to facilitate trading in such funds by retail investors. While the relevant rules in this regard are yet to be released and implemented, the initiative is believed to be a move to attract more retail investors to support the growth of the sunshine private trust funds industry and also provide a greater variety of investment options for domestic investors.

Sunshine private trust funds, a domestic PRC hybrid between a private hedge fund and a public mutual fund, are popular investments with financial institutions and high net worth individuals in China because, in order to comply with certain fund formation, fund raising and regular information disclosure requirements and other regulations, sunshine private trust funds operate in a more transparent way than traditional private hedge funds. Also, sunshine private trust funds are exempted from certain of the investment restrictions and limitations imposed on public mutual funds, which gives more flexibility in the operation of such sunshine private trust funds.

Conclusion

These new regulations and proposals appear to indicate a trend among the PRC regulators towards a more efficient and transparent investment funds regulatory regime in the PRC, which should attract both domestic and foreign participants. It is expected that the QFII application process will be further simplified and that an increased number of QFII licenses will be more easily granted/obtained in the near future.

While the relevant rules in this regard are yet to be released and implemented, the initiative is believed to be a move to attract more retail investors to support the growth of the sunshine private trust funds industry and also provide a greater variety of investment options for domestic investors.

The Proposed Fund Law, although still subject to further changes by the National People's Congress, has generally been welcomed by industry participants. Notwithstanding the current silence of the Proposed Fund Law on how foreign fund managers may raise and market private funds in China, the QDLP program, although initiated only in Shanghai, will (if it is successfully launched) provide a new channel for foreign asset managers to attract RMB-denominated subscriptions.

---

* Selina Wong, trainee solicitor, provided research for this article.

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

Jessica Shao
Hong Kong
+852 3518 4714
jshao@dechert.com

Upcoming and Recent Events

OCTOBER 16, 2012
The U.S. JOBS Act: What Fund Managers Need to Know and CFTC Update
Hong Kong

The SEC on 29 August 2012 proposed rules to eliminate the ban on advertising and general solicitations by entities such as hedge funds and other private funds conducting private placements in the United States. The proposed rules would allow the marketing of hedge fund and private funds by means of public communications, such as print and media advertisements, internet-based advertisements and discussions at public conferences. This seminar will examine how the JOBS Act can change the marketing of hedge funds and other private funds in the United States. A brief update will also be provided as to recent CFTC changes, focusing on upcoming deadlines for funds and asset managers.

SEPTEMBER 20, 2012
Fund Distribution in Asia: Current Trends
London

This seminar provided an overview of the latest regulatory developments over the past year in the key Asian fund distribution centres of Hong Kong, Mainland China, Singapore, Taiwan and India. Speakers provided practical tips on what asset managers should look out for when seeking to distribute their products in Asia, and discussed fund passports and proposals for the Asia-Pacific region and ASEAN.

AUGUST 22, 2012
Fundamentals of CFTC Registration: What Asian Fund Managers Need to Know
Webinar

The U.S. CFTC recently adopted final rules that modify or eliminate certain CFTC registration and operational exemptions widely used by Asian fund managers. As a result, private funds that use commodity futures, commodity options or many other derivatives face a significantly altered regulatory landscape. Panelists discussed the overhaul of the CFTC's regulations in this area and its impact on private funds.

For more information, or to receive materials from the seminars and webinar listed above, please contact Beth Goulston at +1 202 261 3457 or beth.goulston@dechert.com.

Implementation of the AIFM Directive: The German Approach

by **Angelo Lercara** and **Martin Hüwel**

On 20 July 2012, the German Ministry of Finance (BMF) published the draft of a bill (Draft AIFM Act) to implement the Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) into German law. Within the framework of implementing the AIFMD, the Draft AIFM Act provides, in particular, for the repeal of the German Investment Act (*Investmentgesetz* — InvA) that, among other things, implemented the UCITS Directive 2009/65/EC (UCITS Directive). In addition, 26 other acts and regulations have been amended and/or adjusted by the Draft AIFM Act.

This article focuses on some important issues of the Draft AIFM Act. For further information, please see *DechertOnPoint* "The German Implementing Act for the AIFM Directive: A Critical Survey of the Draft Bill", authored by Robert Eberius, Carsten Fischer, Till Friedrich, Martin Hüwel, Angelo Lercara, Achim Pütz, Florian Rinck, Daniel Schäfer, Hans Stamm, Benedikt Weiser and Frank Wilbert.

To replace the InvA, the Draft AIFM Act provides for the creation of the "German Investment Code" (*Kapitalanlagegesetzbuch* — GIC), which will comprise the future legal framework for all investment funds in Germany. The AIFMD must be implemented into national law by 22 July 2013. Numerous provisions in the draft of the GIC refer to the implementing Regulation for the AIFMD (version of July 2012) (Regulation).

Various provisions of the draft GIC distinguish between funds that only allow for non-individual investors, so-called "Special Investor Funds" (*Spezialfonds*), and funds that also allow for individual investors (Mutual Funds).

Approach Taken by the German Legislator

In principle, the draft of the GIC aims at a one-to-one transposition of the AIFMD. This means that the provisions of the AIFMD should be incorporated into German law unchanged to the greatest extent possible. On several points, however, the BMF has gone beyond

the mandatory minimum requirements of the AIFMD and imposed a more stringent legal framework on the German investment fund sector than that stipulated by the European legislator.

Scope of Application — "Investment Fund by Substance"

In determining the scope of the new regulations, the GIC abandons the prior approach of "investment fund by form" and replaces this with "investment fund by substance", corresponding to the AIFMD. Based on this approach, in the future, a collective investment will be required to qualify either as an investment fund in accordance with the UCITS Directive (UCITS Fund) or as an Alternative Investment Fund (AIF) according to the AIFMD and the GIC. Other fund types will no longer be permitted.

To replace the InvA, the Draft AIFM Act provides for the creation of the "German Investment Code".

Expanded Marketing Concept — Abolishment of Private Placement

The present rules for the marketing of investment funds are subject to substantial changes under the draft GIC. A key change is the expansion of the concept of "marketing", which will prohibit the concept of "private placement". While under the InvA (with the exception of provisions for single hedge funds), only "*public* marketing" was relevant in terms of regulatory law, in the future, the concept of "marketing" will encompass the direct or indirect offering or placement of shares or stocks of an investment fund, as well as advertising for an investment fund or a management company.

As a consequence of this revised concept, the previous regulation (according to which the marketing to certain institutional investors, as well as under certain circumstances the offering in general, is not considered as public marketing) will be discarded. However, certain of the exemptions that had been provided by the InvA will continue to apply. Such exempted activities (e.g., the designation by name of an investment fund, the publication of issue and redemption prices, the disclosure of taxation bases pursuant to Section 5 of the German Investment Tax Act (*Investmentsteuergesetz* — GITA)) are also not considered "marketing" under the draft GIC. In this respect, the concept of "public" marketing no longer plays a role.

This also means that all investment funds currently placed under the "private placement regime" in Germany have to retroactively submit registration notifications. The draft GIC provides a period of one year for obtaining such registration after the draft of the GIC comes into effect (i.e., until July 2014).

Definition of Investor

The adoption of the investor classification mechanism of the Securities Trading Act (*Wertpapierhandelsgesetz* — WpHG) introduced by the MiFID Directive constitutes another pillar of the marketing regulations of the draft GIC. Under the WpHG, investors are classified either as "professional investors" or as "retail investors". In principle, the duties to provide information stipulated in the AIFMD initially apply to both groups. When regulating the marketing directed at retail investors, however, the German legislator made use of the option to stipulate stricter rules as provided by the AIFMD. This applies first and foremost to comprehensive duties to provide information and to certain disclosure obligations.

Notification Obligation for All Funds Before Starting Marketing

Also new is a requirement that a notification to the BaFin must be made prior to the start of the marketing of all AIFs — including domestic ones (!). For UCITS Funds, on the other hand, the existing disclosure procedure (EU passporting) remains in place.

The rules for the notification procedure for AIFs differ, based upon: whether the funds being marketed are domestic AIFs, EU AIFs or AIFs from third countries; whether the marketing is directed at professional investors or retail investors; and whether master-feeder funds are marketed or referred to. The possible combinations of these factors results in almost case-by-case notification provisions under the draft GIC. With respect to marketing to retail investors, foreign AIF management companies must designate a reliable, suitable representative with a registered office in Germany, among other things. In contrast to the current legal situation, however, this representative must be able to exercise the compliance function for the management and marketing activities.

EU Passport for Certain Funds

Another essential element with regard to the marketing of AIFs to professional investors is the EU passport provided for in the AIFMD, which entitles a fund management firm authorised in a Member State to conduct marketing of AIFs on an EU-wide basis. The management company from a non-EU country, however, first must register in a Member State of reference of the European Economic Area (EEA).

General Introduction of the Three-Parties Concept ("Investment Triangle")

In the past, the InvA provided for a separation of investment firms and custodians, each in contrast with the investor, in whose interest they must always act. Previously, this so-called "investment triangle" did not apply to unregulated fund structures. The draft of the GIC provides for replacement of the term "custodian" (*Depotbank*) with that of "depositary" (*Verwahrstelle*) and, due to the differing prescriptions in the UCITS Directive and the AIFMD, provides for separate regulations for UCITS depositaries and AIF depositaries. Under the new framework of the draft of the GIC, a depositary must be designated for any investment fund in the future. Here, from the perspective of investor protection, some mandatory, stricter rules for AIF depositaries were carried over to UCITS depositaries and in anticipation of the UCITS V Directive.

Fund Vehicles Under the Draft GIC

Further changes are planned regarding permitted types of fund vehicles. The draft GIC would retain the current distinction set out in the InvA between contractual Special Investor Funds of investment firms and statute-defined sub-funds of investment stock corporations (*Investmentaktiengesellschaft* — InvestmentAG). An additional investment fund in the statute-defined form — the investment limited partnership (*Investmentkommanditgesellschaft* — InvestmentKG) — is being introduced into law. This will create a new closed-ended investment vehicle in Germany for tax-transparent pooling of a company's pension funds as well as for real asset funds.

The draft of the GIC also makes a distinction between open-ended and closed-ended funds. Closed-ended funds must choose between an InvestmentAG (with fixed capital) or a closed-ended limited partnership, so-called InvestmentKG.

Single Hedge Funds

Whereas currently, units in single hedge funds can be distributed only by way of private placement, and public distribution is prohibited, in the future even the private placement of such units will be prohibited. Under the draft of the GIC, it will only be possible to set up single hedge funds as open-ended Special Investor Fund AIFs, the units of which may be held only by professional investors.

Private Equity Funds

Based on the draft of the GIC, private equity funds should normally be regarded as closed-ended (i.e., redemption is not required at least once a year), since such funds typically invest in illiquid assets. Even if the liquidity necessary to qualify as an open-ended investment fund (with at least annual redemption rights) could be generated from an operational point of view, it must be taken into account that open-ended Special Investor Fund AIFs must invest predominantly in financial instruments and cannot have control over unlisted companies.

Open-Ended Real Estate Funds

Under the draft of the GIC, it will no longer be possible to set up open-ended real estate funds. This applies both to Mutual Funds and to Special Investor Funds. This restriction is a surprise to the industry, since new redemption restrictions for open-ended real estate funds were introduced in the recent amendment of the InvA.

It is particularly surprising that open-ended Special Investor Fund real estate funds will not be permitted in the future, because no liquidity issues had been experienced by such funds, nor were such issues expected, in principle, in light of the typical provisions used in related contractual agreements with institutional investors.

Closed-Ended Funds

Closed-ended funds, up to now unregulated in terms of their investment policy and management, will be assigned to the regulated fund category under the draft of the GIC. The approach to new regulation by the legislator indicates the following major regulation principles for closed-ended funds:

- Closed-ended domestic investment funds may be set up solely as an InvestmentAG with fixed capital or closed-ended InvestmentKG.
- The ultimate consequence of this mandatory legal form is that investors may participate in closed-ended funds (both Mutual Fund AIFs and Special Investor Fund AIFs) only as shareholders/partners. As a supplementary measure, the breakdown of the shares into voting shares and non-voting shares has been nullified with regard to closed-ended InvestmentAG with fixed capital.
- Both closed-ended Mutual Fund AIFs and closed-ended Special Investor Fund AIFs must invest their funds primarily in assets that are not financial instruments within the meaning of the AIFMD.
- While stronger product-based constraints are intended for Mutual Fund AIFs, such constraints only apply to Special Investor Fund AIFs on a limited basis.
- Leverage (on the fund level) is to be limited to 30%.

Amended Outsourcing Rules

Portfolio management and risk management functions may only be outsourced to entities that are authorised or registered to provide asset management or financial portfolio management and that are subject to supervision by regulatory authorities (as is already currently the case where portfolio management is outsourced). An exception is made for AIF asset management companies that, upon authorisation by the BaFin, are permitted to outsource the portfolio management or risk management of Special Investor Fund AIFs under their management to companies that have not been authorised for asset management purposes. The requirements for a sufficient licence to provide asset management will be set forth in greater detail in the Regulation.

Outlook

The draft of the GIC is a step forward for harmonisation in the area of investment law, which will now extend beyond just UCITS Funds. However, it can be assumed that the AIFMD will not be the end of the harmonisation attempts at the European level. On the contrary, there are already further drafts of directives and regulations in the area of investment and capital market law at the European level — examples include the UCITS V and UCITS VI Directives, the MiFID II Directive and the Regulations on European venture capital funds and European social entrepreneurship funds.

Angelo Lercara, LL.M. EuR
Munich
+49 89 21 21 63 22
angelo.lercara@dechert.com

Martin Hüwel
Frankfurt
+49 69 7706194214
martin.huewel@dechert.com

Luxembourg Developments

by **Marc Seimetz**, **Antonios Nezeritis**, **David Heinen** and **Laura Rossi**

CSSF Regulation on Risk Management and Conflicts of Interest with respect to Specialized Investment Funds

Following the law of 26 March 2012 amending the law of 13 February 2007 on specialized investment funds (the Law of 2007) in Luxembourg, specialized investment funds (SIFs) are now required in accordance with Article 42a of the Law of 2007:

- to implement risk management systems to identify, measure, manage and monitor appropriately the risks associated with their investment positions and the contribution of those positions to overall portfolio risk; and
- to be structured and organised in such a way as to mitigate the risk of any potential conflicts of interest.

On 13 August 2012, the CSSF issued CSSF Regulation 12-01, which adopted the implementing measures relating to these requirements (Regulation 12-01).

SIFs that existed at the time of the entry into force of Regulation 12-01 will have until 31 December 2012 to comply with its provisions.

Risk Management Function and Policy

Risk Management Function

Regulation 12-01 requires that SIFs implement and maintain a permanent risk management function that is hierarchically and functionally independent from operating units, unless a derogation has been granted by the CSSF (which can be done on a case-by-case basis). This is a concept similar to that proposed under the Alternative Investment Fund Managers Directive (the AIFM Directive).

Risk Management Policy

A SIF's risk management policy must allow the SIF to detect, measure, manage and monitor the exposure to market, liquidity and counterparty risks, and exposure to all other risks, including operational risk, which may be material to the SIF's activities.

Delegation of Risk Management Function

SIFs may delegate all or part of their risk management function to a third party, provided that the third party has the necessary competence and capacity to perform the activities of the risk management function reliably, professionally and efficiently in accordance with applicable legal and regulatory requirements. The delegation of the risk management function does not relieve the board of directors of the SIF (or the board of directors of the management company of a SIF in the form of an FCP) from their responsibility in terms of the implementation of the risk management, as indicated above.

CSSF Consent

The risk management policy (and any subsequent change thereto) must be communicated to the CSSF and approved by the SIF's board of directors (or the board of directors of the management company of a SIF in the form of an FCP). It must be subject to regular and documented review.

Conflicts of Interest

Identification of Conflicts of Interest

Regulation 12-01 identifies several types of conflicts of interest that may arise in the course of providing services and activities. The conflicts of interest rules aim to determine if a "relevant person", as defined below (whether as a result of providing collective portfolio management activities or otherwise):

- is likely to make a financial gain, or avoid a financial loss, at the expense of the SIF;
- has an interest in the outcome of a service or an activity provided to the SIF or another client or of a transaction carried out on behalf of the SIF or another client, and which is distinct from the SIF's interest in that outcome;
- has a financial or other incentive to favour the interests of another client or group of clients over the interests of the SIF;

- carries on the same activities for the SIF and for another client or clients that are not also SIFs; and/or
- receives or will receive, from a person other than the SIF, an inducement in relation to collective portfolio management activities provided to the SIF, in the form of monies, goods or services, other than the standard commission or fee for that service.

Regulation 12-01 defines a "relevant person" as any person contributing towards the business activities of the SIF or any person directly or indirectly linked to the SIF.

Conflicts of Interest Policy

SIFs will need to implement and maintain an effective conflicts of interest policy that must be set out in writing and, more specifically, must be appropriate to the size and organisation of the SIF as well as the nature, scale and complexity of the business of the SIF in question.

The policy must identify the circumstances that constitute, or may give rise to, a conflict of interest entailing a material risk of damage to the interests of the SIF, and the procedures to be followed and measures to be adopted in order to manage each such conflict.

The policy must also cover personal transactions by a relevant person and the exercise of voting rights attached to instruments held by the SIF that may give rise to a conflict of interest. If the SIF is a member of a group, the policy shall also take into account any circumstances that may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

Management of Conflicts of Interest

The conflicts of interest policy should provide measures and procedures to manage any conflicts of interest or potential conflicts of interest. More specifically, the SIF must ensure that these measures and procedures take account of the following to ensure a requisite degree of independence:

- effective procedures to prevent or control the exchange of information between relevant persons if the exchange of such information would harm the interests of the SIF;
- the separate supervision of relevant persons involved in carrying out collective portfolio management activities on behalf of, or providing services to, clients or investors whose interests may conflict with the interests of the SIF;
- the removal of any direct link between the remuneration of relevant persons principally engaged in a given activity and the remuneration of, or revenues generated by, other relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;
- measures to prevent or limit any person from exercising inappropriate influence over the way in which a relevant person carries out collective portfolio management activities; and
- measures to prevent or control the simultaneous or sequential involvement of a relevant person in separate collective portfolio management activities where such involvement may impair the proper management of conflicts of interest.

Regulation 12-01 specifies that SIFs may adopt alternative or additional measures and procedures if the adoption or the practice of one or more of the above measures and procedures does not provide the requisite degree of independence.

In the event that organisational or administrative arrangements do not prevent a risk of damage to the interests of the SIF or its unitholders/shareholders from arising, the board of directors of the SIF (or the board of directors of the management company of a SIF in the form of an FCP) must be promptly informed and may take any necessary decision to suggest solutions to such a situation. This action must be reported to investors along with the reasons for the decision taken by the board of directors.

CSSF Information

The SIF must confirm to the CSSF that a conflicts of interest policy has been implemented, in order to be approved by the CSSF.

The aforementioned law of 26 March 2012 was the first step in the implementation of the AIFM Directive in Luxembourg. Regulation 12-01 is the logical follow-up, especially in view of the draft bill implementing the AIFM Directive, which is further described later in this article.

CSSF Circular on Unlaunched Sub-Funds, Sub-Funds Awaiting Reactivation and Sub-Funds in Liquidation

The CSSF issued, on 9 July 2012, Circular 12/540 relating to unlaunched sub-funds, sub-funds waiting to be reactivated and sub-funds in liquidation (Circular 12/540).

Scope

Circular 12/540 is applicable to all legal types of undertaking for collective investment ("UCIs") that are subject to the law of 17 December 2010 on undertakings for collective investment and to the law of 13 February 2007 on SIFs, although it is worth noting that Circular 12/540 is only applicable to umbrella UCIs (but would include those with only one sub-fund). Single UCIs are not covered by Circular 12/540. As a consequence, Circular 12/540 applies to umbrella UCITS, umbrella part II funds and umbrella SIFs.

Purpose

The purpose of Circular 12/540 is to clarify the legal situation of a:

- sub-fund that has been approved by the CSSF, but not yet launched (an "unlaunched sub-fund");
- sub-fund that has been launched, but has become inactive following redemption of all of its shares/units (a "sub-fund waiting to be reactivated"); and
- sub-fund that has been liquidated.

Circular 12/540 specifies that an unlaunched sub-fund and/or a sub-fund waiting to be reactivated must be launched or reactivated within 18 months following its approval by the CSSF or its inactivity.

Unlaunched sub-funds, or sub-funds waiting to be reactivated that were in existence on 9 July 2012, must be launched or reactivated by no later than 8 January 2014.

If the unlaunched sub-fund or the sub-fund waiting to be reactivated has been removed from the offering document of the relevant umbrella UCI, the CSSF will consider that the launch or reactivation of such a sub-fund has been abandoned. If the unlaunched sub-fund or sub-fund waiting to be reactivated has not yet been removed from the offering document, it must be so removed as part of the next update of the offering document, or at the latest within six months of the expiry of the 18-month period.

Liquidated sub-funds will need to be removed from the offering document of the umbrella UCI at its next update, and in any event within six months of the decision to liquidate the sub-fund.

The CSSF has now set a new deadline with respect to the launch date of new sub-funds to ensure that the UCIs in question are aware that sub-funds may not remain inactive or unlaunched for a lengthy period of time.

Legal Reporting

Circular 12/540 requires all umbrella UCIs to complete a form (which is available on the CSSF's website) that shows whether or not there are any sub-funds which are currently inactive, unlaunched or which have already been liquidated, but are still listed in the offering document of the umbrella UCI.

UCIs that have no unlaunched sub-funds, sub-funds waiting to be reactivated or sub-funds in liquidation must also complete and file the form.

The form should reflect the situation at the end of September 2012 and must be sent to the CSSF by 15 October 2012 at the latest.

Conclusion

As a result of Circular 12/540, UCIs will need to determine the fate of an unlaunched sub-fund and/or a sub-fund waiting to be reactivated within a given period of time, which may lead to numerous offering documents of umbrella UCIs being amended to remove sub-funds that will not be launched or reactivated. Furthermore, the CSSF has now set a new deadline with respect to the launch date of new sub-funds to ensure that the UCIs in question are aware that sub-funds may not remain inactive or unlaunched for a lengthy period of time, and that a decision will need to be taken in that respect.

CSSF Press Release 12/29 on Use of the Value at Risk (VaR) Approach in Determining Global Exposure of Luxembourg UCITS

The CSSF issued, on 31 July 2012, a press release that clarifies how Luxembourg undertakings for collective investments in transferable securities (UCITS) using a value at risk (VaR) approach in determining their global exposure should take into account the recent clarifications issued by the European Securities and Market Authority (ESMA). Specifically, on 25 July 2012, ESMA issued a document entitled "*Questions and Answers: Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (2012/ESMA/429)*" dealing with the disclosure of leverage levels.

Clarifications regarding Leverage Disclosure

The CSSF considers that the leverage disclosure standard for UCITS using a VaR approach to determine their global exposure should be based on the so-called "sum of the notionals approach".

This means that the leverage disclosure to be included in the prospectus and annual reports should be determined based on the sum of the notionals of derivative instruments used while allowing these UCITS to supplement this calculation using leverage figures calculated based on the commitment approach.

The CSSF states that the purpose of the calculation of the level of leverage using the VaR approach should allow:

- a close monitoring of the level of leverage as required in CESR's "Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (ref: CESR/10-788)" of 28 July 2010; and
- the disclosure, in the UCITS' annual report, of the level of leverage employed during the financial year to which it refers.

Timelines for Application of the Sum of the Notionals Approach by Luxembourg UCITS

Newly established UCITS (including their sub-funds) will have to determine, from their launch, their level of leverage on the basis of the sum of the notionals approach, and not on the basis of the commitment approach.

Existing UCITS (including their sub-funds) will have to determine their level of leverage on the basis of the sum of the notionals approach as quickly as possible, and in any event by no later than 1 January 2013. Until then, they may continue to use the commitment approach (either alone or alongside the sum of the notionals approach).

Newly established UCITS (including their sub-funds) must base the disclosure of leverage in the prospectus on the sum of the notionals approach as from inception. If this calculation is complemented by leverage figures determined on the basis of the commitment methodology or other methods, this must be clearly stated and a detailed explanation given on the underlying method of calculation.

Existing UCITS (including their sub-funds) must base the prospectus leverage disclosure on the sum of the notionals approach in any update of the prospectus issued after the CSSF press release and in any event by no later than 31 December 2012.

For any financial year ending after 31 December 2012, the leverage information to be included in a UCITS' annual report must be based on the sum of the notionals approach for accounting periods starting on or after 1 January 2013.

This does not however prevent a UCITS from using other figures, such as those derived from the commitment approach calculation or another basis of calculation, provided that this is clearly stated and explained.

The CSSF will update circular 11/512 on risk management in order to incorporate the above clarifications and guidelines.

Draft Bill Regarding Implementation of the AIFM Directive and Proposing Other Interesting Changes

On 24 August 2012, draft bill no. 6471 (the Bill) implementing the directive 2011/61/EU of 8 June 2011 on alternative investment fund managers (the AIFM Directive) and amending certain Luxembourg laws was submitted to the Luxembourg parliament.

Although the deadline imposed by the European Commission on EU Member States for the implementation of the AIFM Directive into national law is 22 July 2013, it is expected that the Bill will be adopted before the end of 2012 as Luxembourg seeks a first mover advantage.

The implementation of the AIFM Directive in Luxembourg is being made through the amendment of existing Luxembourg legislation. The main non-AIFMD changes proposed by the Bill, in summary, are set forth below.

New Professional of the Financial Sector (PSF)

In addition to banks, a new category of PSF will be entitled to act as depositary for alternative investment funds.

Special Limited Partnership (*société en commandite spéciale* — SLP)

The Bill introduces the possibility for SIFs or investment companies in risk capital (SICARs) to be incorporated under the legal form of a SLP, which is similar to an English limited partnership in that it is established using a limited partnership agreement, does not have separate legal personality and should be treated as transparent for tax purposes.

Taxation of Carried Interest

The Bill proposes a new beneficial tax regime (subject to compliance with specific conditions) for the employees of alternative investment fund managers and of management companies of an alternative investment fund, but not for the general partner itself. The carried interest received by such an employee will not be considered as a normal "salary" and will, subject to compliance with specific conditions and for a limited time period (maximum period of 11 years), be subject to a reduced favorable tax rate that is 25% of the marginal personal tax rate (*i.e.* a maximum rate of 10.335%).

Court Supervised Liquidation of a Management Company by the CSSF

Upon approval of the Bill, the Luxembourg regulator will be entitled to request the judicial liquidation of a management company.

Broadened Regime of Delegation of Portfolio Management Functions in Certain Pension Funds

Pension funds created as pension saving associations (*associations d'épargne-pension* — ASSEPs) or as pension saving companies with variable capital (*sociétés d'épargne-pension à capital variable* — SEPCAVs) will be able to delegate their portfolio management function to a Luxembourg manager or a manager domiciled elsewhere in the European Union, provided that the delegate is duly authorized to provide these services in accordance with the AIFM Directive.

Changes to Luxembourg Company Law

The Bill proposes to amend the Luxembourg law of 10 August 1915 on commercial companies (as amended) in order to include the possibility of incorporating unregulated commercial enterprises as SLPs and to modernize the existing regimes of common limited partnerships (*sociétés en commandite simple*) and partnerships limited by shares (*sociétés en commandite par actions*).

The Bill is being viewed as an additional opportunity to improve the competitiveness of Luxembourg and the proposals included therein have in general been received positively by the asset management industry.

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

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

David Heinen
Luxembourg
+352 45 62 62 30
david.heinen@dechert.com

Laura Rossi
Luxembourg
+352 45 62 62 24
laura.rossi@dechert.com

ESMA's Draft Guidance on the Remuneration Principles of the AIFMD

by **Jason Butwick** and **Ed Holmes**

EU Member States are required to implement the Alternative Investment Fund Managers Directive (AIFMD) by 22 July 2013. Annex II of AIFMD contains a set of remuneration principles with which alternative investment fund managers (AIFMs) managing certain alternative investment funds (AIFs) within the scope of AIFMD must comply when establishing and applying remuneration policies for certain types of employees. These principles will apply to a wide range of AIFMs, including managers of hedge funds, private equity funds and real estate funds. The remuneration principles of AIFMD are similar to the remuneration principles established by the Capital Requirements Directive III (CRD III), but are focused upon the alternative investment fund management industry. The remuneration principles established under CRD III have been implemented in the UK through revisions to the FSA's Remuneration Code (SYSC 19A of the FSA Handbook).

For the remuneration principles of CRD III, the Committee of European Banking Supervisors (CEBS) was required to develop guidelines on sound remuneration principles, and the FSA followed these guidelines when revising the Remuneration Code. For the remuneration principles of AIFMD, the European Securities and Markets Authority (ESMA) is required to develop guidelines on sound remuneration policies. The FSA will follow these guidelines when deciding how to implement the remuneration principles of AIFMD.

On 28 June 2012, ESMA published a consultation paper outlining its draft guidelines (the Guidelines). This article provides a high-level summary of the key elements of the draft Guidelines and highlights some of the more significant deviations from CEBS' approach in its guidelines relating to the remuneration principles established by CRD III.

Which Entities are Covered?

The remuneration principles of AIFMD will apply to all AIFMs that are within the scope of AIFMD, namely:

- AIFMs that have their registered office in a Member State (so-called "EU AIFMs"), which manage one or more AIFs irrespective of whether such AIFs are EU AIFs[1] or non-EU AIFs;
- Non-EU AIFMs that manage one or more EU AIFs; and
- Non-EU AIFMs that market one or more AIFs in the European Union irrespective of whether such AIFs are EU AIFs or non-EU AIFs.

Which Staff are Covered?

The remuneration principles will apply to staff whose professional activities have a material impact on an AIFM's risk profile or the risk profiles of the AIFs that it manages (so-called "Identified Staff"). Identified Staff under the Guidelines are effectively the same as Code Staff under the Remuneration Code. Primarily, it will be the responsibility of the AIFM to determine who constitute Identified Staff. The AIFM should be able to show how it has carried out that identification exercise. This should involve an analysis of job functions and responsibilities.

According to the Guidelines, the following categories should be included as Identified Staff, unless the AIFM can establish that the activities of such individuals have no material impact on the AIFM's risk profile:

- Members of the AIFM's governing body (i.e., the directors or management committee members);
- Senior management;
- Control functions (not to be confused with the concept of "Controlled Function" as defined by the FSA, which would include all FSA Approved

Persons) — namely, staff responsible for risk, compliance, internal audit;

- Heads of certain business lines — portfolio management, HR, marketing, administration; and
- Other risk takers who individually or together can assert material influence on the AIFM or AIF's risk profile (for example, individual traders or trading desks).

In addition, other employees should also be Identified Staff if they have a material impact on the risk profile of the AIFM or AIF, and their total remuneration takes them into the same bracket as senior managers.

Remuneration for the purpose of AIFMD is defined very broadly.

Currently, under the FSA's guidance on the Remuneration Code, for asset management firms that ae not part of a group, there is no requirement that a fund manager be classified as Code Staff unless he or she is a senior manager or fills a control function. From the Guidelines as drawn, it seems unlikely that the FSA will apply a similar approach in relation to Identified Staff.

Types of Remuneration

Remuneration for the purpose of AIFMD is defined very broadly. Under the Guidelines, it includes any amounts paid by the AIFM (salary, bonus, profit share) and any amount paid directly by the AIF (including carried interest and transfer of units or shares in the AIF) to Identified Staff in exchange for professional services rendered by the AIFM staff.

Carried interest for this purpose includes any share of profit of the AIF paid to the AIFM (or staff directly) as compensation for managing the AIF, but does not include any pro rata return on a direct investment into the AIF made by the AIFM or any staff, provided that the investment is funded by the staff member. So, profit from investments in the AIF made by Identified Staff out of their personal pockets is not covered. In the same vein, remuneration will not include returns on co-investments made by staff alongside an AIF (a common form of incentive in the private equity sphere) unless that co-investment is funded by the AIFM (for example through loans that have not been repaid by a staff member by the time the return is paid).

AIFMs that are Part of a Group

There will be no exception to the application of the AIFMD's remuneration principles for AIFMs that are part of a group of companies to which other remuneration principles, such as those under CRD III, already apply.

Remuneration Committee

AIFMs that are significant, in terms of their size or the size of the AIFs they manage, their internal organization and the nature, scope and complexity of their activities, must establish a remuneration committee that is responsible for, amongst other things, the preparation of decisions regarding remuneration. None of the members of the remuneration committee should perform executive functions, and the majority, including the chairman, should be independent.

The Guidelines suggest that although AIFMs that are not significant (in terms of size, internal organization and the nature, scope and complexity of their activities) will not be required to establish a remuneration committee, it would nonetheless be good practice for them to do so. The Guidelines suggest that the following AIFMs will not be considered significant and will not, therefore, be obliged to establish a remuneration committee:

- AIFMs that manage portfolios of AIFs of 250 million Euros or less, in the aggregate; and
- AIFMs that are subsidiaries of credit institutions which are obliged to establish a remuneration committee that performs its tasks and duties for the whole group.

Remuneration Principles

ESMA proposes a number of guidelines in relation to each of the remuneration principles of Annex II of AIFMD. The most pertinent are described in the following sections.

Ratio between Fixed and Variable Remuneration

AIFMs must ensure that fixed and variable remuneration elements are appropriately balanced and

that the fixed proportion is sufficiently high to allow for a fully-flexible policy on variable remuneration. The Guidelines emphasise that this implies not only that variable remuneration should decrease as a result of negative performance, but also that it can fall to zero in certain cases.

Deferral

AIFMs must ensure that payment of performance-based remuneration is spread over a period which takes account of the redemption policy of the AIFs they manage. It also requires AIFMs to ensure that a substantial portion, and in any event at least 40%, of variable remuneration is deferred over a period that is appropriate in view of the life cycle and redemption policy of the AIF concerned. Where variable remuneration is particularly high, at least 60% should be deferred. The minimum deferral period is three to five years, unless the AIFM can show that the life cycle of the AIF concerned is shorter. For example, if an AIF's life cycle is one year, then the minimum deferral period must be at least one year.

The Guidelines emphasise that this implies not only that variable remuneration should decrease as a result of negative performance, but also that it can fall to zero in certain cases.

As is the case under CRD III, deferred remuneration should not vest more quickly than on a pro-rata basis. For example, where there is a deferral period of three years, deferred compensation should not vest more quickly than at the rate of one third each year.

Performance Adjustment

Variable remuneration (including the deferred portion) must only be paid, or only vest, if it is both sustainable according to the AIFM's financial situation and justified according to the performance of the business unit, the AIF and the relevant Identified Staff members concerned. The Guidelines make clear that AIFMs must be able to adjust variable remuneration as time goes by and as the outcome of Identified Staff members' actions materialise. This may be through malus" arrangements (whereby the value of deferred remuneration may be reduced) or clawback provisions.

Non-Cash Instruments

AIFMs must ensure that a substantial portion, and in any event at least 50%, of any variable remuneration consists of units or shares of the AIF concerned (or equivalent ownership interests, share-linked instruments or non-cash instruments), unless the management of AIFs accounts for less than 50% of the total portfolio managed by the AIFM. The Guidelines also make clear that 50% of both deferred and non-deferred variable remuneration should consist of non-cash instruments.

The Guidelines provide that, in order properly to align their interests with those of the relevant AIFs, Identified Staff should only receive non-cash instruments related to the AIFs for which they perform activities. The Guidelines also note that share-linked instruments may not be available in relation to many AIFs, such as common funds, because of the AIF's legal form or because it may be difficult to determine a share price that represents the AIF's net asset value between annual net asset value calculations. In such situations, alternative instruments can be used, provided they reflect the AIF's value and have the same intended effect as share-linked instruments.

Retention

Separate from the requirements regarding deferral, non-cash instruments must be subject to an appropriate retention policy designed to align incentives provided to Identified Staff with the interests of the AIFM and the AIFs it manages. The Guidelines emphasise that use of retention periods (such as, for example, a three-year retention period during which the recipient cannot sell the instruments) is the only mechanism available to emphasise the difference between cash paid up front and instruments awarded up front.

Payments Related to Early Termination/Severance

Payments made by AIFMs relating to the early termination of employment should reflect performance achieved over time, and not reward failure. The Guidelines explain that golden parachute payments that entitle employees leaving an AIFM to large payouts without any performance and risk adjustment would be inconsistent with this principle.

Guarantees

Guaranteed variable remuneration must be exceptional, only occur in the context of hiring new staff and be limited to the first year of employment.

The Proportionality Principle

As with CRD III, AIFMD has a proportionality principle that applies to the general and specific remuneration requirements set out in its Annex II. Accordingly, not all AIFMs will have to comply with the remuneration requirements in the same way, or to the same extent.

The CEBS guidelines for CRD III stated that the application of the proportionality principle could lead to certain specified requirements being "neutralized" for institutions with lesser risk profiles. These requirements included, by way of example, payment of 50% of variable remuneration in non-cash instruments, deferral of 40% to 60% of variable remuneration for between three to five years, and the application of a maximum ratio between fixed and variable remuneration. From these guidelines, the FSA divided firms into four (now three) tiers and allowed certain firms falling into the third and fourth tiers to disapply (or neutralize) such requirements.

Unlike the CEBS guidelines, there is no mention of "neutralization" in the Guidelines. Instead, the Guidelines say that the proportionality principle may lead to a "tailored" approach, but specify that such tailoring "should not be understood as allowing any AIFM to disregard any of the requirements of Annex II of AIFMD". There is no equivalent language to that in the CEBS guidelines regarding neutralization. With that said, the list of remuneration requirements to which tailoring may apply under the Guidelines is very similar to the set of requirements to which neutralization was allowed to apply in CEBS guidelines under CRD III.

The difference between the language around tailoring in the Guidelines and the language relating to neutralization in CEBS guidelines suggests that there should be no scope for any AIFM covered by the Guidelines to disapply requirements such as payment in shares and deferral. Nor is there anything in the Guidelines to suggest that there can be any alteration of the fixed numerical provisions of Annex II (such as, for example, the requirements that 50% of any variable remuneration consist of units or shares of the AIF and that 40% or, where relevant, 60% of variable remuneration be deferred for between three to five years).

This is likely to create potential issues for some AIFMs. For example, the Alternative Investment Management Association notes that the requirement for 50% of variable remuneration to consist of non-cash instruments will raise complex issues for the majority of hedge fund managers that do not issue publicly tradable equities or equity-like instruments for which there is a secondary market.

If the requirements cannot be disapplied and the numerical provisions cannot be altered, the question rather remains as to what ESMA is considering could be tailored, and how that tailoring might look in practice.

Disclosure

AIFMD imposes various internal and external disclosure obligations on AIFMs, including a requirement to make an annual report available each financial year for each of the AIFs it markets in the EU and each of the EU AIFs it manages. Such annual reports must contain, amongst other things, information on the total amount of remuneration, split into fixed and variable components, paid by the AIFM to its staff in the financial year.

Timetable

The consultation on the Guidelines closed on 27 September 2012. ESMA will now consider the responses it received, with a view to finalising the Guidelines in the final quarter of 2012. In finalising the Guidelines, ESMA will also take into account its work on a separate set of guidelines, which will be complementary to the CEBS guidelines, focused on remuneration policies of investment firms from an investor protection perspective.

---

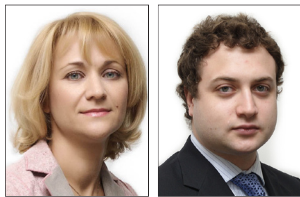
[1] "EU AIFs" are defined as AIFs which are authorised or registered in a Member State under the applicable national law or which are not so authorized or registered but which have their registered office and/or head office in a Member State.

Jason Butwick
London
+44 20 7184 7569
jason.butwick@dechert.com

Ed Holmes
London
+ 44 20 7184 7495
ed.holmes@dechert.com

Dechert LLP

Russian Developments



by **Evgenia Korotlova** and **Kirill Skopchevskiy**

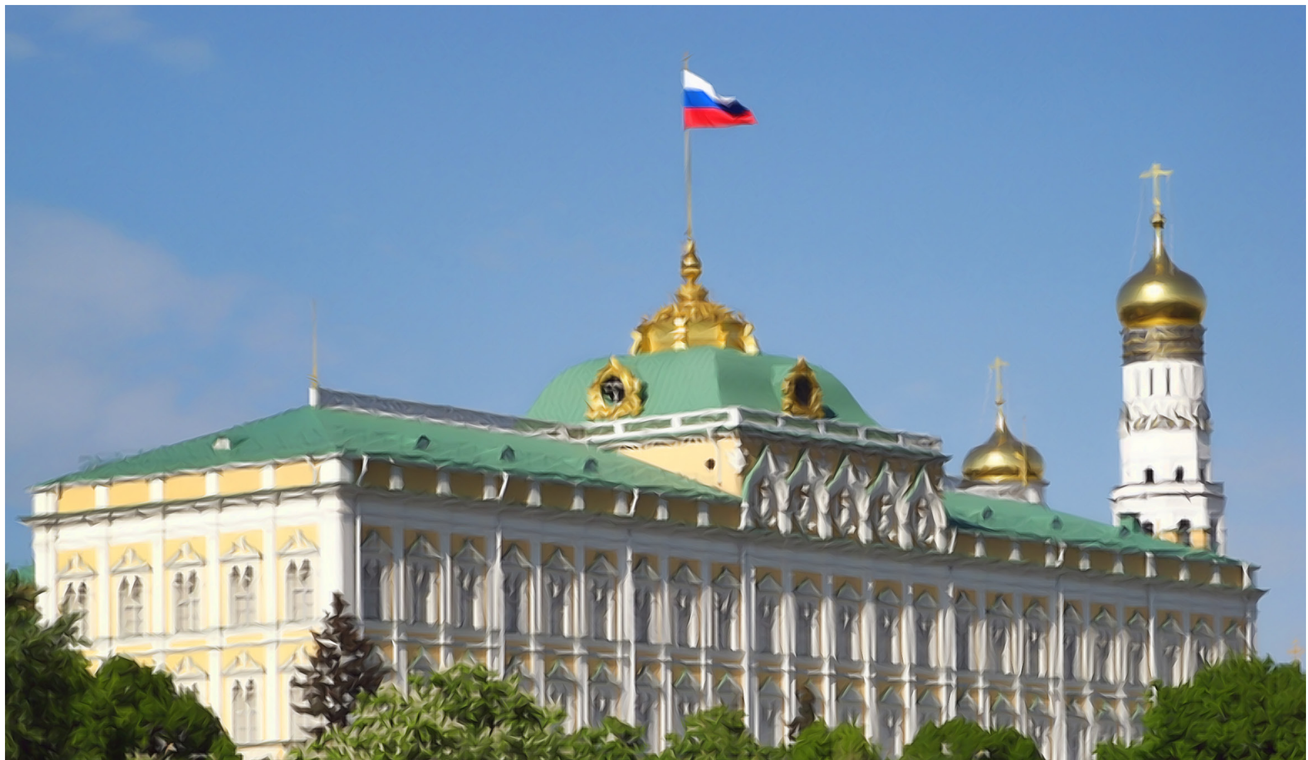
ETFs Finally Come to Russia

Recent changes to the legislation on investment funds will finally provide the much needed basis for the formation of exchange-traded funds (ETFs) under Russian law. Until recently, all investment funds in Russia were either open-ended, closed-ended or blended type, and investors were bound by a rigid agreement with an investment manager — thus limiting the investor's ability to promptly react to changing market conditions. The new amendments to the Russian Federal Law "On Investment Funds" (enacted by Federal Law No. 145-FZ "On Amendments to Certain Legislative Acts of the Russian Federation," dated July 28, 2012) introduce the concept of an ETF and outline the principal rules that will apply to trading in ETFs.

The amendments, which became effective on September 1, 2012, classify four categories of persons dealing with ETFs in Russia: owners of shares (units) in an ETF; persons authorized by an ETF manager (the Authorized Person, whose functions are discussed below); designated stock exchanges; and market makers.

Analysts cautiously expect that the new legislation will increase investment in the Russian securities market, as well as provide greater protection to investors due to the greater transparency of ETFs as compared to traditional funds currently present in the Russian market.

The principal difference between an ETF and a traditional Russian unit investment fund is that the owner of a share in the ETF has the right to demand that an Authorized Person buy all or a portion of the owner's shares in an ETF, as well as the right to



sell the shares on a designated stock exchange on the terms set out in the ETF management rules (the Rules), which must be registered with the Russian securities regulator, the Federal Service for Financial Markets (the FSFM). An Authorized Person who is also the owner of the shares in an ETF has the right to demand that the ETF manager buy out either all of the Authorized Person's shares in the ETF on the terms set out in the Rules (thereby terminating the agreement between the Authorized Person and the ETF manager) or a portion of the ETF's shares held by the Authorized Person.

Authorized Persons, who either may act as intermediaries between the owner of shares in an ETF and the buyer/seller of the shares, or may themselves be the owners of the shares in an ETF, must be specifically named in the Rules. The Rules must also name the Russian stock exchanges where shares in an ETF are admitted to trade and where the market makers are obliged to maintain the price, supply, demand and the volume of shares in the ETF. The same entity can act as an Authorized Person and a market maker for a particular ETF. Prior to the state registration of the Rules and the admission of the ETF shares to trade, a stock exchange must enter into an agreement with the persons who will act as market makers for a particular ETF. Russian ETFs can be traded on a foreign stock exchange, subject to the rules of that foreign stock exchange.

This provides an opportunity to Russian stock exchanges to attempt to compete for issuers . . . and is one further step in building a robust financial services industry in Russia.

In order to maintain the price level for a particular ETF, the Rules provide that the price for which a market maker may purchase/sell the shares in the ETF cannot deviate by more than 5% from the estimated price of these shares, which price must be stated in the Rules.

It remains to be seen how popular this new instrument will become with investors. However, analysts cautiously expect that the new legislation will increase investment in the Russian securities market, as well as provide greater protection to investors due to the greater transparency of ETFs as compared to traditional funds currently present in the Russian market.

Updated Registration Procedure for Foreign Issuers

The Russian securities regulator, the FSFM, has recently adopted legislation that outlines the registration procedures for prospectuses of foreign issuers who would like to admit securities for placement and/or public circulation in Russia, under Order No. 12-10/pz-n, dated March 6, 2012 (the Order). Prior to the adoption of this legislation, Russian regulations did not specify the procedure for registration of prospectuses of foreign issuers in Russia, thus effectively preventing foreign issuers from placing or publicly offering their securities to Russian investors.

The Order fills this gap by specifying in detail the FSFM review process, providing a list of documents required for the registration and listing the grounds on which the registration may be denied. The Order must be officially published before it comes into legal effect; however, the exact date of publication has not yet been announced. This provides an opportunity to Russian stock exchanges to attempt to compete for issuers willing to raise capital in a jurisdiction with significantly less strict disclosure and other obligations associated with public listings, as compared to traditional financial centers (such as New York and London) and is one further step in building a robust financial services industry in Russia.

Evgenia Korotkova
Moscow
+7 499 922 1160
evgenia.korotkova@dechert.com

Kirill Skopchevskiy
Moscow
+7 499 922 1164
kirill.skopchevskiy@dechert.com

French Tax Developments

by **Bruno Leroy**, **Antoine Sarailler** and **Damien Fenard**

French Source Dividend Payments to Non-French Resident Investment Vehicles: The *Santander Case* and the Legislative Response

by **Bruno Leroy** and **Damien Fenard**

Domestic withholding tax imposed by EU Member States on dividend payments made to non-resident investment vehicles has been an on-going issue for some time now, due to the argument that such taxes may restrict the free movement of capital within the EU. The European Court of Justice (ECJ) recently handed down a major decision in the *Santander* case regarding this matter, finding that the French withholding tax (WHT) — levied on dividend payments by French-resident companies to non-resident investment vehicles — is not compatible with EU law.

This decision not only relates to the right to a refund of WHT from French company dividends, but also provides a basis for seeking refunds of WHT from other EU-based companies, where the WHT has been imposed on a basis similar to that employed by France.

Background

The French Tax Code imposes a 30% withholding tax on dividend payments made by French-resident companies to non-resident investment vehicles. Prior to 1 January 2012, this tax was levied at the rate of 25%.

In the instant case, Belgian, German, Spanish and U.S. investment vehicles that were subject to the WHT brought a claim before a French administrative court, arguing that the tax was not compatible with EU regulations, since French investment vehicles were not subject to either corporate income tax or the WHT. The French court referred this to the ECJ.

ECJ Decision

The ECJ held that the difference in treatment with respect to imposition of the WHT upon resident and non-resident investment vehicles constituted a restriction of the free movement of capital, insofar as it could discourage non-resident investment vehicles from investing in French companies and French investors from investing in non-resident investment vehicles.

The ECJ concluded that non-resident and resident investment vehicles should be considered as comparable and that the difference in the WHT treatment could not be supported. Further, the ECJ stated that its decision had retroactive effect. As a consequence, the French tax authorities were not entitled to withhold any tax, and comparable non-resident investment vehicles can make a claim for the refund of the French tax previously withheld.

Implications

This decision has very broad scope, as it applies to investment vehicles, including those incorporated in the form of mutual funds, and whether located within or outside the EU. While the ECJ did not provide clear guidance on what type of funds were "comparable" to French funds, it is possible that the decision also extends to private funds.

As the ECJ ruling is broadly applicable to dividends paid to investment vehicles resident in foreign

countries, without regard to whether or not such countries have established tax treaties with France, it is our belief that an entity located in a tax haven jurisdiction could seek to obtain a refund of the tax withheld, unless the entity is located in a non-cooperative Territory or State, provided that the entity can demonstrate that it has the status of an investment fund that is "comparable" to a French investment vehicle.

Although the ECJ decision involved French WHT, the ruling should be applicable to other EU Member States as well. Accordingly, EU Member States that impose a WHT with respect to dividend payments made to non-resident investment vehicles — but not to resident investment vehicles — presumably will soon take steps to amend their legislation so as to be in conformity with EU law.

This decision not only relates to the right to a refund of WHT from French company dividends, but also provides a basis for seeking refunds of WHT from other EU-based companies, where the WHT has been imposed on a basis similar to that employed by France.

Implementation of an Additional Tax for the Corporate Income Tax

The French parliament approved a new financial bill, effective 16 August 2012, which provides an exemption from the imposition of WHT for dividend payments made to certain investment vehicles.

The exemption applies to investment vehicles that:

- are resident in another EU Member State or in a country that has entered into a tax treaty with France which provides for an exchange of information, or that has entered into an exchange of information agreement with France (for instance, Cayman Islands, Jersey, Guernsey and the British Virgin Islands);
- have similar characteristics to French *organismes de placements collectives* (UCITS) pursuant to sections 1, 5 or 6 of article I of L. 214-1 of the Monetary and Financial Code;
- raise funds in accordance with the interests of their investors and the vehicle's defined investment policy;
- are not located in a non-cooperative jurisdiction, as listed by the French Tax authorities.

In order to fill the gap in tax revenues resulting from the implementation of the WHT exemption, an additional tax upon corporations has been implemented in France. Pursuant to this new regime, each French resident company that pays a dividend is required to pay a tax of an amount equal to 3% of the dividends paid.

France, as well as the EU, is trying to discourage tax avoidance and treaty-shopping schemes. The WHT was initially enacted to prevent tax avoidance schemes whereby investments might be made through vehicles located in tax havens but the investor would not be taxed in its country of residence upon the dividends received. Since the 3% contribution will be made by the dividend-paying company and not by the recipient, the new tax regime might not serve as a deterrent to the use of tax avoidance schemes.

Conclusion

The contribution requirement should be considered as a temporary remedy to make up for tax revenue lost as a result of the exemption from the WHT. The French government may try to implement a more permanent regime that could more effectively prevent the use of tax avoidance schemes.

France, together with other EU countries, is waiting to see how the U.S. FATCA legislation will be implemented. It is likely that comparable legislation may be enacted, either on a Member State-by-Member State basis or at the EU level, in order to discourage the use of tax avoidance and treaty-shopping schemes through foreign investment vehicles.

Bruno Leroy
Paris
+33 1 57 57 80 34
bruno.leroy@dechert.com

Damien Fenard
Paris
+33 1 57 57 80 17
damien.fenard@dechert.com

Dechert LLP

French Financial Transactions Tax

by **Antoine Sarailler**

Effective 1 August 2012, the financial transactions tax (*taxe sur les transactions financières* — TFF), recently adopted by the French Parliament, entered into force.[1] The TTF, in fact, consists of three distinct taxes: (i) a TFF on acquisitions of equities in listed companies having their registered offices in France, with a stock market capitalisation exceeding 1 billion euros; (ii) a TTF on "high frequency" trading transactions in equities, by entities dealing as principal; and (iii) a TTF on naked sovereign debt credit default swaps (CDSs).

Tax on the Purchase of French Equities

The tax, at a rate fixed at 0.2%, applies to any purchase of equities, meeting *all* of the following conditions:

- The transaction is an acquisition, for consideration, of an equity or a security deemed equivalent to an equity within the meaning of the Monetary and Financial Code *(Code monétaire et financier* — FMC*)* (collectively, Equity).
- The acquisition gives rise to a transfer of ownership upon payment, with the Equities being recorded in the purchaser's securities account. This acquisition may take the form of the exercise of an option, a forward purchase, an exchange or an allotment in return for a capital contribution. In the event of a swap, the two parties will pay the tax on the amount of their respective acquisitions.
- The Equity is admitted for trading on a recognised foreign market, or on a European or French regulated market.
- The Equity is issued by a company having its registered offices in France, which company had a stock market capitalisation exceeding one billion euros on 1 December of the year preceding the imposition of the tax[2]. This threshold is aimed at taxing only French companies in Euronext compartment A[3].

The tax applies to investment certificates *(certificats d'investissement)* as well as depositary receipts (*certificats représentatifs d'actions* — CRAs) issued by any entity irrespective of its place of establishment (e.g., American depositary receipts). For CRAs, the first acquisitions subject to the tax will be those made as of 1 December 2012.

The tax also applies to securities giving access directly or indirectly to the equity of an issuer, such as: (i) convertible bonds (*obligations convertibles en actions* — OCAs); (ii) equity commitment notes (*obligations remboursables en actions* — ORAs); (iii) warrants (*bons de souscriptions d'actions* — BSAs); and (iv) preferential subscription rights (*droits préférentiels de souscription* — DPSs). However, these securities will only be taxed when the bond or commitment is converted into shares.

The following, however, fall outside the scope of the tax: (i) debt securities; and (ii) shares or units in collective investment undertakings (*organismes de placement collectif* — OPCs), including exchange-traded funds (ETFs) and derivative products (such as options and futures), so long as they are not Equities within the meaning of French law.

Acquisitions of Equities will be subject to the TTF, irrespective of: (i) the place of establishment of the regulated market on which the Equity is traded; (ii) the place of establishment or residence of the parties to the transaction; and (iii) the place where any relevant contract was entered into.

The following exemptions have been provided:

- Equities issued on the primary market;
- market-making activities carried out by investment companies and credit institutions, including abroad;
- transactions carried out by a clearing house or central depositary;
- transactions carried out on behalf of issuers in order to contribute to the liquidity of their Equities, in accordance with practices accepted by the French regulator (*Autorité des Marchés Financiers* — AMF);
- intra-group acquisitions between parent company and subsidiary (within the meaning of Article L.233-3 of the Commercial Code) and restructuring transactions;
- temporary transfers of Equities (such as securities borrowing and lending, sale and repurchase agreements); and
- acquisitions by a fund for employee savings plans.

The tax is due on the first day of the month following the transfer of ownership of the Equities.

The payer of the tax is the entity that provides “investment services” (as defined in Article L.321-1 of the FMC), wherever its place of establishment, when carrying out purchase orders on behalf of a third party or when purchasing as principal.

In the event that several investment service providers are involved in the transaction, the tax is payable by the entity that receives the purchase order from the final purchaser. However, if the acquisition is made without an intermediary investment service provider, the tax will be payable by the entity that acts as custody account-keeper.

Tax on High-Frequency Trading

The following conditions *all* must be met for the tax to be applied:

- The company carries out “high-frequency” transactions using “automated processing systems”. A high-frequency transaction is defined as “habitually sending orders using a system for the automated processing of these orders characterised by the sending, modification or cancellation of successive orders for a given security separated by a period of less than half a second”. An automated processing system is “any system enabling transactions to be made on financial instruments in which a computer algorithm automatically determines the various parameters of the orders, such as the decision to make the order, the date and time of making the order and the price and quantity of the financial instruments concerned”. [4]
- The transactions concern Equities. As opposed to the tax on Equity purchases, there is no limitation with respect to the country in which the Equity issuer’s registered offices are located or the issuer’s stock market capitalisation.
- The company operates in France — this includes branches of foreign companies operating in France with a European Passport under the freedom of establishment rules. As opposed to the tax on Equity purchases (which also concerns transactions made abroad), this tax focuses on a company that engages (in France) in speculative transactions in these securities.
- The transactions are carried out by the company for its own account. In practice, this excludes all transactions carried out on behalf of third parties under a management mandate or collective investment scheme (CIS).

The TTF is also imposed, above a certain threshold (described below), with respect to orders that are cancelled or modified over the course of a stock market business day. The tax rate applicable to such cancelled/modified orders is fixed at 0.01%, and the tax is imposed only upon the orders that are cancelled/modified over the course of a stock market business day that exceed the threshold of 80% of

the orders placed on that day. The taxable base is obtained by multiplying (i) the amount of orders cancelled/modified that exceed the 80% threshold by (ii) the average price of the security during the stock market business day. Once the 80% threshold has been met, the TTF will be due on the first day of the month following the day on which the cancelled or modified orders were transmitted.

Whether such an EU FTT will ever be agreed upon remains unclear.

As with the TTF on Equity purchases, transactions in the context of market making are exempted, provided that they contribute to the proper working of the market by ensuring its liquidity.

Tax on Naked Sovereign Credit Default Swaps

The imposition of the TTF on naked sovereign CDSs requires that *all* of the following criteria are met:

- The instrument must be a credit default swap — that is, a derivative instrument used for the transfer of credit risk within the meaning of Annex I, Section C(8) of Directive 2004/39/EC of 21 April 2004 (MIFID I Directive).
- THE CDS must be issued by a Member State of the European Union, not by a private issuer.
- The instrument must be the subject of a purchase.
- The purchase must be "naked". The purchase of a sovereign CDS will only be subject to payment of TTF if the purchase is not made to hedge assets or commitments related to the value of the sovereign debt covered by the CDS.
- The buyer of the CDS must be established in France for tax purposes — that is, natural persons domiciled in France within the meaning of Article 4B of the General Tax Code, companies operated in France within the meaning of Article 209 I of the General Tax Code, and legal entities established or registered in France. In this respect, this should include the foreign branches of a legal entity that is established or registered in France.

The rate of the tax is fixed at 0.01% of the notional amount of the contract, which means the par value or face value used to calculate payments connected with the CDS. The TTF is due as of the conclusion of the CDS and paid together with the payment of VAT.

As with the TTF on share purchases and the TTF on high-frequency trading, transactions made in a market-making context are exempted, provided that they contribute to the proper working of the market by ensuring its liquidity.

Conclusion

The scope of the French TTF is relatively narrow and should not have a significant impact on market participants.

There may be reason to temper celebration, with the prospect of a Financial Transaction Tax (FTT) at the European level. The European Commission recently proposed plans for an EU-wide FTT to take effect from 1 January 2014. This tax would be payable on all transactions of equities and bonds at 0.1% of value and all derivative transactions (both exchange-traded and OTC) at 0.01% of value calculated on the basis of the derivative's notional underlying value. However, whether such an EU FTT will ever be agreed upon remains unclear.

---

[1] The TFF was created by the corrective Finance Law No. 2012-354 of 14 March 2012, which in turn was amended by the corrective Finance Law adopted on 31 July 2012.

[2] As an exception, for the current year, the amount of the stock market capitalisation will be assessed on 1 January 2012 for all transactions made up to and including 31 December 2012.

[3] In August 2012, this categorisation applied to 109 companies, most of which are included in the CAC 40 Index and SBF 80 Index.

[4] However, the law specifies that "an automated processing system does not include systems used for the purpose of optimising the conditions for the execution of orders or for dispatching orders to one or more trading platforms or to confirm orders".

Antoine Sarailler
Paris
+33 1 57 57 80 16
antoine.sarailler@dechert.com

The U.S. Consumer Financial Protection Bureau at Its First Anniversary

by **Thomas P. Vartanian**, **Robert H. Ledig** and **Gordon L. Miller**

The creation of the Consumer Financial Protection Bureau (Bureau) has been one of the most controversial aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The agency's independence and its potential to impose costs and compliance obligations on a wide range of banking and nonbanking companies have been the source of many critics' concerns. Emblematic of the Bureau's contentiousness, its first director was not installed until January 2012, nearly six months after the agency formally commenced doing business, and he was a recess appointment made without the advice and consent of the U.S. Senate. The legality of the appointment has been challenged in court and by some members of Congress.

The creation of the Consumer Financial Protection Bureau has been one of the most controversial aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Bureau's jurisdiction, based on the definition of "consumer financial product or service" in Dodd-Frank, is expansive. With certain exceptions, a company engaged in any line of business that happens to offer or provide a consumer financial product or service is a "covered person" subject to regulation and, in some cases, direct supervision and examination, of its consumer financial activities by the Bureau.

The Bureau will have an offshore impact as well. For example, the first substantive final rule adopted by the agency implemented an amendment to the Electronic Fund Transfer Act, pursuant to Dodd-Frank, to require disclosures to U.S. consumers making international remittances.

The Bureau's jurisdiction, based on the definition of "consumer financial product or service" in Dodd-Frank, is expansive. . . . The Bureau will have an offshore impact as well.

On July 21, 2012, the Bureau reached its first anniversary, making this an appropriate time to assess what the Bureau has been doing and what type of agency is taking form.

Broad Agency Responsibilities and Ambitious Agency Goals

The Bureau came into operation on July 21, 2011 with a full agenda and, as its staffing has grown to an operational level, it has begun to exert its authority over consumer financial matters. Under Dodd-Frank, the Bureau has a fourfold mission: (i) ensure that consumers receive timely and understandable information when they consider and enter into consumer financial transactions; (ii) protect consumers from unfair, deceptive or abusive acts and practices in the offer, sale and administration or servicing of consumer financial products and services; (iii) review and streamline consumer financial regulations; and (iv) ensure that the markets for consumer financial products and services function transparently and efficiently.

On July 21, 2012, The Bureau reached its first anniversary, making this an appropriate time to assess what the Bureau has been doing and what type of agency is taking form.

The Bureau also has undertaken to build a new institution. It inherited from seven federal financial agencies the responsibility to administer and, in some cases, enforce 18 federal consumer financial laws. These include laws that apply quite broadly, such as the Equal Credit Opportunity Act, the Truth in Lending Act and the privacy provisions of the Gramm-Leach-Bliley Act. The Bureau also has been charged with new federal responsibilities, such as the oversight of nonbanking providers of consumer financial products and services. As of June 30, 2012, the Bureau had grown to 889 employees. Its funding is provided by the Board of Governors of the Federal Reserve System (FRB), of which it is a nominal part, and, as required by Dodd-Frank, it is substantial. For fiscal year 2012, the Bureau has been allocated 11% of the FRB's total operating expenses, or $548 million, and, for fiscal year 2013 and after, it will be allocated 12% of the FRB's total operating expenses. The Bureau clearly has the opportunity and the means to create a significant role for itself.

A New Approach to Consumer Protection

The Bureau has undertaken to do certain things differently than did its predecessors. In particular, it has indicated a determination to go beyond the role that consumer protection divisions have served within those federal agencies that have responsibility for the prudential supervision of banking organizations and to become more of an advocate for consumers. Among its innovations, the Bureau has established a complaints website, which is initially focused on credit card-related issues, where the agency has posted unverified as well as verified complaint information, including the identities of the providers of the products and services. It has studied consumer decision-making through the use of focus groups, field testing and academic research, to help it to understand how consumers perceive and process the financial information provided to them and to guide the drafting of disclosure guidelines and model disclosure forms. The Bureau also has worked to support state-level enforcement efforts through information-sharing and collaboration with state attorneys general and other state officials responsible for enforcing federal consumer financial laws, and it has supported private enforcement efforts by soliciting requests for and filing amicus briefs.

Policy-Making through Rulemaking and Enforcement

Since the beginning of 2012, the Bureau has issued formal rules and informal guidance at a brisk pace. See *DechertOnPoint* "U.S. Consumer Financial Protection Bureau: A New Frontier for Cost-Benefit Analysis." It has issued a final rule regarding international remittances and a final rule that extends the agency's supervision, examination and enforcement authority to certain consumer reporting agencies. It also has issued significant procedural final rules addressing the confidential treatment of privileged information, the conduct of investigations and the notification by state officials to the Bureau of actions brought under delegated authority. The Bureau has issued a proposed rule setting forth procedures for designating particular nonbank covered persons for supervision and examination and several proposed rules that address mortgage-related issues. See *DechertOnPoints* "U.S. Consumer Financial Protection Bureau Proposes Mortgage Servicing Reforms" and "U.S. Consumer Financial Protection Bureau in Process of Restructuring Regulation of the Residential Mortgage Market: Qualified Mortgage Rule Emerges as Critical Issue."

The Bureau has issued a substantial amount of guidance in the form of an examiner's manual for the supervision and examination of covered persons, specialized examination procedures for mortgage origination, mortgage servicing and short-term small dollar-volume lending, interagency guidelines for small insured depository institutions under the SAFE Mortgage Licensing Act and interagency guidelines for mortgage servicers whose borrowers are members of the U.S. military. The Bureau also has released bulletins that discuss several matters, including the marketing of add-on features to credit cards, fair lending obligations and the activities of service providers.

Time will tell how often the Bureau follows this approach and how effective it will be, but "rulemaking through enforcement" can have distinct consequences.

The director of the Bureau is a former state attorney general, and his background has contributed to debate regarding the extent to which the Bureau may rely on enforcement actions rather than rulemaking to set policy. The Bureau has publicly announced two enforcement actions, the details of which provide a template for the use of enforcement as a policy-making tool.

On July 18, 2012, the Bureau announced that it had issued a consent order against Capital One Financial Corporation (Capital One) regarding the marketing of payment protection and credit monitoring features to its credit card holders. The Bureau based its claims against Capital One on the agency's authority to take action against unfair, deceptive or abusive conduct. See *DechertOnPoint* "U.S. Consumer Financial Protection Bureau Couples First Enforcement Action with Warning to Financial Services Industry." Capital One agreed to cease all marketing of such products until a compliance plan acceptable to the Bureau was put in place and to pay $140 million in reimbursement to cardholders and $25 million as a civil monetary penalty to the Bureau.

The Bureau's first year has been eventful, and the agency can be expected to maintain its energetic pace. However, its first year only provides hints as to the methods and procedures that it will use and what their consequences may be.

At the same time, the Bureau issued a Compliance Bulletin that set forth a list of "CFPB Expectations" applicable to the credit card industry in general, which addressed in detail such matters as the use of marketing materials and telemarketing and service center scripts, employee compensation for promoting and selling these products, employee training, compliance programs and the oversight of service providers. Subsequently, other large credit card companies announced that they were discontinuing the offering of these products. These events indicate that the agency may prefer to use high-impact, high-profile enforcement actions not merely to correct behavior but to send a clear signal regarding related policy issues.

Time will tell how often the Bureau follows this approach and how effective it will be, but "rulemaking through enforcement" can have distinct consequences. For example, it may enable the Bureau to flesh out what constitutes "unfair, deceptive or abusive" acts and practices, a controversial standard introduced in Dodd-Frank, without following the public notice and comment procedures of the Administrative Procedures Act, analyzing the costs and benefits of implementing any "CFPB Expectations" or studying their impact on small providers. The Bureau's enforcement actions therefore are likely to receive close scrutiny in order to discern the nature and direction of the agency's policy-making activities.

Supervision and Examination Agenda

The Bureau also has instituted an examination and investigation program. The Bureau has reportedly issued numerous civil investigative demands to, and made voluminous document requests of, nonbanking companies in connection with the Bureau's reviews of consumer financial law compliance. The Bureau also has on occasion assigned enforcement attorneys to its bank examination teams. The Bureau has explained that the assignments were made for training purposes, but the practice differs from the approach used by bank regulatory agencies in their examinations. Some have expressed concern that an attorney's involvement blurs the line between an examination and an investigation and can chill the atmosphere of cooperation that examination teams typically strive to establish. The direct participation of Bureau attorneys in examinations, also may raise issues regarding the permissibility of the Bureau attorneys' contacts with officers, directors and employees who are represented by counsel, the use of Bureau attorneys as witnesses in any administrative or judicial proceedings that may arise from an examination and the effect of a switch from the role of attorney to witness on the confidentiality of the materials produced by or given to the attorney.

The complaint website, discussed above, is an example of the Bureau's adoption of new media tools. The website may post unverified individual complaints, including the name of the providers involved and the resolution of the dispute, if any. Only narrative details and allegations of discrimination have been omitted. In its Policy Statement in June 2012 announcing the launch of the program, the Bureau stated that

it may rely on the database to set agency priorities in supervision, enforcement and market monitoring. Some commenters have objected to the release of so much unanalyzed and, in some cases, raw data, on the grounds that it may be misinterpreted and may encourage groundless litigation. The Bureau, however, stated in its Policy Statement that it would "allow the marketplace of ideas to determine what the data shows." The agency also stated that it expects to expand the program by year-end 2012 to include complaints regarding mortgages, certain other consumer loans and transactions in general with insured depository institutions.

Another example of the Bureau's approach may be found in the final rule it has issued for the identification of larger participants in the credit reporting market, discussed above. In the preamble, the Bureau discussed its general considerations in selecting the criteria, which approach the agency may follow generally to identify larger participants in other consumer financial markets. The size threshold for "larger" credit reporting agencies was established not simply to cover a handful of the largest providers but to include a sufficient number and range of providers, including specialists and potentially even small businesses, to give the Bureau insight into the operation of and compliance issues in the market generally. In addition, the CFPB has indicated that, once a provider has been identified as a larger participant in a particular consumer financial market, the Bureau will supervise the provider with respect to all consumer financial activities in which it engages.

Protection of Privileged Information

A final noteworthy development is the effort of the Bureau to protect the confidentiality of any privileged information that may be provided to it in the course of its performing its supervisory or examination responsibilities. See *DechertOnPoints* "U.S. Consumer Financial Protection Bureau Issues Regulation Protecting Privileged Information from Waiver of Privilege" and "Building Consumer Financial Protection Bureau Relationships: Access to Documents." The ability of the federal banking agencies to provide similar protection to banks, thrifts, their holding companies and other affiliates was not clearly established until Congress amended the Federal Deposit Insurance Act in 2006. It has been suggested that similar legislation is required to protect information disclosed to the Bureau. In adopting a final rule on this topic, the Bureau has stated that it welcomes such legislation but does not consider it to be necessary. According to the Bureau, the agency has rulemaking authority from Congress that allows it to preserve the confidentiality of privileged information provided to it by regulated entities.

The Bureau has taken the position that it has the authority to compel the production of privileged material, but it has stated that it will seek privileged information from supervised entities only when the information is material to its supervisory objective and it cannot practicably obtain the same information from non-privileged sources. The Bureau's position does not address the 1992 ruling of the U.S. Ninth Circuit Court of Appeals in *Clarke v. American Commerce National Bank*, in which the court refused to enforce a subpoena issued to a national bank by the Office of the Comptroller of the Currency, the primary federal supervisory authority for national banks, seeking attorney billing record information that would have revealed attorney-client privileged information.

Conclusion

The Bureau's first year has been eventful, and the agency can be expected to maintain its energetic pace. However, its first year only provides hints as to the methods and procedures that it will use and what their consequences may be. The Bureau clearly deserves further close attention.

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

Robert H. Ledig
Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

Gordon L. Miller
Washington, D.C.
+1 202 261 3467
gordon.miller@dechert.com

Financial Services Contacts

For more information, please contact the authors, one of the partners or counsel listed or any Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/financial_services.

Karen L. Anderberg
+44 20 7184 7313

David L. Ansell
+1 202 261 3433

Peter D. Astleford
+44 20 7184 7860

Adrienne M. Baker
+1 617 728 7151

Margaret A. Bancroft
+1 212 698 3590

Sander M. Bieber
+1 202 261 3308

Stephen H. Bier
+1 212 698 3889

Gus Black
+44 20 7184 7380

Thomas C. Bogle
+1 202 261 3360

Julien Bourgeois
+1 202 261 3451

Laura M. Brank
Moscow:
+7 499 922 1122
Washington, D.C.
+1 202 661 3484

Kevin F. Cahill
+1 949 442 6051

Susan M. Camillo
+1 617 728 7125

Christopher D. Christian
+1 617 728 7173

Elliott R. Curzon
+1 202 261 3341

Carl A. de Brito
+1 212 698 3543

Douglas P. Dick
+1 202 261 3305

Olivier Dumas
+33 1 57 57 80 09

Karl J. Paulson Egbert
+852 3518 4738

Koji E. Felton
+1 415 262 4521

Carsten Fischer
+49 6977 06 19 42 11

Joseph R. Fleming
+1 617 728 7161

Brendan C. Fox
+1 202 261 3381

Richard Frase
+44 20 7184 7692

Robert M. Friedman
+1 212 649 8735

Allison Harlow Fumai
+1 212 698 3526

David M. Geffen
+1 617 728 7112

John Gordon
+44 20 7184 7524

David Gubbay
+44 20 7184 7420

Chris Harran
+971 4 425 6329

David J. Harris
+1 202 261 3385

Christopher P. Harvey
+1 617 728 7167

Richard L. Heffner, Jr.
+44 20 7184 7665

Robert W. Helm
+1 202 261 3356

Richard M. Hervey
+1 212 698 3568

Richard Horowitz
+1 212 698 3525

Andrew Hougie
+44 20 7184 7373

Martin Hüwel
+49 89 21 21 63 35

Basil H. Hwang
+852 3518 4788

Megan C. Johnson
+1 202 261 3351

Jane A. Kanter
+1 202 261 3302

Geoffrey R.T. Kenyon
+1 617 728 5694

Matthew K. Kerfoot
+1 212 641 5694

Steven P. Kirberger
+1 212 698 3698

Robert H. Ledig
+1 202 261 3454

Angelo Lercara
+49 89 21 21 63 22

Angelyn Lim
+852 3518 4718

Marc M. Luftglass
+1 212 698 3673

Stuart Martin
+44 20 7184 7542

George J. Mazin
+1 212 698 3570

Gordon L. Miller
+1 202 261 3467

Michelle Moran
+353 1 436 8511

Jack W. Murphy
+1 202 261 3303

Antonios Nezeritis
+352 45 62 62 27

John V. O'Hanlon
+1 617 728 7111

Declan O'Sullivan
+353 1 436 8510

Andrew L. Oringer
+1 212 698 3571

Reza Pishva
+1 213 808 5736

Edward L. Pittman
+1 202 261 3387

Jeffrey S. Puretz
+1 202 261 3358

Achim Pütz
+49 89 21 21 63 34

Jon S. Rand
+1 212 698 3634

Robert A. Robertson
+1 949 442 6037

Keith T. Robinson
+1 202 261 3438

Antoine Sarailler
+33 01 57 57 80 16

Kevin P. Scanlan
+1 212 649 8716

Marc Seimetz
+352 45 62 62 23

Jeremy I. Senderowicz
+1 212 641 5669

Michael L. Sherman
+1 202 261 3449

Hans Stamm
+49 89 21 21 63 42

Mark Stapleton
London:
+44 20 7184 7591
Moscow:
+7 499 922 1100

Stuart Strauss
+1 212 698 3529

Richard J. Temko
+32 2 535 5430

Patrick W.D. Turley
+1 202 261 3364

Brian S. Vargo
+1 215 994 2880

Thomas P. Vartanian
+1 202 261 3439

David A. Vaughan
+1 202 261 3355

Benedikt Weiser
+49 6977 06 19 42 20

M. Holland West
+1 212 698 3527

Anthony H. Zacharski
+1 860 524 3937

Robert Zack
+1 212 698 3522

Jay Zagoren
+1 215 994 2644

Financial Services Quarterly Report Editorial Board

Gus Black
+44 20 7184 7380

Karl J. Paulson Egbert
+852 3518 4738

Wendy Robbins Fox
+1 202 261 3390

Christopher Gardner
+44 20 7184 7460

David J. Harris
+1 202 261 3385

Megan C. Johnson
+1 202 261 3351

About Dechert LLP

An international law firm with 26 offices throughout the United States, Europe, Asia and the Middle East, Dechert has the resources to help clients succeed wherever they do business. We focus on core transactional and litigation practices, providing world-class, top-ranked services to major corporations, financial institutions and private funds worldwide.

Dechert's core practices are financial services and investment management, corporate and securities, complex litigation and international arbitration, finance and real estate, intellectual property and energy. The firm also has well-established practices in tax, insolvency, employment, health and environmental law.

We welcome your feedback. Please let us know if there are any topics you would like to see covered in future reports.

Subscribe to receive Dechert's *Financial Services Quarterly Report* or our other *DechertOnPoints*.

Dechert LLP

www.dechert.com

© 2012 Dechert LLP. All rights reserved. Materials have been abridged from laws, court decisions, and administrative rulings and should not be considered as legal opinions on specific facts or as a substitute for legal counsel. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

The United States Treasury Department issues Circular 230, which governs all practitioners before the Internal Revenue Service. Circular 230 was amended to require a legend to be placed on certain written communications that are not otherwise comprehensive tax opinions. To ensure compliance with Treasury Department Circular 230, we are required to inform you that this letter is not intended or written to be used, and cannot be used, by you for the purpose of avoiding penalties that the Internal Revenue Service might seek to impose on you.

Almaty • Austin • Beijing • Boston • Brussels • Charlotte • Chicago • Dubai • Dublin • Frankfurt
Hartford • Hong Kong • London • Los Angeles • Luxembourg • Moscow • Munich • New York
Orange County • Paris • Philadelphia • Princeton • San Francisco • Silicon Valley • Tbilisi • Washington, D.C.