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Contracts for Differences - Irish Stamp Duty Exemptions under threat

In a statement published by Crest on St Patrick's Day (17th March), the Irish Revenue Commissioners stated their view that stamp duty exemptions would not be available in respect of share transactions carried out for the purpose of hedging derivative instruments. They said that this was not a change of policy, but merely clarifying the existing position.

These contracts for difference ("CFDs") enable the purchaser to take a position on a stock without actually owning it. CFDs have become very popular, and may account for as much as 30% of trading in Irish equities.

The first exemption, known as 'Market Maker relief', provides that stamp duty is not chargeable on securities transferred to a market maker acting in the ordinary course of its business. The Irish Revenue has indicated that the 'ordinary course of business as a market maker' does not cover the transfer to a market maker of securities purchased by him for the purposes of hedging derivative instruments.

In such cases, there will be a liability to stamp duty of 1% of the price paid for the shares, plus interest on the duty from the date of transfer at 0.0273% per day from 1 April 2005 and a further penalty of 10% of any such duty remaining unpaid for not more than six months. Where the duty remains unpaid for not more than 12 months, the penalty will be 20%, and where it remains unpaid for more than 12 months, 30% will be chargeable.

The second exemption, known as 'broker/dealer relief', provides that no stamp duty is payable on an initial purchase of shares by an Irish or UK member firm of the Irish or London Stock Exchanges if the shares are sold on to a bona fide purchaser within one calendar month and a bi-annual report of all such exempt transactions is submitted to the Irish Revenue.

The Revenue says it does not consider that the stamp duty exemption covers instances where share transactions relate to the hedging of derivative instruments. Here, the onward bona fide purchaser requirement will not be deemed to be met because the shares are sold and re-purchased solely for the purposes of retaining ownership for hedging without payment of stamp duty.

In this scenario, there would be a liability to stamp duty of 1% of the price paid for the shares, plus interest on the duty after the specified calendar month at 0.0273% per day from 1 April 2005 and a further penalty of 1% of unpaid duty per day.

This move by the Revenue is understandably causing much unease in the industry. Some prime brokers are believed to have ceased offering CFDs on Irish shares, or have begun to collect the duty.

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Representatives of the Irish Stock Exchange are engaged in on-going discussion with Revenue officials about this issue, and the Irish Minister for Finance, Brian Cowan, has stated that he plans to review the law in this area. He is anxious that the market in Irish equities continues to be "a modern, liquid market, conducive to capital acquisition by Irish firms".

New Listing Rules for Closed-ended Investment Funds

On 30 March 2006, the FSA issued a consultation paper (CP 06/4 "Implementation of the Transparency Directive/Investment Entities Listing Review") which included proposals for a fundamental review of the listed investment companies regime. These proposals will be of interest to:

- persons considering the establishment of a closed-end investment vehicle; and
- hedge fund managers seeking an alternative vehicle for distribution to retail investors, particularly in the UK.

While the impact on traditional long-only investment trusts investing solely in equities or bonds will be relatively limited, the changes will make it significantly easier for more innovative investment entities to obtain a listing and trading facility on the London Stock Exchange's main market. They may also reverse the recent trend towards floating investment companies on the London Stock Exchange's Alternative Investment Market (AIM), which has few specific restrictions. While there may be few "single hedge funds" taking advantage of the new relaxations, they will also assist funds of hedge funds (of which there are a number traded on the London Stock Exchange) as some of these currently have to employ artificial devices to comply with the rules, and these would no longer be necessary.

Existing listed investment entities may wish to consider the implication of the new proposals for their compliance costs and procedures, and respond to the consultation paper accordingly.

CP 06/4 – Investment Entities Listing Review

The FSA first published a discussion paper on revising the listing regime in July 2002, and a first consultation paper on proposed changes in October 2003.This was followed by a second consultation paper in October 2004. In the October 2004 paper the FSA said:

> "In CP203, we asked whether the Listing Rules relating to listed investment companies should be aligned more closely with those applicable to authorised collective investment schemes. As a result of your responses, and so that we can consult more widely, we have decided that chapters 21 (investment entries), 24 (securitised derivatives) and 26 (venture capital trusts) of the existing sourcebook would benefit from a detailed review in their own right."

Background

The listing regime for investment entities in the UK starts from the premise that investment entities generally cannot comply with the requirements for listing of a "trading" company, specifically requirements that they have a three-year revenue-generating track record and have controlled the majority of their assets for at least that three-year period.

Subject therefore to compliance with certain additional eligibility conditions and extended continuing obligations, investment entities (specifically entities that do not control their underlying investments) are able to obtain a listing without a three-year track record. The FSA is considering whether the current eligibility conditions and disclosure obligations are still appropriate having regard to the following regulatory objectives:

- Boards should not be constrained, through detailed listing rules, from undertaking investment activity which they believe is in the interests of their shareholders.
- The quality standards of listing, that were supported in the 2005 review of the listing rules generally, should be maintained for investment entities.
- Disclosure and governance arrangements need to ensure appropriate investor protection, and any gaps in the regime need to be identified and addressed.
- Where possible, rules that restrict the choice of investment activity should be removed and only retained where specific concerns need to be addressed, such as those associated with multi-layered funds.
- The integrity of the eligibility requirements applicable to other listed (i.e. trading) companies must not be undermined by allowing such companies to qualify for listing as investment entities when this is not appropriate.
- Where it is possible to rely on other regulations to achieve a desired outcome (such as assessing eligibility of an investment manager's experience), this should be done.

- Listing should be made available to investment entities employing more sophisticated investment strategies than at present, through the introduction of a more principles-based approach which allows them to demonstrate they are maintaining an appropriate spread of risk.

- The new regime should be effective and long lasting.

The consultation period will close on 30 June 2006. The FSA is hoping to issue a feedback statement in late Summer and have the new rules in place by 1 January 2007 (when the statutory provisions enabling the establishment of Real Estate Investment Trusts (UK-REITs) are expected to come into force).

The proposals – eligibility requirements for an investment company listing

The FSA propose:

- to replace the specific rule limiting individual investments to 20% of a fund's total assets with a more detailed definition of the term 'investment entity'. To meet this definition (and so be considered for listing), an investment entity must be established with the object of investing funds with a view to spreading investment risk, and must have a published policy making clear, if necessary with a quantitative analysis, how its investment policies will achieve a spread of investment risk including with respect to asset allocation, risk diversification and gearing. This will be coupled with a requirement for a statement in the annual report and accounts about how this objective is achieved (as to which see below).

- to relax the FSA's policy on investment activity, giving investment entities much greater flexibility in their choice of investment strategy. Under the proposals the FSA would permit short selling and greater use of synthetic instruments to achieve exposure to underlying assets, and the current requirement that the investment entity not be a "dealer" in investments would also be removed.

- to remove the present rule requiring an investment entity to be a passive investor. This is because the FSA believes investment entities may want to exercise influence in their capacity as shareholders in the same way as other shareholders are able to. The proposals clarify the extent to which an investment entity may influence the businesses in which it invests – it may provide strategic advice and may have non-executive representatives on the boards of companies in which it invests, provided it does not take board control or become actively involved in the day-to-day management of those businesses. The consultation paper does not discuss investment entities seeking to acquire (by takeover) another investment entity – a transaction that is permitted by the UK's tax requirements for investment trusts, and this may need clarifying in the consultation process. Some investment trusts have expanded in the past by making acquisitions of (or mergers with) other investment trusts for shares and mergers of smaller investment companies has generally been regarded (at least in concept) as a useful process in the sector, cutting costs and increasing the viability of the merged company.

- to consider whether there should be further relaxation of the "control" restrictions without undermining the listing regime for other listed (i.e. trading) companies. The FSA are conscious that it has been considered appropriate to retain the requirement for a trading company to have a three year track record of operations to be eligible for listing. If new investment entities were able to take controlling stakes in companies, then there would be a risk that the integrity of the listing regime for trading companies could be undermined because a trading company (or holding company) without the necessary three year record could present itself for listing as an investment entity.

- to relax the requirements for feeder funds so that a feeder fund need not ensure that its directors comprise a majority of the board of the company in which it invests, provided that it is able to control the investment policies of the investee (without specifying how this must be achieved). The FSA acknowledge that in many master-feeder structures, the feeder fund does not control the investment policies of the master fund (although it may have certain veto rights over changes) and thus would remain ineligible for listing.

- to remove the existing disapplication for investment companies of the standard listing requirement to have 12 months working capital. Under the prospectus directive, investment entities are required to make a working capital statement, and the FSA consider that given the proposed wider range of investment powers and strategies the disapplication would no longer be appropriate.

- to extend the rules introduced in 2004 for investment companies on the independence of directors and investment managers to all investment entities (including Venture Capital Trusts, to which they did not previously apply).

- to extend the requirement for the directors and the investment manager to have sufficient and appropriate experience in the management of investments of the relevant size and type to new investment managers and directors of existing listed investment entities; but to provide that sufficient and appropriate experience will normally be presumed in the case of an FSA-authorised investment manager and to relax existing practice so that three years' experience in managing a portfolio of half the size and of the same type as that of the proposed investment entity will normally be regarded as appropriate experience.

- to remove a raft of restrictions presently in place regarding significant investment in real estate. These include restrictions on gearing, limits on the proportion of leasehold property that can be held and rules requiring diversification of tenancies and assets.

- to allow UK-authorised open-ended investment companies to be listed without compliance with the eligibility requirements, but to remove the current exemption for unauthorised collective investment schemes from complying with the listing rules to the extent that to do so would breach the UK financial promotion regime on the basis that such schemes could not widely disseminate a prospectus and therefore should not be listed.

The proposals – continuing obligations

The FSA propose:

- as referred to above, to require investment entities to report annually explaining, with quantitative analysis as appropriate, how the entity is achieving its objective of spreading investment risk.

- to require a significant change in an investment entity's risk profile to be immediately announced. Guidance included with the proposed rule sets out the various factors that are likely to be considered, including portfolio composition (even where within the published investment policy), gearing, counterparty risk, credit risk, liquidity risk, currency risk and custodial risk - the FSA note that to be able to comply with this rule, investment entities would need to ensure they have systems and controls in place to monitor their risk profiles. Given the amount of similar information already required to be produced on a periodic basis, the FSA anticipate that this will be achieved by the relatively modest redesigning of existing systems and controls. In any event, they consider that there will be a correlation between the costs of compliance and the complexity of the investment activity or structure concerned, so that for the very prudent investment company, the FSA considers there is unlikely to be a material cost arising from this proposal.

- to remove the requirement for monthly/quarterly portfolio composition disclosure and a raft of provisions relating to detailed financial disclosure required to be included in annual reports and accounts. The FSA note that these requirements have limited effectiveness, and would cause problems if disclosure of short positions was required.

- to extend the continuing obligations governing the independence between boards and investment managers to all investment entities (including Venture Capital Trusts, to which they did not previously apply) but subject to an 18-month transitional period to enable boards to be restructured (although the FSA are consulting on whether existing VCTs should have a more generous relaxation).

- to make it easier for directors to obtain dispensation from the model code provided that the investment entity makes an announcement that all "inside information" has already been notified to the market.

- to remove the present rules prohibiting the payment of dividends unless they are covered by income received from underlying investments and preventing the distribution as dividend of realised capital gains – this mainly affects non-UK (i.e. offshore) entities since UK company and tax law applicable to investment trusts imposes similar requirements.

- to remove restrictions on investments by investment companies that invest in real estate, retaining only a rule that after the expiry of a 12-month period, investment entities that invest more than 20% of their assets in property will be subject to the "class test" rules so that, for example, where the investment entity enters into a transaction where one of the appropriate ratios exceeds 5%, it must issue a detailed announcement, and if one of the appropriate ratios exceeds 25%, it must obtain shareholder approval.

- to extend the experience requirements for directors and investment managers to proposed new directors and investment managers (as referred to above).

- to remove the prohibition on an investment entity issuing shares at a discount to its net asset value (NAV) unless those shares are first offered to existing shareholders. The FSA note that investment entities are subject to the

restriction applicable to all listed companies which, in most cases, prevents companies from issuing shares where the issue price is at a discount of more than 10% to the middle market price, and the FSA considers this to be sufficient protection against dilution through share issues. It is also the case that, in the case of investment entities that are companies, the fiduciary duties of the directors would no doubt require them to have good grounds for issuing shares at a discount to NAV.

Hedge Fund Side Letters – the New FSA Requirements

Last month the FSA published Feedback Statement 06/2, following up on the Hedge Fund Discussion Paper (05/04) which it published last year. Most of the FSA's conclusions are measured and realistic. One proposal, however, will be of particular concern to hedge fund managers whose funds have entered into side letters with particular investors.

Different hedge fund investments do not normally need to be accepted on identical terms, and large institutional investors have developed the habit of negotiating personalised "side letter" terms for their investments. There is currently a movement towards some generalised disclosure of the existence of these arrangements, most logically in the private placing memorandum, which is the key document on which the fund is sold, and would be available to potential as well as existing investors.

The FSA has now stated in FS 06/2 that:

> "as a minimum we would expect acceptable market practice to be for managers to ensure that all investors are informed when a side letter is granted and any conflicts that may arise are adequately managed....We are expecting firms to disclose the existence of these side letters, when granted, to other investors and are not requiring them to disclose the nature of individual agreements."

Rather surprisingly, the FSA envisages a new disclosure being made every time a new side letter is entered into, even though the contents of the letter, and presumably also the identity of the investor concerned, would not be specified.

The FSA has also suggested that it sees a failure to disclose the existence of side letters as a potential breach of Principle 1. But a breach of Principle 1 (a firm must conduct business with integrity) is generally seen as equivalent to a finding of dishonesty, and to fall foul of this, the manager would have to be doing something pretty drastic – arranging a side letter for dishonest reasons perhaps, or deliberately seeking to mislead investors.

What other basis is there in the FSA rules for requiring such a specific disclosure? Principle 5 (a firm must observe proper standards of market conduct) seems an obvious candidate, albeit that the relevant standard of conduct is currently still being established. Principle 7 (a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading) is another possibility, though the mere omission of a particular piece of information, in itself, would normally not be misleading unless the recipient had a genuine expectation that such information, if it existed, would be disclosed to it, such that a failure to disclose and that information would influence its investment decision. Again we seem to be back to a market practice standard of conduct.

The Alternative Investment Management Association is currently is discussion with the FSA as to the way forward on this topic.

Retail Funds of Hedge Funds

The FSA has just published a Feedback Statement on this subject, following up from its Discussion Paper on Wider-Range Retail Investment Products (FS06/3, 23.03.06). The original Paper, published in June 2005, noted that investors in the retail market already have access to a wide variety of investment products which carry increasing investment risk. For example, closed-ended funds of hedge funds are already listed on the London Stock Exchange and are therefore available to the retail public. The FSA therefore sought views on whether, to protect consumers, the UK's present regulatory regime on authorised collective investment products should be extended to include such products.

Retail Funds of Hedge Funds

Currently a Non-UCITS retail scheme (NURS) can invest only 20% of its scheme assets in unregulated collective investment schemes and unapproved securities. The FSA is now minded to remove the 20% restriction, subject to certain safeguards. This will allow the establishment of "wider-range products" in the form of authorised "funds of hedge funds," "funds of private equity funds" and so on.

Further detailed consultation is scheduled for the first quarter of 1997. It is unclear as yet when any changes might come into effect. The regulator also recognises that a change in the existing onshore taxation rules will be crucial to the success of the new regime.

The quid pro quo for this relaxation will be the application of new quality criteria to the underlying unregulated

collective investment schemes. This approach already exists in the FSA's Qualified Investor Schemes (QIS) regime. QISs are UK-authorised funds which are only available to limited classes of non-related investors. They specify that where a QIS invests in unregulated funds, each fund must have an annual audit, must not have more than 15% of its value in units of schemes, must operate risk spreading, have its value independently audited, and have mechanisms to enable unitholders to redeem units within a reasonable time. The rules for a NURS investing in hedge funds are likely to be at least as stringent as for a QIS.

Consumer Information and Awareness

The FSA does not anticipate imposing special categorisation or product regulation requirements on these new wider-range products, or restricting access to specific categories of "sophisticated" consumer. Instead it will reinforce its message to consumers of "not putting all their financial eggs in one basket", the importance of reading disclosure materials, and the increasing need to seek financial advice on novel and different products. However some extra forms of consumer safeguard may still be considered.

Product Provider Responsibility

The FSA stresses the continuing importance of providers and distributing advisers helping customers to achieve a fair deal, e.g. product information should be clear and suitable. This is also addressed by the FSA on an ongoing basis under its "Treating Customers Fairly" initiative.

Other Issues in FS06/3

UCITS III and risk management systems and controls - the FSA will continue to consider the adequacy of firms' derivatives risk management programmes, further examine new funds to be launched utilising wider UCITS III investment powers, and monitor UCITS III advertisements to ensure that risk and performance features are communicated clearly and fairly.

The FSA intends to examine the practical differences between collective investment scheme and closed-ended corporate structures, such as investment trust companies, and their divergent regulatory regimes.

Switzerland: Guidelines on transparency of management fees

On 1 August 2005 the Swiss Federal Banking Commission (FBC) adopted Guidelines on transparency with regard to management fees (the "Guidelines"). They are designed to provide transparency with regard to management fees charged to funds offered and distributed publicly in Switzerland; and apply to both Swiss investment funds and non-Swiss investment funds which are registered with the FBC.

The Guidelines require disclosure in the fund prospectus of the intended use of the management fee, broken down between administration, asset management and distribution. Reimbursements to unitholders and trail fees to distributors may only be paid out of the distribution component and on certain terms.

The Guidelines will come into force for new funds on 1 July 2006. Funds already authorised and new funds registered in Switzerland before 30 June 2006 will have to implement the Guidelines by 31 December 2006, but the requirement may be accelerated where an existing fund changes its fee structure or creates a new sub-fund after 30 June and before 31 December 2006.

Practice group contacts

For more advice on any of the above, please contact either of the lawyers listed or the Dechert lawyer with whom you regularly work.

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