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A legal update from Dechert's Financial Services Group

In this issue

Financial Services Update

FSA Proposes Wider Access to Hedge Funds for Retail Customers

The UK Financial Services Authority (FSA) has issued a Consultation Paper setting out proposals to allow UK retail customers to invest in funds of hedge funds and other alternative investments sold by firms authorised in the UK. The FSA's proposals would:

- introduce retail-oriented funds of hedge funds into the existing FSA regulatory regime for Non-UCITS Retail Schemes (NURS);
- lift the existing 20% restriction on investment in unregulated collective investment schemes for NURSs, thereby allowing the development of retail funds of hedge funds;
- apply due diligence guidance for fund managers producing funds of hedge funds, to guide them on the matters to consider in making their initial and on-going investment decisions;
- for existing NURSs, leave the current rules unchanged, although a few consequential changes would be necessary to ensure overall consistency in the regime; and
- ensure the regime for Qualified Investor Schemes (QISs) is in line with the FSA's revised approach for NURSs.

The consultation will close on 27 June 2007. A Policy Statement with feedback and final rules will be issued towards the end of the year.

IOSCO and AIMA Issue Guidance on Hedge Fund Valuation

The Technical Committee of the International Organisation of Securities Commissions (IOSCO) has issued a Consultation Report on principles for the valuation of hedge fund portfolios. The Report acknowledges the increasing importance of hedge funds to global capital markets and the central role of financial instrument valuations to hedge funds, and proposed nine principles for hedge fund portfolio valuation, including:

- comprehensive, documented policies and procedures for valuing financial instruments;
- periodic review of the policies and procedures to ensure continued appropriateness;
- a high level of independence in the application of the policies and procedures and in their review;
- an appropriate level of independent review of individual values, particularly any valuations influenced by the manager;
- the arrangements for valuation of the portfolio should be transparent to investors.

IOSCO seeks comments from the public, including investors and managers, governing bodies, hedge fund counterparties, and service providers, by 21 June 2007. A final paper is expected to be published by IOSCO in autumn 2007.

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The Alternative Investment Management Association (AIMA), which issued a detailed survey on asset pricing and fund valuation practices in the hedge fund industry in April 2005, has also issued a guide to sound practices for hedge fund valuation. This sets out AIMA's 15 recommendations (streamlined from the 20 recommendations in AIMA's previous survey). They broadly echo IOSCO's nine principles, and deal with such matters as governance, transparency, procedures, processes and systems, and sources, models, and methodology.

FSA Fines Citigroup Analyst £52,500 for Market Misconduct

The FSA has fined Roberto Casoni, a former equities analyst with Citigroup, £52,500 for failing to observe proper standards of market conduct while carrying out his role as an approved person. This was a breach of Principle 3 of the FSA's Statement of Principle for approved persons.

Mr Casoni prepared a draft report for Citigroup on an Italian Bank, Banca Italease (BI). However, prior to the report's publication, Mr Casoni selectively disclosed details of his valuation methodology, final recommendation, and target price to clients (none of whom acted on the information). This was a breach of Citigroup's internal approval procedures, and Citigroup itself brought the matter to the FSA's attention.

The case is another example of the FSA's readiness to bring an enforcement action on the basis of a breach of principle rather than a breach of a specific regulation.

Disclosure of Confidential FSA Material in Litigation Proceedings

The Court of Appeal has upheld the decision of the court of first instance in *Real Estate Opportunities Ltd v Aberdeen Asset Managers Jersey Ltd* (a case in connection with the split-capital investment trusts litigation). This decided that section 348 of the Financial Services and Markets Act 2000 (FSMA), which prohibits disclosure of confidential information by the FSA or by any person obtaining such information from the FSA, does not preclude the recipient of that information from disclosing it to another party in separate litigation proceedings where the recipient either provided the information to the FSA in the first place or already knew of it. "Confidential information" for this purpose is information provided to the FSA in connection with its regulatory functions.

The court held that although section 391 of FSMA prohibits the publication of a warning or decision notice issued by the FSA, this does not prevent its disclosure in litigation proceedings. In the view of the court, publication necessarily involves dissemination with a view to making the information public, which is not the same thing as disclosure.

UCITS – Implementing Directive and Level 3 Guidelines on Eligible Assets for UCITS

The European Commission has issued a Level 2 implementing Directive specifying the criteria for assessing whether different types of financial instrument are eligible for inclusion in UCITS funds. This is intended to help to remove uncertainty as to whether UCITS can properly invest in financial instruments such as asset backed securities, listed closed end funds, Euro Commercial Paper, index based derivatives, and credit derivatives.

The implementing Directive takes into account advice from the Committee of European Securities Regulators (CESR), which has been published in the form of Level 3 guidelines on eligible assets for investment by UCITS. Member States now have until March 2008 to implement the Directive in national law. The Commission will carefully monitor this process to ensure even application throughout the EU.

One area of potential Level 3 material remains outstanding—namely the classification of hedge fund indices as eligible assets for investment by UCITS. CESR is currently consulting on this issue and additional Level 3 guidelines are expected in mid-2007.

UCITS – Interpretive Communication Clarifying Home State and Host State Responsibilities for Marketing of UCITS

The European Commission has issued an Interpretive Communication intended to clarify the respective powers of Home States and Host States with regard to the marketing of UCITS in the EU. Under the UCITS Directive a fund authorised in one Member State (the "Home" State) can be marketed in any other Member State provided it is notified to the supervisory authority of that Member State (the "Host" State). The supervisory authority of the Host

State has up to two months to review the notification and can specify how the fund should be advertised and promoted in its territory. However, there has sometimes been uncertainty over the procedure and the respective responsibilities of the Home State and Host State supervisory authorities. The Interpretive Communication confirms that an investment fund's Home State supervisory authority has sole responsibility for monitoring compliance with EU rules, and that the notification procedure cannot be used by Host States to challenge authorisation of UCITS granted in Home States.

UCITS – Further Commission Proposals to Improve Efficiency of UCITS

The European Commission has also put forward for consultation a number of proposals setting out the form of possible amendments to the UCITS Directive, intended to facilitate market-driven restructuring and boost efficiency in the European fund market. These cover such areas as the fund passport, fund mergers, asset pooling/master-feeder structures, the management company passport, simplified prospectus/product disclosures, and supervisory cooperation. The proposals are intended to address the areas identified as being in need of reform in the Commission White Paper of November 2006 (see *DechertOnPoint* January 2007 / Issue 4).

The deadline for comments on the proposals is 15 June 2007. The Commission will finalise its formal proposals towards the end of 2007.

German Federal Court Forces German Banks to Disclose Kickbacks to Customers

In December, the German Federal Court gave a judgment which changes German banks' previous practice of non-disclosure of kickbacks to their customers. The court's decision was published in March. The head note states that when advising customers and recommending investments in funds, banks must disclose any fees they receive (i.e., kickbacks of subscription fees and management fees). This is to ensure that customers are able to determine if the bank's recommendation is in their interest and based on an objective assessment, or if the bank is simply recommending the fund which pays it the highest fees.

In the case before the court, the customer had been told about subscription and management fees but not the fact that the bank received kickbacks. The court decided that as a consequence of this non-disclosure, the customer had a claim against the bank for damages in respect of any purchases of units in funds where kickbacks had not been disclosed. The claim was based on the bank's wilful conduct (in failing to disclose the kickbacks), because the bank had a duty to disclose kickbacks and thus inform the customer of its conflict of interest. The form in which kickbacks were received (i.e., whether paid back or deducted directly from the fees payable) was irrelevant.

Non-compliance with the duty to disclose was itself a breach of the duties set out in section 31 of the German Securities Trading Act. This requires an investment services enterprise to provide its services with the requisite expertise, diligence, and conscientiousness and in the interest of its customers. It must also try to avoid conflicts of interest and ensure that, in case of unavoidable conflicts of interest, customers' orders will be executed with due regard to their interests. An investment services enterprise is also obliged to provide its customers with all the appropriate information necessary to protect the clients' interests, depending on the nature and extent of the proposed transaction.

The judgment also indicated that customers may rescind contracts for the subscription of units or the purchase of other securities if the bank has failed to disclose kickbacks. It is not necessary for the bank's conduct to have been wilful, but the claim will be subject to a time limit of three years (i.e., any such claim will be barred if it is not asserted within three years after the subscription/purchase). Customers will only have to prove the bank's intent if they assert their claims after the lapse of the three year limitation period.

The judgment means that banks will have to change their current practice and will have to implement procedures to comply with the rules set out in the judgment. Some German banks are already transferring kickbacks back to their customers. It is currently unclear how disclosure should be made (i.e., whether this should be the actual amount or just the percentage of the fees received).

Practice group contacts

For more information, please contact one of the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/financialservices.

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

Katharina Ebell
Munich
+49 89 21 21 63 41
katharina.ebell@dechert.com

Philip Orange
London
+44 20 7184 7585
philip.orange@dechert.com

Dechert LLP
www.dechert.com

UK/Europe

Brussels
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Paris

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