

## In this issue

A legal update from Dechert's Financial Services Group

## Financial Services Update

### New US Hedge Fund Guidelines

Regulators in the United States have published new principles and guidelines regarding hedge funds (referred to in the guidelines as "private pools of capital"). The guidelines acknowledge that private pools of capital bring significant benefits to the financial markets, but state that they also present challenges for market participants and policymakers. Investors, creditors, counterparties, pool managers, and supervisors need to be aware of these challenges and work to address them. The guidelines state that public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk.

The guidelines have been issued following discussion between members of the President's Working Group on Financial Markets (PWG)—which includes the US Treasury, the SEC, and other agencies—set up after the collapse of Long Term Capital Management in 1998.

The guidelines might be seen as an attempt to deflect demands for greater hedge fund regulation, demands which have become increasingly vociferous both in the United States and in Europe, particularly in France and Germany, although UK and EU financial regulators have recently made it clear that they are firmly against greater hedge fund regulation.

The US hedge fund principles and guidelines follow the recent proposal by the SEC of two new "hedge fund" rules: the anti-fraud rule, which would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to a pooled investment vehicle to make false or misleading statements, and the accredited natural person

rule, which would require an investor to hold at least \$2.5 million in investments (exclusive of a residence) in order to be eligible to invest in private offerings.

### Hedge Fund Valuation Good Practice

In a letter to IOSCO, Hector Sants, Managing Director of the FSA's Wholesale and Institutional Markets Division, has summarised what the FSA considers to be the main good practice points for valuation of the assets of hedge funds. These include:

- Clear separation of duties between the portfolio managers and the back office
- Regular conciliations between the manager's back office and the prime broker
- Training in new investment types and instruments for the manager's valuation staff
- Regular visits to the funds' administrators, including reviewing pricing controls
- Reviewing legal agreements with third parties on a regular basis
- Ensuring that audit reports are received on a timely basis
- Having a separate stand-alone pricing policy document, approved by senior management, available to administrators, prime brokers, and other external parties, specifying the pricing comparisons to be used and the procedures to be followed
- Having written procedures in place for the day-to-day operation of the pricing process

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## Consultation on Hedge Fund Indices for UCITS

The Committee of European Securities Regulators (CESR) has published a consultation paper proposing additional criteria for hedge fund indices (HFIs) to qualify as financial indices under Article 19 (1)(g) of the UCITS III Directive. The additional criteria (“level 3 criteria”) are intended to address concerns at an early stage in the development of the HFI market, so that derivatives based on appropriately constructed HFIs can qualify as eligible investments for UCITS. The final form of the requirements will be published after the consultation period ends on 16 April 2007. CESR members have agreed not to authorise the setting up of new UCITS with hedge fund indices until the conclusion of the review.

## Investment Manager Exemption

Her Majesty’s Revenue and Customs (HMRC) has been consulting on a revised Statement of Practice containing guidance on the Investment Manager Exemption (i.e., the application of the rules in Finance Act 1995 and Finance Act 2003 regarding UK investment managers who act on behalf of overseas clients). The Statement of Practice sets out the circumstances in which a non-UK resident fund that is trading in certain classes of investment in the UK through a UK investment manager, will not be subject to UK tax. Dechert has submitted a detailed response to the consultation. HMRC will publish feedback on all responses by 31 March 2007, but no fixed time-scale has been given for finalising and implementing the revised Statement of Practice.

## Investment Entities Listing Review

In December 2006, the FSA published a further consultation paper on the Investment Entities Listing Review, including feedback on its earlier consultation in March 2006. In the consultation paper, the FSA sets out proposals for a radical reform of the London Stock Exchange listing regime, including its recategorisation into eight separate listing categories, each with its own distinct set of obligations under the Listing Rules.

The proposed categories are:

- Premium Company Standard
- Closed-Ended Fund Standard
- Open-Ended Fund Standard
- European Core Standard
- Preference Share Standard
- Core Debt Standard

- Depositary Receipt Standard
- Securitised Derivatives Standard

In the paper, the FSA also confirms its view that it is not appropriate to prevent overseas investment companies from applying for a secondary listing on the London Stock Exchange under Chapter 14 of the current UK Listing Rules (due to become the European Core Standard, a directive minimum regime, under the FSA’s proposals), even if the company does not have a primary listing elsewhere. According to the FSA, a large number of foreign investment firms have applied to list under the directive minimum regime.

## New Luxembourg Funds Law

Luxembourg has recently passed a new law providing for “Specialized Investment Funds”, reserved for institutional investors, professional investors, and sophisticated investors. The law provides a more flexible framework for investment funds established in Luxembourg than the old 1991 law. Under its provisions, a fund promoter will no longer need to be approved by the CSSF (the Luxembourg regulatory authority), the fund will be able to be marketed to a wider range of investors, and there will be increased flexibility in terms of permitted investments. The law has now been adopted by the Luxembourg parliament, making Luxembourg a potentially attractive onshore domicile for hedge funds, in competition with offshore domiciles such as Cayman Islands and BVI.

## UCITS White Paper

In November, the EU published a White Paper on the Enhancement of the EU Framework for Investment Funds (see *DechertOnPoint* January 2007 / Issue 4 – US). Central to the discussion is the question of whether the UCITS framework provides the flexibility necessary for competitive fund management across the EU, without damaging the reputation of UCITS as a benchmark for investor protection.

Although significant amendments were made to the original UCITS Directive in 2001, the current legislative framework does not accurately reflect the structural changes that have occurred as a result of the rapid pace of innovation, the emergence of new financial instruments, continuing disintermediation, and the move towards a pan-European open architecture, with greater use of third party distribution agreements.

The White Paper concludes that action must be taken to:

- Strengthen the cross-border marketing of UCITS, thereby enabling the fund industry to serve European and global investors more efficiently

- Ensure that investors are in a position to make informed decisions and rely on qualified intermediaries for objective expert advice
- Assess whether a single market framework should be created to allow cross-border sale of some types of non-UCITS to retail investors
- Establish a pan-European private placement regime to facilitate the sale of non-harmonised funds and financial instruments to institutional and sophisticated investors in other Member States

## MiFID Implementation

Ireland has become the fourth EU Member State to transpose the Markets in Financial Instruments Directive (MiFID) into national law (the others being the UK, Lithuania, and Romania).

CESR has recently published a consultation paper on best execution under MiFID. In the consultation paper, CESR has asked for responses on a number of issues, including:

- What the content of a firm's execution policy should be, and how supervisory compliance can be achieved
- How a firm should disclose its policy to clients
- How firms can obtain their clients' "prior and express consent" to their execution policies
- How to achieve supervisory convergence in the treatment of relationships and responsibilities between firms in chains of execution
- How firms should be expected to review and monitor their execution policies
- How firms can monitor the quality of their execution

CESR has also asked the European Commission for clarification on the scope of MiFID's best execution requirements, in particular whether it believes that the FSA's proposal to exempt quote-driven dealing from the best execution requirements is in the spirit of MiFID. When it has received the Commission's response it will publish an addendum to the paper.

## CRD Implementation

The Capital Requirements Directive (CRD), a substantial redraft of the Capital Adequacy Directive (CAD) and the Banking Consolidation Directive (BCD), was implemented in the UK on 1 January 2007. The CRD itself implements

the Basel II framework, a revision of the Basel I framework agreed in 1988 by the Basel Committee on Banking Supervision, and is aimed to strengthen the soundness and stability of the international banking system by requiring banks to maintain higher capital ratios. Basel II is intended to further reduce the probability of consumer loss or market disruption as a result of prudential failure by seeking to ensure that the financial resources held by a firm are commensurate with the risks associated with the business profile and the control environment of the firm.

The CRD directly affects banks, building societies, and certain types of investment firms (including those subject to MiFID). It has been implemented in the UK by new prudential regulations (GENPRU and BIPRU) covering capital resource requirements, credit risk, operational risk, market risk, group risk, securitisation, concentration risk, liquidity risk, and disclosure.

Although CRD was implemented on 1 January 2007, firms can take advantage of transitional rules that allow continued use of certain IPRU(INV) rules during 2007. Firms can choose to implement the CRD fully at any time in 2007, provided they notify the FSA of the date they propose to stop using the transitional rules.

## UK Companies Act 2006

The UK Companies Act 2006 received the Royal Assent in November 2006 and comes into force in stages over an extended period from 1 January 2007 to October 2008. Although much of the Act is a consolidation of previous companies legislation, there are a number of significant changes to current company law. In particular, the Act sets out for the first time a statutory basis for the general duties owed by directors to the company. The most controversial change is the inclusion in the Act of the duty for directors to "*promote the success of the company for the benefit of its members as a whole*". The Act also contains a new procedure for enforcement of those duties by shareholders on behalf of the company.

Other significant changes include provisions relating to narrative reporting, auditors' liability, takeovers, shareholder enfranchisement and transparency, financial assistance, and company administration.

The Act also implements the EU Transparency Directive in the UK. This introduces a new regime for the notification of major shareholdings. The new disclosure regime applies to anyone who holds shares in UK public companies or any entity (non-UK entities included) whose shares are admitted to trading on a regulated market (such as the London Stock Exchange) or a prescribed market (such as AIM), where the UK is their home state for the purposes of the Prospectus Directive.

## Prime Broker Ordered to Pay \$160 Million to Hedge Fund's Creditors

Bear Stearns, which acted as prime broker to Manhattan Investment Fund, a failed hedge fund, has been ordered by a US federal bankruptcy judge to pay almost \$160 million (representing 9% of Bear Stearns' earnings in 2006) to the fund's creditors. The judge held that Bear Stearns, which made \$2.4 million in profits from executing transactions for the fund, "failed to act diligently in a timely manner" after individuals at the investment bank became aware of the possibility of fraud by the

fund's manager, Mr. Michael Berger. The fund lost nearly \$400 million by making wrong bets on internet stocks during the late 1990s.

Before the fund failed, Berger transferred \$141.4 million to the fund's account at Bear Stearns to meet increased margin calls. Because Bear Stearns failed to take "simple steps" to investigate Berger, the judge ruled that it could not prove that it used the money in good faith, so the creditors of the fund were entitled to have the money repaid, with interest. If the judgment is upheld on appeal, it is likely to cause prime brokers to review their internal control procedures in relation to hedge funds.

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## 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](http://www.dechert.com/financialservices).

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