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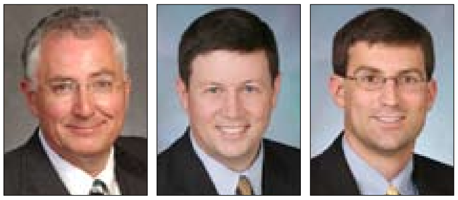
Countries Harmonizing Asset Disclosure Practices to Combat Tax Evasion



by **Robert W. Helm**, **Thomas C. Bogle** and **Eric D. Simanek**

On the eve of the September 2009 G20 summit in Pittsburgh, Pennsylvania, delegates from over 70 countries and international organizations gathered in Mexico to discuss methods to combat tax evasion around the world. In an environment where it has become easier to transfer assets across borders, some have increasingly sought to hide assets from domestic tax authorities by maintaining assets abroad, making it more difficult for the domestic authorities to verify the correct tax due. It has been estimated that the revenue loss from tax evasion in the United States alone exceeds $100 billion annually.[1] In spite of long-standing efforts to control the use of tax havens, they have continued to flourish. The Organization for Economic Cooperation and Development ("OECD") has launched an effort to improve access to bank information and promote international transparency for tax purposes.

Such information sharing would make it more difficult for taxpayers to avoid their tax obligations by hiding their assets overseas.

Background

In the mid-1990s, the OECD began an effort to study harmful tax practices and develop measures to promote transparency and fairness in tax policies. In a 1998 report, the OECD composed a list of tax havens, characterized by zero or low effective tax rates, preferential tax treatment for foreign persons, and non-disclosure to foreign tax authorities of information regarding domestic assets.[2] Moreover, in many countries, non-payment of taxes is a civil matter, rather than a criminal matter, making those regimes more attractive to tax evaders. The OECD offered recommendations to reduce harmful tax practices. Such recommendations include uniform

treatment of foreign and domestic taxpayers, greater transparency in countries' tax laws and the application of such laws, and increased sharing of information between the tax authorities of different countries.

The OECD's Mexico meeting was part of an effort by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes ("Global Forum") to promote sharing of relevant tax information relating to assets held by domestic institutions. Such information sharing would make it more difficult for taxpayers to avoid their tax obligations by hiding their assets overseas. At the meeting, the Global Forum took steps to play a leading role in international efforts to fight tax evasion. These efforts capped a six-month period that saw great progress in the adoption of globally accepted standards for the disclosure of assets held domestically.

Global Standards for Combating International Tax Evasion

The Global Forum developed standards for transparency and the exchange of information ("Standards") that have served as guiding principles to which countries should adhere in adopting policies regarding the exchange and disclosure of tax information. The G20 Ministers of Finance and the United Nations Committee of Experts on International Cooperation in Tax Matters have endorsed these Standards[3] and the Global Forum encourages all countries to commit to following the prescriptions of the Standards and oversees their implementation.

The Standards require:

1. Exchange of information on request where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of the treaty partner;
2. No restrictions on information exchange caused by bank secrecy or domestic tax interest requirements;
3. Availability of reliable information and powers to obtain it;
4. Respect for taxpayers' rights; and
5. Strict confidentiality of information exchanged.[4]

The Standards served as the basis for the Global Forum's 2002 Model Agreement on Exchange of Information on Tax Matters ("Model Agreement").[6] The Model Agreement contains a model for both a bilateral and multilateral tax information exchange agreement, and, as of April 2009, had served as

the basis for more than 70 such agreements. The central terms of the Model Agreement provide for the "exchange of information that is foreseeably relevant to the . . . determination, assessment and collection of such taxes, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters." The country receiving the request may decline to furnish information that the party making the request would not be able to obtain for purposes of the administration of its own tax laws, as well as information that would reveal trade secrets. The Model Agreement further provides that any information exchanged must be treated confidentially and may not be used for any purpose other than tax matters.

Such recommendations include uniform treatment of foreign and domestic taxpayers, greater transparency in countries' tax laws and the application of such laws, and increased sharing of information between the tax authorities of different countries.

OECD Progress Report on Implementation of the Standards

as of December 14, 2009[5]

JURISDICTIONS THAT HAVE SUBSTANTIALLY IMPLEMENTED THE STANDARDS			
Argentina	Denmark	Japan	Russian Federation
Aruba	Estonia	Jersey	San Marino
Australia	Finland	Korea	Seychelles
Austria	France	Liechtenstein	Singapore
Bahrain	Germany	Luxembourg	Slovak Republic
Barbados	Gibraltar	Malta	Slovenia
Belgium	Greece	Mauritius	South Africa
Bermuda	Guernsey	Mexico	Spain
British Virgin Islands	Hungary	Monaco	Sweden
Canada	Iceland	Netherlands	Switzerland
Cayman Islands	India	Netherlands Antilles	Turkey
Chile	Ireland	New Zealand	United Arab Emirates
China	Isle of Man	Norway	United Kingdom
Cyprus	Israel	Poland	United States
Czech Republic	Italy	Portugal	US Virgin Islands

JURISDICTIONS THAT HAVE COMMITTED TO THE STANDARDS, BUT HAVE NOT YET SUBSTANTIALLY IMPLEMENTED THEM		
Andorra	Grenada	Philippines
Anguilla	Guatemala	Samoa
Antigua and Barbuda	Liberia	St. Kitts and Nevis
Bahamas	Malaysia	St. Lucia
Belize	Marshall Islands	St. Vincent and the Grenadines
Brunei	Montserrat	Turks and Caicos Islands
Cook Islands	Nauru	Uruguay
Costa Rica	Niue	Vanuatu
Dominica	Panama	

Many countries have also entered into "double taxation treaties" that aim to eliminate the double taxation of income or gains derived from activities in one territory and received by residents of another territory. In such situations, both of the interested countries can have valid claims to tax the income and gains under their domestic tax laws, and these treaties are designed to allocate the income and gains between the two jurisdictions. Over 1300 such bilateral agreements have been signed. Both the OECD and the UN have adopted model tax conventions (the "OECD Model Tax Convention" and the "UN Model Double Taxation Convention," respectively) to serve as a basis for bilateral double taxation agreements.

Until 2009, several countries had consistently resisted Article 26's requirements regarding the exchange of tax information.

Article 26 of both the OECD Model Tax Convention and the UN Model Double Taxation Convention addresses the exchange of tax information. In each case, this Article incorporates the fundamental principle of the Standards – the exchange of information that is "foreseeably relevant for carrying out the provisions of [the convention] or to the administration or enforcement of the domestic laws concerning taxes of every kind and description." However, until 2009, several countries had consistently resisted Article 26's requirements regarding the exchange of tax information. Switzerland is one such country that resisted the implementation of Article 26,[7] and its double taxation treaty with the United States contains a provision relieving either party from "carry[ing] out administrative measures at variance with the regulations and practice of [that party] or which would be contrary to its sovereignty." This provision would relieve Switzerland of the obligation to exchange information in contradiction of its banking secrecy laws. However, Switzerland has committed to changing this Article in such double taxation treaty to better conform to the Standards.[8]

Recent Progress in Countries Committing to the Standards

In the months since the April 2009 G20 meeting, over 70 tax information exchange agreements have been signed, more than doubling the number signed between 2000 and April 2009. In its Progress Report published on December 14, 2009, the Global Forum found that 20 additional countries had "substantially implemented" the Standards since April 2, 2009.[9] Furthermore, the Global Forum found an increase in the number of countries that had "committed" to the Standards without having yet substantially implemented them. Every one of the 100 countries surveyed in September 2009 had at least committed to the Standards. This trend demonstrates that the OECD's principles concerning the exchange of tax-related information are quickly gaining traction internationally.

As of mid-December 2009, the United States had signed 13 tax information exchange agreements – with Antigua and Barbuda, Aruba, The Islands of the Bahamas, the British Virgin Islands, the Cayman Islands, Gibraltar, Guernsey, the Isle of Man, Jersey, Liechtenstein, Monaco, the Netherlands Antilles and Switzerland. Each of these agreements closely resembles the Model Agreement, meaning that the United States and these counter-parties are obligated to exchange information in connection with legitimate tax issues raised by their respective tax authorities.

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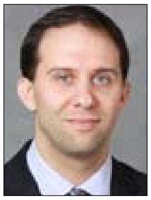
The Latest Steps Taken in Mexico

On the heels of such growth in the acceptance of the necessity for tax disclosure, representatives from almost 90 countries convened in Mexico to strengthen the Global Forum's role as an overseer and promoter of greater transparency in the fight against tax evasion. The Global Forum convened with three purposes: 1) to restructure the Global Forum to expand membership and ensure that each member participates on an equal footing; 2) to establish a peer review process to monitor progress towards full and effective exchange of information; and 3) to identify methods to speed up the negotiation and conclusion of agreements regarding transparency and the exchange of information.[10]

continued on page 23

Risk Management for Investment Management Firms: Applying the Lessons from the Recent Financial Crisis*

by **Stephen H. Bier** and **Matthew A. Wolfe**

The market events beginning in the summer of 2007 and their impact on the investment management industry have resulted in an increased focus on risk management and oversight by investment management firms, the funds they manage and, in some cases, fund boards, as well as by regulators throughout the world. In response, a number of investment management firms have recently taken steps to address risk management in a more systematic and transparent manner. At the same time, there have been calls for increased government oversight of risk, including calls for some type of systematic risk regulator.[1] With or without this type of macro-level systematic risk regulation, what should investment managers be doing now with respect to risk management?

In the wake of these market events, there have been a number of recent studies, articles and other commentary that address risk management issues. While much of this commentary was not specifically directed to investment management firms, there is a clear consensus regarding certain best practices and lessons learned that could be beneficially applied to investment managers with respect to portfolio management, operations, compliance and overall risk oversight.

With or without this type of macro-level systematic risk regulation, what should investment managers be doing now with respect to risk management?

Enterprise-Level Risk Management

In March 2008, the Senior Supervisors Group, consisting of banking and securities regulators from France, Germany, Switzerland, the United Kingdom and the United States (the "Group"), issued a report entitled *Observations on Risk Management Practice during the Recent Market Turbulence* (the "SSG Report").[2] The SSG Report surveyed risk management practices of various firms worldwide and highlighted the "risk management practices that may have enabled some firms to weather the financial market turmoil better than others."[3]

The SSG Report underlined the responsibility of senior management for implementing and emphasizing a firm's risk management practices, evoking the need to set a "tone at the top" and the importance of a firm-wide approach to risk management. A major fault of some firms was pressure from senior manage-

ment to generate earnings without providing guidance regarding an appropriate level of risk tolerance. While the SSG Report looked at these attributes with respect to "earnings," the same analysis could apply to investment management firms by replacing "earnings" with "investment performance."

The SSG Report emphasized the need for senior management teams as a whole to include members with expertise in a range of risks, given the unpredictability of market disruptions. The Group found that firms are more likely to maintain a risk profile consistent with the board and senior management's tolerance for risk if they establish risk management committees that discuss all significant risk exposures across the firm, meet on a frequent basis, and include executive and senior leaders from key business lines and independent risk management and control functions (*e.g.*, the chief financial officer and senior managers from the legal function and operations areas) as equal partners. A good example of this enterprise-wide approach in practice would be a situation where an adviser's portfolio manager would like to invest in a complex financial instrument such as a collateralized debt obligation ("CDO"). Before doing so, it is important for the adviser to have a process in place to ensure that the fund has the operational capabilities to value the instrument and that the legal department has reviewed the CDO documentation to ensure that the terms of the instrument match the portfolio manager's expectations with respect to issues such as subordination and other rights.

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The SSG Report also found that firms with less hierarchical structures and more direct channels of communication with senior managers received better risk information from their employees. The breadth and depth of internal communication in a firm was also critical to risk management success, and the SSG Report encourages firms to avoid organizational "silos" that compartmentalize information.[4]

Many of the points raised by the SSG Report were also reflected in a 2007 speech entitled "Risk Management for Broker-Dealers" by Mary Ann Gadziala, Associate Director of the Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations. Ms. Gadziala noted that, as a result of inspections conducted by the SEC staff, it found that senior management involvement in making key risk management policy decisions, as well as documented periodic review of firm-wide limits or risk levels for authorized business activities, were essential to successful risk management.[5]

Similarly, a recent white paper issued by Deloitte[6] noted that overall responsibility for risk management belongs with the Chief Executive Officer, and that in many financial institutions, a chief risk officer, or "CRO," position has been established that provides leadership for and executes the organization's risk management plans. Under this view, senior management – with board input and approval – is responsible for setting the institution's risk appetite, and clearly communicating it throughout the organization.

Another area where senior management participation in the risk management process is crucial is compensation. For example, the SSG Report observed that an issue for a number of firms was whether compensation policies had struck the right balance with respect to the risk-reward trade-off and properly incentivizing short-term versus longer-term performance.

Risk Oversight

In overseeing a firm's risk management policies, it is critical that the company's overall risk management system be not only appropriate for compliance purposes, but effective in the actual operations of the company. Material risks must be adequately identified in a timely manner and risk management strategies must be responsive to the company's specific material risk exposures. What is most important is that throughout the company, business decision making should include consideration of risk and risk management, and the company should have policies and procedures to ensure that necessary information with respect to material risks is adequately transmitted to senior executives and, as appropriate, to the board or relevant committee.

Applying these principles, investment management firms should compile a risk inventory, and senior management and boards should ensure processes are in place to address all identified material risks. While risk oversight is often delegated to a board committee, rather than undertaken by a board directly, boards should consider creating a committee specifically dedicated to risk oversight, or at least ensuring that any standing committee (typically, the audit committee) has dedicated meeting times to address risk management issues. Because the full board is ultimately responsible for risk oversight, the full board should also receive information about the company's risk management system and the most significant risks that the company faces. In order to achieve this, the board, or committee charged with risk oversight, should have executive sessions with the managers primarily responsible for risk management, and should be provided with appropriate information.

It is critical that the company's overall risk management system be not only appropriate for compliance purposes, but effective in the actual operations of the company.

Specific Areas of Focus

The following are examples of recommendations to manage substantial risk areas that need to be addressed at a firm-wide level. While not tailored specifically to investment companies and their advisers, the analysis and advice below with respect to valuation risk and credit risk is largely transferable.

Valuation Risk

A firm's valuation process and abilities are always a concern of the board and management, and central to risk management. Among the recommendations in the SSG Report and the Deloitte white paper are that firms should:

- take a more active approach to verifying their valuations, using internal resources in a coordinated and centralized fashion;
- enforce discipline internally in marking their assets to their estimated prices, using consistent marks across both proprietary positions and financed counterparty positions; and
- test the accuracy of their valuations during periods of market turmoil.

The practice of testing valuations of illiquid products against actual trade prices can reveal valuation anomalies and provide an early warning signal to risk managers about valuation model errors and changing market conditions.

The valuation of over-the-counter derivatives, such as structured credit products, is particularly challenging, especially as such valuation has moved to model-based efforts instead of transaction-based information, often creating less reliable valuations and greater pricing risk. The SSG Report suggests firms should give particularly thorough consideration to the interplay of the market sensitivities of derivative exposures, notional limits, value-at-risk (VaR) methodologies, static single-factor stress tests, and historical and forward-looking scenario analysis. A simplifying assumption commonly made in some models is that correlation between the prices of certain instruments will follow historical relationships; however, this did not prove true during the recent financial crisis. Many firms are planning to change the volatility estimates in their VaR methodologies to make them more sensitive to volatility spikes.

In addition, among the biggest problems with current valuation practices, as identified in the Deloitte paper, is that valuation and monitoring measures of structured credit trading positions often do not adequately evaluate the underlying collateral, leading to underestimated risk exposures. Some valuation and risk models fail to use current spread information and do not build newer, complex products into the existing risk infrastructure. Other models use assumptions that attempt to map complex instruments to general index-type exposures, thereby ignoring the products' specific risks. Continuous and thorough analysis of this nature should be done internally to identify weaknesses and anomalies. To the extent that this analysis results in enhancements to its processes, management should bring both the identified problems and the proposed solutions promptly to the board's attention, and the board should be meaningfully involved in evaluating the success of the implemented response.

continued on page 25

New Framework for Offering Russian Securities to Foreign Investors


by **Laura M. Brank** and **Valentin Andrianov**

On June 10, 2009, the Federal Service for the Financial Markets of the Russian Federation ("FSFM") approved new regulations (the "Regulations")[1] requiring specific permission for Russian issuers to place and circulate[2] securities abroad. The Regulations will likely enhance the liquidity of the local Russian securities market, but they will complicate the process of selling Russian securities in international capital markets. The Regulations will become effective on January 1, 2010.

The Regulations reduce the maximum percentage of each class of a Russian issuer's shares that may be placed and/or circulated abroad (including in the form of depositary receipts). This percentage is determined based upon the quotation list on which the shares are listed on the relevant Russian stock exchange. Under the Regulations, as was previously the case, Russian issuers would still need to list their shares on a Russian stock exchange before listing them abroad.

A Note on Quotation Lists

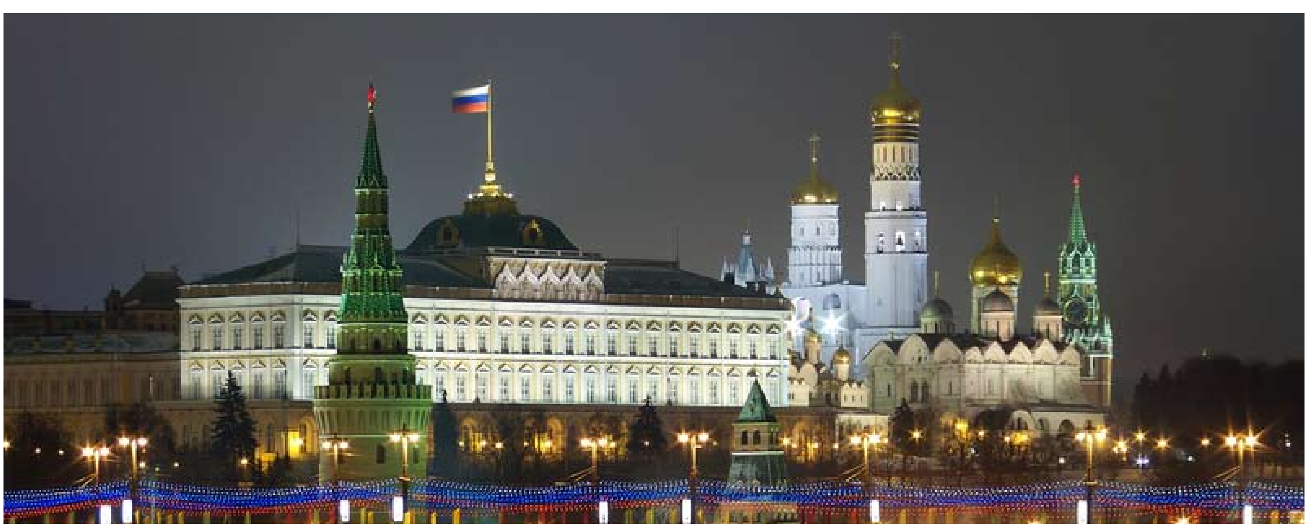
Russian securities can be traded on the two major Russian stock exchanges – the Moscow Interbank Currency Exchange ("MICEX") and the Russian Trading System Stock Exchange ("RTS") – by virtue of being admitted to one of the following quotation lists:

- A (1st Level or 2nd Level);
- B;
- V; or
- I.

Stricter Limits on the Percentage of an Issuer's Shares Offered Outside of Russia

The new limits specified by the Regulations are as follows:[3]

- 25% for shares on Quotation List A (whether 1st or 2nd Level);
- 15% for shares on Quotation List B;
- 5% for shares on Quotation Lists V or I; and
- 5%, if the Russian issuer is a strategic company that is engaged in geological study, exploration or production of natural resources on subsoil plots of federal significance (a "strategic subsoil company", defined in accordance with Federal Law No. 57-FZ "On the Procedure for Foreign Investment in Commercial Organizations of Strategic Importance for the National Security of the Russian Federation", dated April 29, 2008 (the "Strategic Sectors Law"[4]). Such strategic subsoil companies are capped at 5% regardless of the quotation list on which their securities are included.



	A, 1ST LEVEL	A, 2ND LEVEL	B	V	I
Maximum percentage of common shares of the issuer that can be owned by one person and its affiliates	75%	75%	90%	N/A	N/A
Minimum capitalization of the issuer	RUB 10 billion (approximately US$345 million) in common shares or RUB 3 billion in preferred shares	RUB 3 billion in common shares or RUB 1 billion in preferred shares	RUB 1.5 billion in common shares or RUB 500 million in preferred shares	N/A	RUB 60 million in common shares or RUB 25 million in preferred shares
Duration of issuer's existence	At least three years	At least three years	At least one year	At least three years	N/A
Limitation on operating at a loss	May not have had two years of losses in previous three years	May not have had two years of losses in previous three years	N/A	May not have had two years of losses in previous three years	N/A
Minimum volume of transactions in the issuer's shares during previous three months	RUB 25 million per month	RUB 2.5 million per month	RUB 1.5 million per month	N/A	N/A
Corporate governance	Must meet the requirements in relation to its management bodies (e.g., have three independent members on its board of directors)	Must meet the requirements in relation to its management bodies (e.g., have three independent members on its board of directors) within one year of its securities being admitted to the relevant quotation list	Must meet the requirements in relation to its management bodies (e.g., have one independent member on its board of directors) within one year of its securities being admitted to the relevant quotation list	Must meet the requirements in relation to its management bodies (e.g., have one independent member on its board of directors)	Must meet the requirements in relation to its management bodies (e.g., have one independent member on its board of directors)
Financial statements	IFRS or U.S. GAAP	IFRS or U.S. GAAP	N/A	N/A	N/A
Minimum number of shares to be placed or offered for public sale	N/A	N/A	N/A	10% of all common shares of the issuer	10% of all common shares of the issuer
Agreement with a market maker	N/A	N/A	N/A	Required	Required
Agreement with a financial consultant	N/A	N/A	N/A	N/A	Required

For shares listed on Quotation Lists B, V, or I, the 5% limit may be increased to 25%, if the issuer of foreign securities representing the Russian shares (i.e., a depositary) is incorporated in a country whose securities regulator has entered into a cooperation agreement with the FSFM. According to the FSFM's official site, such agreements exist between Russia and the following jurisdictions: Belarus, Brazil, China, Cyprus, France, Germany, Kyrgyzstan, India, Oman, Syria, Turkey, Venezuela and UAE. Unfortunately, in practice, such relief will not be immediately available in connection with many issuances because most depositaries servicing the Russian market are not incorporated in those countries.

The Regulations provide potential relief with respect to issuances of shares by Russian strategic subsoil companies. Companies that receive preliminary approval from the Federal Antimonopoly Service of the Russian Federation ("FAS") to place or circulate shares abroad may receive permission from the FSFM to place or circulate abroad a percentage of their shares approved by FAS, up to a maximum of 25% of all issued shares of the same class. However, it appears that further legislative amendments may be required to implement this, because the authority of FAS to approve transactions that involve placement and circulation of shares abroad is not specified in the Strategic Sectors Law. Without such amendments, such relief is likely to be unavailable in practice.

Stricter Limits on the Percentage of an Issuer's Shares per Issue Offered Outside of Russia

In addition, the Regulations have reduced the percentage of shares per issue that may be offered on foreign exchanges – from 70% to 50%. The Regulations stipulate that no more than 50% of the shares of a single issue, or no more than 50% of the shares being offered by an existing shareholder, can be placed or offered abroad. This 50% limit will not apply to circulation abroad of Russian shares made in connection with corporate reorganizations of Russian issuers that previously received permission from the FSFM to place their shares abroad.

Although the Regulations have not yet entered into force, the FSFM has already prepared draft amendments to the Regulations, which would also become effective on January 1, 2010[5]. According to the draft amendments, if shares are included on Quotation List A (1st Level or 2nd Level) of the stock exchange, then the 50% limit would not apply if:

1. a signed application is made to the FSFM for consent to sponsor the circulation of shares of a Russian issuer outside the Russian Federation by a depositary established in accordance with the laws of the Russian Federation, provided such depository: has performed depositary activities for at least seven years; has capital of at least 150 billion Rubles; has accepted for depositary service at least 150 billion Rubles of securities; and has not entered into any procedure for insolvency (bankruptcy), or had suspensions of its activities or cancellations of its license for depositary activities initiated against it during the last two years;
2. the contract under which circulation of shares of a Russian issuer is carried out outside the Russian Federation obliges the issuer of foreign securities to open a custody account in the depositary that meets the above-mentioned requirements, and the Russian issuer's shares are deposited in this custody account; and
3. the contract under which circulation of shares of a Russian issuer is carried out outside the Russian Federation obliges the issuer of foreign securities to submit to the Russian issuer regularly, on at least a quarterly basis, a list of the owners and/or nominal holders of the foreign securities (persons who are not owners, but who hold rights to foreign securities in favor of third parties), indicating the quantity of foreign securities registered in their name.

Other Changes Under the Regulations

Within 30 days of the completion of the share offering, the issuer (and, with respect to any offering of existing shares, the selling shareholder) must submit a report to the FSFM on the results of the offering. The report must include information about the number of shares offered in Russia and abroad, as well as the stock exchange and the broker involved in the offering.

If any modification is made to an existing depositary receipt program, the issuer (or the depositary bank if the issuer is not a party to the deposit agreement) must notify the FSFM of the modification in writing, and attach a certified copy of the amended agreement in Russian.

In contrast to the current regulations, which do not impose a time limit on the validity of a permit or provide grounds for its revocation by the FSFM, the Regulations stipulate that permits issued by the FSFM will expire if:

- within one year of the date of the permit, the shares are not placed or circulated outside Russia (including by way of a depositary receipts program);
- the report on the results of the offering is not submitted to the FSFM within the prescribed 30-day timeframe; or
- the shares to which a permit relates are redeemed (cancelled).

Impact of the Regulations; Unresolved Issues

Despite the pending effectiveness of the Regulations, it would seem that permits issued under the current regulations will continue to be valid (subject to the regime in existence at the time the permit was issued), although this issue is not expressly addressed in the Regulations. Presumably, the limitations provided by the Regulations would not have retroactive effect.

It also seems reasonable to presume that if, upon effectiveness of the Regulations, an issuer is over the percentage limit of shares that may be placed abroad, its securities may not placed abroad until the securities meet the criteria set forth for a higher level (e.g., a movement from Quotation List B to Quotation List A). The Regulations do not address an issue of circulation (i.e., secondary market sales) of shares that are in the limit according to the current regulations (i.e., 30%) but, after January 1, 2010, would be over the limits provided in the Regulations.

Conclusion

The Regulations do not offer any potential benefits to Russian issuers, and limit the size of Russian issuers' depositary receipt programs. The Regulations may be intended to strengthen Russian financial markets by forcing investors to purchase shares of Russian companies in Russia. For Russian issuers contemplating an international offering, one of the main obstacles to raising capital under the Regulations lies in the requirement to obtain an initial listing at the relevant level. Perhaps the Regulations are also intended to ensure that only large companies experienced in placing their shares abroad can do so.

The Regulations may make it more attractive to establish a group holding company as an IPO vehicle in an offshore jurisdiction (e.g., Cyprus, the Netherlands, Luxembourg or Channel Islands with a Cyprus company as an intermediary holding company). In this scenario, the foreign holding company would then issue the securities and offer them on international stock exchanges. However, the FSFM might construe this as evasion of the Regulations, and prohibit such action. In addition, transferring the shares of Russian strategic companies to foreign holding companies would also probably require approval of the Government Commission for Control over Foreign Investment in the Russian Federation, which might likewise construe this as evasion and refuse to approve such a transaction.

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1 "Regulation on the Procedure of Issuance by the Federal Service for the Financial Markets of Approvals for Placement and (or) Organization of Circulation of Securities of Russian Issuers Outside the Russian Federation", approved by the FSFM order dated June 10, 2009 No. 09-21/pz-n and registered in the Ministry of Justice on October 2, 2009.

2 A placement is considered the issuance of securities by an issuer to its initial shareholders (i.e., sales of newly issued securities). A circulation is considered the conclusion of transactions that entail the transfer of title to securities (i.e., secondary market sales).

3 According to the current regulations, the limit is 30%.

4 The Strategic Sectors Law lists 42 sectors that the Russian Government considers to be of strategic importance. Any company engaged in any of the 42 listed activities is deemed to be a strategic company. The Strategic Sectors Law applies to proposed transactions that would result in a foreign investor controlling, directly or indirectly, a strategic company. However, the 5% limit mentioned above applies only to strategic subsoil companies.

5 Apparently, strategic non-subsoil companies, which are subject to a 25% limitation under the current regime, would be subject to the same requirements as Russian issuers that are not strategic companies at all.

6 The draft amendments are available on the FSFM web site at http://www.fcsm.ru/document.asp?ob_no=212785.

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Marketing Under the Alternative Investment Fund Managers Directive

by **Jim Baird**

The "Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers" (the "Directive") continues to stimulate considerable debate both within the European Union (the "EU") and amongst those who would seek to access its capital markets. In a break from the formal process of the "codecision" procedure where the European Parliament and the Council of the European Union propose successive drafts for consideration by the other, the Parliament and the Council have simultaneously published revised drafts of the Directive, respectively the "Gauzès Report" (named after the Parliamentary "rapporteur" allocated to this Directive) and the "Swedish Compromise Proposal" issued by Sweden as current holder of the Presidency of the Council of the European Union.

One of the few potentially positive elements of the original draft Directive published in April this year (the "Original Draft") was the introduction of a so-called "European Passport" allowing funds managed by alternative investment fund managers ("AIFM") authorised under the Directive to market the funds they manage in other European States under a single set of uniform arrangements. However, given that EU marketing rights are possibly the principal carrot (or depending on your perspective, stick) by which the Directive seeks to exert its influence outside the EU, the Directive's marketing provisions have been among the more controversial, particularly from the non-EU perspective.

The Original Draft Directive

The Original Draft permitted authorised AIFM to market the alternative investment funds ("AIF") they manage to professional investors in their home Member States and also provided the European Passport to market those AIF to professional investors in other Member States. In addition, the Original Draft allowed (but did not require) individual Member States to permit marketing of AIF to retail investors under national law, subject to additional conditions the Member State may impose.

However, the Original Draft was not without its difficulties. It provided for an effective standstill for three years before non-EU AIF could be marketed under the European Passport (which was widely seen as protectionist). Even after this period, the Original Draft required an OECD-model tax sharing agreement to be in place between the authorities in the AIF's domicile and each Member State where the AIF was to be marketed. It was also unclear whether the existing private placement regimes of individual Member States would be permitted to continue.

Further, the definition of "marketing" in the Original Draft was widely drafted and made clear that even if an investment was initiated by the investor, the simple fact of that investment itself still constituted marketing, thus effectively prohibiting investment even where no active marketing had occurred, unless within the narrow confines permitted by the Directive.

Given that EU marketing rights are possibly the principal carrot (or depending on your perspective, stick) by which the Directive seeks to exert its influence outside the EU, the Directive's marketing provisions have been among the more controversial, particularly from the non-EU perspective.

The Gauzès Report and the Swedish Compromise Proposal propose a number of changes to the marketing provisions of the Directive although, as outlined below, the position is still far from being clear (or for that matter satisfactory).

Definition of ''Marketing'' and ''Professional Investor''

The definition of "marketing" is key in shaping the extent of the Directive's marketing restrictions. Both the Gauzès Report and the Swedish Compromise Proposal would amend the definition of "marketing" so that investments made at the initiative of the investor would no longer in themselves be deemed to constitute marketing of the AIF. In addition, the Gauzès Report (and tacitly the Swedish Compromise Proposal) contemplate the involvement of intermediaries in the distribution of AIF under the Directive (although the principal rights to market are, generally, still derived from the authorised AIFM).

In an earlier draft, the Swedish Compromise Proposal also excluded information contained on websites from the definition of marketing. However, this is absent in the latest draft of the Swedish Compromise Proposal, suggesting that access to website material could be considered marketing.

The definition of "professional investors" (to whom marketing rights under the Directive are generally linked) is derived from that used in Annex II of the Markets in Financial Instruments Directive (or "MiFID"). The Swedish Compromise Proposal clarified that the definition of professional investor includes persons in part II of this Annex who may be treated as being professional investors, subject to passing an assessment based on certain criteria. Importantly, this would include certain private individuals, although the applicable requirements are such that very few individuals would actually qualify.

Home State Marketing Rights – Professional Investors

Both the Gauzès Report and Swedish Compromise Proposal retain the right of authorised AIFM to market AIF to professional investors in their home Member State under the Directive, but would expressly restrict this right to AIF domiciled in the EU. In addition, the Swedish Compromise Proposal would eliminate this right in respect of feeder funds unless they invest in a master fund that is both established in the EU and managed by an authorised AIFM.

Both drafts allow, but do not require, Member States to permit authorised AIFM to market non-EU AIF (and, in the case of the Swedish Compromise Proposal, non-compliant feeders) in their home Member States. This is, in the Gauzès Report, subject to additional requirements relating to cooperation agreements designed to ensure exchange of information in relation to systemic risk.

Marketing Rights – Retail Investors

Both drafts also retain the ability for Member States to permit marketing of AIF to retail investors under national law (subject to conditions such Member States may impose). The Swedish Compromise Proposal suggests that such marketing can be on either a domestic or cross-border basis, and includes a sensible provision that the requirements imposed on AIF marketed on a cross-border basis may not be more stringent than those marketed domestically.

The Gauzès Report is silent on the issue of cross-border marketing, but includes a further prohibition on sales to retail investors of AIF that invest more than 30% of their assets in other AIF that do not benefit from the European Passport. However, by linking this restriction to eligibility of underlying funds to the European Passport, the provision seems to go further than is required simply to avoid circumvention of the local retail marketing restrictions through the use of fund of fund structures and looks more like protectionism or product level regulation.

In addition, the Explanatory Statement to the Gauzès Report suggests a prohibition on retail investment in feeders that invest in a non-EU master. Taken together with other provisions, these support the notion, discussed further below, that private placement regimes, though permitted, will be restricted to professional investors.

The European Passport

Under both drafts, the European Passport would apply only for EU-domiciled AIF managed by EU AIFM. Therefore, the potential to market non-EU AIF under the European Passport after the three-year standstill (or indeed at all) has been removed. The provision in the earlier draft of the Swedish Compromise Proposal requiring review of this position after three years has also been removed, suggesting a consensus of sorts between the different EU legislative bodies. As such, the only way a non-EU AIF could access EU investors would be on a private placement basis under national law or by reverse solicitation.

Both the Gauzès Report and the Swedish Compromise Proposal make clear that the rights under the European Passport should not be circumvented through master-feeder structures. Therefore, a feeder would only be eligible for the European Passport where its master would also be eligible, thus denying the benefit of the passport for EU feeders into non-EU AIF (or other AIF that do not meet the requirements of the Directive).

The recitals of the Gauzès Report also suggest that where AIF invest more than 30% of their assets (measured on an aggregated basis) in non-passportable AIF, the European Passport will not be available. This raises real concerns as to whether a viable fund of funds structure could be operated or marketed in the EU. This could, for example, affect a UK non-UCITS retail fund of funds that invested more than 30% of its assets in non-passportable funds.

Private Placement Regimes

In light of the exclusion of non-EU AIF from the European Passport (and other marketing routes), national private placement exemptions (to the extent permitted by the Directive) have now become more important. Where the Original Draft left uncertainty as to whether existing national private placement regimes would persist, both the Gauzès Report and the Swedish Compromise Proposal express a positive intention in this respect (although there remain uncertainties as to the scope of permitted private placements particularly for non-EU AIFM). This is of particular importance for non-EU AIFM as the ability of non-EU AIFM to obtain authorisation under Article 39 of the Original Draft (that would have allowed such AIFM to access the Directive's marketing rights) has been removed from both drafts.

The Swedish Compromise Proposal and the Explanatory Memorandum to the Gauzès Report suggest that private placements under national law will be permitted, but that they will be limited to professional investors (which is narrower than many existing national private placement regimes, although wider than some Member States currently allow). The Gauzès Report makes clear that private placement regimes may continue, provided the AIFM is EU-based or an appropriate network of cooperation agreements is in place to ensure exchange of systemically important information. However, in neither draft is it entirely clear whether or to what extent active marketing by non-EU AIFM will be permitted.

Summary

The overall consensus emerging seems to be that the scope of the European Passport will be limited to EU AIF (in line with the approach in the UCITS Directive that provides a similar passport for retail products). Therefore, the need for private placement exemptions under national law not to be limited under the Directive becomes critical. However, the current drafts as they stand do not provide sufficient clarity as to the scope and availability of the private placement exemptions, although there seems to be a general move to permit such exemptions, as long as retail investors are excluded and risk information can be gathered. One might expect this to be one of the more closely fought battles, given that withholding EU marketing rights seems to be being used as a bargaining chip in achieving broader compliance with the Directive.

The key will be in achieving the distinction between deliberate attempts to circumvent the provisions of the Directive without impacting on legitimate fund of fund and master-feeder structures (and of course avoiding protectionist measures).

Another area of concern is the inclusion of the restrictions in relation to funds of funds and master feeders. While there is logic in applying rules to prevent circumvention of the Directive through feeder structures, the danger is that these rules will have the unintended consequence of restricting legitimate fund of fund structures. Indeed, as things stand, the rules could be seen from outside the EU as protectionist, if they do in fact restrict or limit marketing rights for AIF that invest in non-EU AIF, or prohibit marketing of non-EU AIF to retail investors under private placements where such marketing may be permitted for EU AIF. The key will be in achieving the distinction between deliberate attempts to circumvent the provisions of the Directive without impacting on legitimate fund of fund and master-feeder structures (and of course avoiding protectionist measures). It seems likely that further developments can be expected in this area.

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QFII and QDII Developments: PRC Regulators Issue New Rules on QFII and QDII Quotas

by **Keith T. Robinson, Henry Wang** and **Derek B. Newman**

After an extended hiatus, the PRC's State Administration of Foreign Exchange ("SAFE") has begun approving new foreign exchange quotas under both the Qualified Foreign Institutional Investor ("QFII") and Qualified Domestic Institutional Investor ("QDII") programs. To further accommodate the programs, SAFE has also issued rules and other guidance to improve the foreign exchange quota application process and administration. However, as regulators often giveth then taketh away, certain aspects of the new rules may create some challenges to industry participants.

Qualified Foreign Institutional Investor Program

SAFE recently released new rules[1] ("QFII Rules") raising the upper limit on quotas for a single investor under the QFII program to US$1 billion from US$800 million. The QFII Rules also address long-standing issues with respect to the foreign exchange administration of QFII investments, such as remittance and repatriation of an investment quota, account management, and disclosure and reporting requirements. However, perhaps the most significant aspect of the QFII Rules pertains to the restrictions placed on the transfer or sale of an investment quota. The QFII Rules supersede rules that had been in place since 2002 and are designed to encourage medium- and long-term foreign investment in Chinese securities and markets.

As regulators often giveth then taketh away, certain aspects of the new rules may create some challenges to industry participants.

Prohibition on Transfer or Sale of Quota

The QFII Rules now expressly prohibit the transfer or sale of an investment quota by a QFII license holder. Under the QFII Rules, such an action is considered "an unlawful use of foreign exchange," which may result in sanctions and the cancellation of the QFII license holder's quota. While the draft rules contained a carve-out from this restriction, the final QFII Rules impose an absolute bar, and in a press release SAFE made clear that the transfer or sale of an investment quota in any manner is prohibited.

This is a significant development for many fund managers (particularly private fund managers) that are not licensed QFIIs, but rather invest directly in China A shares and other RMB denominated securities via third party QFII quotas. This practice, commonly referred to as "leasing" or "renting" quotas, involves an investment manager (on behalf of a client) entering into a contractual arrangement with the QFII license holder for use of a portion of the license holder's quota. Securities acquired through this arrangement are registered in the licensed QFII's name.

As the QFII Rules do not contain clear grandfathering provisions, it is uncertain whether QFIIs will be required to back-out of any current arrangements of this type. However, SAFE officials have requested that all QFII license holders that have transferred or sold investment quotas to report the situation to SAFE. In light of this restriction, managers without QFII quotas may be required to apply for their own QFII license, or shift their focus to China A share index products.

Remittance and Repatriation of Investment Quota

Under the QFII Rules, a QFII license holder must remit its full investment quota within six months from the date the quota is granted. If the actual amount of principal remitted exceeds US$20 million but is less than the full quota, the approved quota amount will be revised downward to the actual amount remitted.

QFII license holders generally must agree to keep their assets in the PRC for a one-year "lock-up" period. However, in order to encourage long-term investment, certain QFIIs are granted preferential lock-up periods. The lock-up period for certain "long-term" investment funds, such as pension funds, insurance funds and mutual funds, is shortened to three months. Prior to the formal issuance of the QFII Rules, SAFE had been granting shortened lock-up periods on a case-by-case basis. The lock-up period for other types of QFIIs (*e.g.*, hedge funds) will remain one year.

Perhaps the most significant aspect of the QFII Rules pertains to the restrictions placed on the transfer or sale of an investment quota.

In addition to the shortened lock-up period, "open-ended China funds" ("OECF") (*i.e.*, publicly offered offshore funds that invest 70% or more of their assets in China's domestic market) enjoy favorable remittance and repatriation terms. For example, upon expiry of the three-month lock-up period, OECFs may freely remit funds into and repatriate funds out of China on a monthly basis so as to accommodate subscriptions and redemptions.[2] However, if the monthly remittance or repatriation amount exceeds US$50 million, prior SAFE approval is required. Furthermore, monthly

net repatriation does not reduce the OECF's quota amount. By way of contrast, other types of QFIIs may not repatriate funds out of China without prior SAFE approval, and repatriation below the approved quota results in a quota reduction.

Custody of Assets – Multiple Account Structure

As part of a long-standing effort to remedy structural challenges faced by QFII licensed fund managers proposing to invest client assets in China, the QFII Rules now permit a fund manager to open a proprietary account in its own name and separate accounts for client assets. The QFII Rules bring the custody/bank account structure into line with the securities account structure permitted under China Securities Regulatory Commission ("CSRC") rules issued in 2006. The CSRC rules permit multiple securities accounts in the QFII license holder's name and separate accounts in joint name with a client (*i.e.*, "QFII + fund" account). In order to maintain proper segregation of assets, QFIIs are not permitted to transfer funds between accounts.

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Reporting

The QFII Rules also strengthen reporting obligations. In the event that there is a change in control of the QFII license holder (*e.g.*, a merger) or other material event (*e.g.*, significant regulatory sanctions), the QFII is required to notify SAFE and amend its foreign exchange registration certificate. For example, a QFII-licensed institution that has received government assistance via a "bail-out" and is now partially government-owned may be required to notify SAFE regarding this change in ownership structure.

Qualified Domestic Institutional Investor Program

SAFE also recently released a circular (the "Circular"), which is intended to improve the foreign exchange administration of out-bound investments by QDIIs.[3] While many of the Circular's provisions are administrative or operational in nature, the Circular expressly prohibits a QDII from transferring or assigning its quota in any manner. The Circular further provides that if a QDII fails to use its investment quota within two years after approval, SAFE has the right to reduce the quota. This latter requirement may be significant for many QDII managers that, due to shaky demand for QDII products during the global economic crisis, may have large portions of unused quota.

The recent flurry of new quotas by SAFE under both programs is certainly encouraging, and the QFII Rules and the Circular generally provide a more sturdy and transparent regulatory footing from which properly licensed fund managers can participate in China in-bound and out-bound investment opportunities.

In addition to new regulatory guidance, industry sources are reporting that SAFE is issuing new quotas to QDII-licensed fund managers that plan to launch "collective investment accounts." As described in greater detail in an article appearing in Dechert's Third Quarter 2009 *Financial Services Quarterly Report*,[4] collective investment accounts permit fund managers to offer non-retail, alternative investment strategies to a limited number of clients on a "collective account" basis. The new quotas issued by SAFE are separate from the fund manager's existing quota dedicated to retail products, and are intended to be used for customized QDII products structured as collective investment accounts.[5]

Conclusion

The recent flurry of new quotas by SAFE under both programs is certainly encouraging, and the QFII Rules and the Circular generally provide a more sturdy and transparent regulatory footing from which properly licensed fund managers can participate in China in-bound and out-bound investment opportunities, respectively. However, the QFII Rules and Circular do change the QFII and QDII landscape somewhat (particularly for fund managers leasing quotas from third parties), which may force fund managers to re-evaluate their current practices.

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1 Provision on the Foreign Exchange Administration for Onshore Securities Investment by Qualified Foreign Institutional Investors (29 September 2009).

2 Monthly remittance and repatriation is based on the net difference between monthly subscriptions and redemptions.

3 Circular on the Relevant Issues Concerning the Foreign Exchange Administration of Overseas Securities Investment by Fund Management Companies and Securities Companies (13 November 2009).

4 *See* "Chinese Regulators Expand the Onshore Segregated Account Management Business," available at http://www.dechert.com/library/Financial_Services_Report_10-09.pdf.

5 "SAFE Allows Customised QDII Products," Asian Investor (9 September 2009).

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ALFI'S Task Force Report in Luxembourg: ALFI's Code of Conduct and Best Practice Guidelines for UCITS Depositaries

by **Marc Seimetz** and **Kristel Gilissen**

In December 2008, ALFI, the Association of the Luxembourg Fund Industry, set up the ALFI Madoff Task Force (the "AMTF") with several objectives, including to gather views from Luxembourg and foreign experts, stakeholders, investor representatives and various other parties regarding the consequences of Mr. Madoff's activities, and to identify ways forward and maintain investor confidence.

The two most important messages that were conveyed by the parties during the hearings were the necessity to strengthen investor protection and to clarify the role and responsibilities of the depositary bank. Such messages were analyzed and discussed by the AMTF in its Madoff Task Force Report that was published in September 2009, the main elements of which are discussed below.

Strengthening of Investor Protection

ALFI Investor Forum

Following the hearings, the AMTF proposed to launch an ALFI investor forum whose aim will be to focus on investors and on their needs and expectations regarding the asset management industry and products. Such a forum will create a platform for investors and permit the development of a dialogue between the AMTF and investors regarding topics such as transparency, investor education, information, and rights and obligations of all the parties involved in the chain of activities of the asset management industry.

ALFI Code of Conduct

Efforts to address recent market events have been incorporated, at the request of the AMTF, in the revised and updated ALFI Code of Conduct (the "Code"), which was inspired by the EU Directive 2006/46/EC of 14 June 2006. The Code contains high-level principles and best practice recommendations that may be useful to the boards of directors for their management of Luxembourg investment funds. The Code is not designed to supersede applicable law and regulations. Contrary to the above-mentioned Directive that only applies to listed companies, the Code covers all types of regulated Luxembourg investment funds that are supervised by the Luxembourg financial supervisory authority, the *Commission de Surveillance du Secteur Financier* (the "CSSF").

The main principles that are set out by the Code are enumerated below.

i. The board of directors of a Luxembourg investment fund should ensure that high standards of corporate governance are applied at all times.

ii. Board members should maintain good professional standing, have appropriate experience, and act fairly, independently and with due care and diligence in the best interest of the investors.

iii. The board should respect the principle of compliance with the fund's constitutional documents, applicable laws and regulations, and respect the principle of proper information and appropriate disclosure to, and equal treatment of, all shareholders.

iv. The board should ensure an effective risk management process and appropriate internal controls.

In addition, the Code provides specific recommendations on how to apply these principles.

Role and Responsibilities of the UCITS Depositary

The AMTF performed research on the legal regime of fund depositaries in Luxembourg, as well as in the other main European domiciles of undertakings for collective investment in transferable securities governed by Directive 85/611/EEC, as amended (the "UCITS Directive").

On the basis of such research, the AMTF was able to conclude that the Luxembourg legislation covering fund depositaries faithfully reflects the provisions of the UCITS Directive, and that Luxembourg has an appropriate framework for the protection of investment fund assets and investors, in line with applicable European standards. The AMTF concluded that the Luxembourg legal and regulatory environment is comparable to that of the other major European jurisdictions. The AMTF acknowledged further that the depositary regime provided by the UCITS Directive has worked well over many years and has set an appropriate standard for the vast majority of cases or situations with which depositaries had to deal or in which they were involved.

The AMTF also noted in its report that it is confident that the ongoing EU Commission's consultation on the UCITS depositary function will assist in clarifying a complex and difficult debate on the depositary function.

Regarding the liability of the depositary, the AMTF specifically addressed the option to harmonize the depositary's responsibilities amongst the UCITS depositaries by imposing very demanding standards on the depositary and to force the depositary to become an "all risks" insurer. The AMTF acknowledged that such option would ensure strong investor protection by requiring a depositary bank to return the assets at first demand in all circumstances. However, the AMTF specifically expressed its concern that the burden would be shifted primarily to the depositary and would not be shared with other stakeholders in the fund's chain of activities, which would not be a sensible and realistic way forward.

Furthermore, the AMTF report provides principles and best practice guidelines for depositary banks in relation to the safekeeping of assets of UCITS held either by sub-custodians through the traditional custody network or through a non-traditional custody network of the depositary. Assets that cannot be held in the traditional custody network are due to the nature of those investments (e.g., derivatives, third-party foreign exchange and deposits, investments in target funds not eligible through the traditional clearing systems, repurchase agreements and lending transactions).

The main principles and guidelines are the following:

1. Assets of UCITS held by sub-custodians through the traditional custody network:
   - The selection process, appointment and monitoring of the sub-custodian in relation to the safekeeping of the assets remains the responsibility of the Luxembourg UCITS depositary.
   - The depositary bank should perform proper (initial and ongoing) due diligence on those sub-custodians through an extensive assessment process.
   - In the case of omnibus accounts maintained at the sub-custody level, the depositary must ensure segregation at the fund/sub-fund level within its systems. At the sub-custody level, the assets should also be "ring-fenced" and held separately from the sub-custodian's accounts and (non-cash) assets. In no circumstances should proprietary assets of the sub-custodian be co-mingled on its books with client assets, to ensure that ownership on the client assets can be easily evidenced and therefore claimed.
   - Re-hypothecation of assets, where authorized by regulation applicable to the fund and the sub-custodian, should be subject to specific disclosure in the sub-custody contract and in the fund's prospectus.

- Sub-custodians are generally not identified in a fund's prospectus. However, for market-directed sub-custodians, a disclosure in the prospectus highlighting the specific risks of the market would be recommended.

2. Assets of UCITS held by third parties that are not held through the traditional custody network:

- With the expansion of the notion of "eligible investments" under the UCITS Directive, a broad range of asset classes are now transacted through, and held by, third parties that are not part of the depositary's global network. Depositaries cannot be liable for the selection of these third parties or ultimately for the associated counterparty risk. On that basis, the selection process, appointment and monitoring of the counterparties in relation to the safekeeping of these assets remains the responsibility of the board of directors of the fund or of the management company.
- It is acknowledged as a general principle that third parties should segregate the assets held on behalf of their clients from their proprietary assets, and ensure that accounts holding the assets of a fund (including collateral) should be opened in the name of the fund (or the sub-fund in case of an umbrella structure) or in the name of the depositary bank in favour of the fund.
- Re-hypothecation of assets, where authorized by regulation, should be subject to specific disclosure in the fund's prospectus, and the board of directors of the fund or of the management company should ensure that safeguards are in place to ensure that the safety and liquidity of the assets subject to the re-hypothecation are not compromised.

The AMTF further announced that more detailed guidelines regarding the role and responsibilities of depositary banks are to be expected in the months ahead.

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The German Courts and the Recently Elected German Government Fill Gaps in MiFID Fee Disclosure Rules


by **Angelo Lercara** and **Nicole Alexander**

Currently, German financial advisors who are subject to the Markets in Financial Instruments Directive ("MiFID") are required to comply with the MiFID fee disclosure provisions. Germany implemented the relevant MiFID disclosure provisions through the German Securities Trading Act ("WpHG"). MiFID included an exemption that allowed member states of the European Union ("Member States") to exclude the application of MiFID to persons who only provide the investment services of reception and transmission of orders in units in collective investment undertakings and the provision of investment advice in relation to such financial instruments, and who, in the course of providing that service, are only allowed to transmit orders to certain licensed entities.

While the German Courts developed fee disclosure rules on the basis of German civil law, the recently elected German government has established, in its Coalition Agreement of 26 October 2009, plans to subject exempt financial advisors to regulation under proposed legislation that possibly would include fee disclosure requirements.

Germany is one of only two Member States that made use of this exemption. Therefore, investment broking, contract broking and investment advice in respect of funds that are admitted to public distribution in Germany (such as UCITS) do not require a licence, provided the financial advisor does not receive or hold monies or shares from the investors.

However, recent developments in the German government and in the case law of the German courts also show a tendency to subject such exempt financial advisors to fee disclosure requirements. While the German Courts developed fee disclosure rules on the basis of German civil law, the recently elected German government has established, in its Coalition Agreement of 26 October 2009, plans to subject exempt financial advisors to regulation under proposed legislation that possibly would include fee disclosure requirements.

This article looks at the current situation regarding fee disclosure requirements for financial advisors and then gives an outlook on possible changes to the relevant legislation.

Fee Disclosure Requirements for Licensed Financial Advisors

In Germany, the MiFID fee disclosure rules are part of the business conduct guidelines and apply to financial advisors, who are considered to be investment services providers giving investment advice.

Investment advice is provided if a customer, or its representative, is provided with personal recommendations relating to transactions in certain financial instruments. The recommendation is personal if it is based on an evaluation of the investor's personal circumstances or is presented as being suitable for the investor and is not provided exclusively via information distribution channels or for the general public.

When providing investment advice, a licensed financial services provider is required to comply with the fee disclosure obligations. These state that an investment services provider may only receive inducements from or provide inducements to third parties (that are not customers of the service rendered) in connection with the provision of investment services if:

1. the inducement is aimed at improving the quality of the investment service and if there is no conflict of interest between the financial advisor's and the customer's interest; and
2. the existence, the kind and the scope of the inducement are properly disclosed to the customer before the provision of the investment service.

Inducements such as commissions, fees, any other payments, monetary benefits or so called "retrocessions" ("kick-back" commissions) must all be disclosed.

Disclosure Obligations of Exempt Financial Advisors

As noted above, certain financial advisors ("Exempt Financial Advisors") are exempted from the license. However, Exempt Financial Advisors do need a permit under general trade provisions contained in the German Trade Act.

An Exempt Financial Advisor is not considered to be an investment services provider. Therefore, although there may be some circumstances in which the MiFID disclosure obligations apply, such as where the Exempt Financial Advisor forms an integral part of a distribution chain run by a licensed entity, an Exempt Financial Advisor as a rule is not subject to the WpHG and the fee disclosure rules set out therein. However, as mentioned earlier, the German Courts have developed disclosure obligations for Exempt Financial Advisors.

It can be expected that the scope of exemptions from the MiFID obligations currently existing under German law will be reduced and that financial advisors will be subject to stricter rules. The exact scope of such possible further regulation remains to be seen.

The German High Court and the Lower Courts have developed some case law in relation to the disclosure of inducements that is also applicable to Exempt Financial Advisors. Generally, a disclosure is required where the customer's interest is specifically endangered by a conflict of interest. Under such circumstances, all inducements received by the Exempt Financial Advisor have to be disclosed. The case law shows a tendency towards balancing out the inefficiencies of the MiFID rules by subjecting Exempt Financial Advisors to disclosure requirements in relation to inducements under civil law rules. The Court decisions are mainly based on the idea of avoiding conflicts of interest as a principle of civil law that can be found, *inter alia*, in the provisions of the WpHG.

According to some authors in the German legal literature, such Court decisions may also be relevant for fund-linked insurance products and may also affect fee disclosure practices in the insurance industry.

Outlook

The disclosure rules developed by the German Courts may be introduced into legislation in the future, although, as a practical matter, both licensed and exempt financial advisors are subject to disclosure requirements at present. At the date of this article, it cannot be said with certainty if Exempt Financial Advisors will be regulated by the German regulator, the Federal Financial Supervisory Authority ("BaFin"), in the future and to what extent the MiFID obligations with respect to fee disclosure requirements will be applicable to them. The German government has given, in its Coalition Agreement, a clear indication of the future actions envisaged. Therein it is stated that the German parties of the coalition:

1. would like to create a consistent law for financial services providers to better protect customers from avoidable losses and incorrect financial advice; and
2. intend to secure, in principle, adequate investor protection against unreliable product providers or incorrect financial advice irrespective of the product or the distribution channel.

In the second respect, the German parties of the coalition explain that the liability for products and distribution should be tightened and that the requirements for advisors and brokers, especially in relation to qualification, registration and professional indemnity insurance, should be adapted to those requirements already in place for insurance agents and brokers. The overall aim of the further regulation is for clients to be able to quickly identify the main elements of an investment and all costs and provisions, including retrocessions.

Accordingly, it can be expected that the scope of exemptions from the MiFID obligations currently existing under German law will be reduced and that financial advisors will be subject to stricter rules. The exact scope of such possible further regulation remains to be seen.

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Countries Harmonizing Asset Disclosure Practices to Combat Tax Evasion

(continued from page 4)

One important measure adopted by the Global Forum was the institution of a peer review process to monitor the implementation of member states' commitments. The Global Forum's "Peer Review Group" is charged with examining the legal and administrative framework in each jurisdiction and the practical implementation of these commitments. The Peer Review Group will continually issue reports with recommendations for member and non-member countries, and countries will be expected to act on the reports' recommendations.

The Global Forum further adopted mechanisms to enable developing countries to benefit from a more cooperative tax environment. Developing countries stand to suffer the most from lost tax revenues, as they do not have the legal systems or the technological capabilities to locate assets that are hidden abroad to avoid taxation. The Global Forum committed to a coordinated technical assistance program to assist developing jurisdictions to implement the standards rapidly.

Long regarded as an international tax haven due to its bank secrecy laws, on March 13, 2009, Switzerland decided to change its policy on international cooperation in tax matters and adopt the OECD Standards.

Swiss Assent to the Standards and UBS' Disclosure of Account Holders

Switzerland has been a significant addition to the list of countries that have agreed to participate in the effort towards greater transparency and cooperation regarding tax information. Long regarded as an international tax haven due to its bank secrecy laws, on March 13, 2009, Switzerland decided to change its policy on international cooperation in tax matters and adopt the OECD Standards. Switzerland had signed 12 agreements that incorporate the Standards, as of mid-December 2009, including an agreement with the United States, making it a country that has "substantially implemented" the Standards.

The recent decision by the Swiss government and UBS AG ("UBS") to settle a tax evasion probe by the U.S. Internal Revenue Service (the "IRS") represents a major cooperative effort between Swiss and U.S. tax authorities. This ended a months-long effort by the IRS to obtain identifying information about holders of some 52,000 accounts held by U.S. citizens at UBS, which the IRS claims are being used to avoid taxes.

Every OECD member country, and many non-member countries, have now at least committed to exchanging information in conformity with the Standards.

The exchange of information will be conducted in accordance with the pre-existing double taxation treaty between the United States and Swiss governments, which allows for the exchange of information to the extent necessary to prevent "tax fraud and the like."[11] UBS will first turn the names of account holders over to the Swiss tax administration, which will determine if the names satisfy the eligibility requirements for disclosure to the IRS.[12] UBS customers will then have the ability to appeal a decision by the Swiss tax administration to reveal their identities to U.S. authorities.

Now what remains is to monitor the implementation and execution of the countries' commitments.

Conclusion

The OECD met with success in raising awareness of the problem of tax evasion and promoting methods to combat it. This is evident from the fact that every OECD member country, and many non-member countries, have now at least committed to exchanging information in conformity with the Standards. Now what remains is to monitor the implementation and execution of the countries' commitments. This task will fall to the Global Forum, and the measures adopted in Mexico are an important step in promoting bank transparency and the exchange of information for tax purposes.

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1 OECD, Countering Offshore Tax Evasion: The Role of the OECD (2009), *available at* http://www.usviedc.com/wp-content/uploads/oecd/Countering%20Offshore%20Tax%20Evasion.pdf.

2 OECD, Harmful Tax Competition: An Emerging Global Issue (1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf.

3 Communique: Meeting of Finance Ministers and Central Bank Governors, Berlin, 20-21 November 2004, *available at* http://www.g20.org/Documents/2004_germany.pdf. Fourth Session of the Committee of Experts on International Cooperation in Tax Matters, Note by the coordinator of the subcommittee on exchange of information: Proposed revised article 26 (October 2008), available at http://www.un.org/esa/ffd/tax/fourthsession/index.htm.

4 OECD, Overview of the OECD's Work on Countering International Tax Evasion (September 30, 2009), *available at* http://www.oecd.org/dataoecd/32/45/43757434.pdf.

5 OECD, A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard (December 7, 2009), *available at* http://www.oecd.org/dataoecd/50/0/43606256.pdf.

6 *Available at* http://www.oecd.org/dataoecd/15/43/2082215.pdf.

7 Austria, Belgium and Luxembourg also resisted implementation of Article 26 of the Conventions, but withdrew their reservations in 2009.

8 Agreement Between the United States of America and the Swiss Confederation ("U.S.–Swiss Agreement on UBS"), *available at* http://www.usdoj.gov/tax/txdv09_US_Swiss_Agreement%20_Decl_Signed.pdf.

9 The OECD has suggested that, at this point in time, a good indicator of progress is whether a jurisdiction has signed 12 agreements on exchange of information that meet the Standards. This threshold will be reviewed to take account of (i) the jurisdictions with which the agreements have been signed (a tax haven which has 12 agreements with other tax havens would not pass the threshold), (ii) the willingness of a jurisdiction to continue to sign agreements even after it has reached this threshold and (iii) the effectiveness of implementation.

10 OECD, Summary of Outcomes of the Meeting of the Global Forum on Transparency and Exchange of Information for Tax Purposes Held in Mexico on 1–2 September 2009, *available at* http://www.oecd.org/dataoecd/44/39/43610626.pdf.

11 U.S.–Swiss Agreement on UBS, *supra* note 8.

12 The United States and Swiss governments agreed not to disclose the specific criteria for revealing the names of the account holders until 90 days after the signing of their settlement.

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Risk Management for Investment Management Firms: Applying the Lessons from the Recent Financial Crisis

(continued from page 7)

Market and Credit Risk

In addition to risks attendant to investment in difficult-to-value instruments, all types of firms are subject to general risks of the marketplace, and to risks inherent in dealing with counterparties. Of course, the degree to which a firm is subject to such risks has a lot to do with market cycles, as well as the unique business practices of the firm. With respect to the recent market turmoil, the top four sources of systemic risk cited in Deloitte's survey were: increased use of leverage to finance investments, credit risk cycles and asset valuation bubbles, inability of markets and regulators to identify excessive aggregate risk, and increase in linkages and interconnectedness of markets produced by globalization. Having precise and effective risk management tools in place firm-wide before these types of systemic risks loom large is crucial to the successful navigation of risk in the marketplace over time.

One risk that can be particularly important for investment advisers to properly consider is basis risk (or correlation risk within an asset class), as well as correlation risk more broadly. As noted in the SSG Report, some firms are reconsidering what should be treated as a true hedge for risk management objectives. The use of both "conditional" and "unconditional" measures of market risk to provide information and limit risk was found to be beneficial. Additional risk measures that have been taken include those that reflect differences in assumed levels of correlations between market variables in benign versus stressed market conditions. All types of firms need sufficient abilities to identify consolidated, firm-wide, single-factor stress sensitivities, and concentrations.

Firm-Specific Risks

As the SEC staff's examinations found, a firm needs to be mindful of risks arising in its own day-to-day operations. This includes consideration of establishing the following:

- an effective reconciliation process to ensure data integrity and completeness;

- a dedicated group and/or committee effective in identifying and establishing controls for operational risks and integrating all systems and material operational risks; and
- consistent approaches to data, models, and processes in order to compile an aggregated view of the firm's risk.

In addressing firm-specific risks, it is important that the models themselves cover the types of risks discussed above (e.g., credit, market, and valuation risks) in addition to risks arising from new products, overlooked exposures and emerging risks.

An obvious but important point to take away from the varied studies on risk management is that the effectiveness of government regulation, as well as self-regulation of firms through their implemented risk management frameworks, is mainly driven by compliance with the discrete provisions of such regulations and frameworks. To successfully manage risk, firms must not only have complete up-to-date written legal and compliance policies and procedures, but they must also effectively monitor compliance and legal issues. Key ingredients to successful risk management mentioned by the SEC staff, for example, include legal and compliance committee approval for participation in new and high-risk business, products or transactions; the clear assignment of authority and responsibility for legal and compliance; and a strong overall compliance culture at the firm. While the requirements of the SEC's compliance program rules[7] are a useful starting point, firms should consider a deeper focus on risk management.

Transparency and Disclosure

Related to all compliance and risk management framework issues raised herein is the importance of providing clear, easily understood, risk-related information to the outside world in an appropriate level of detail. It is also important for fund operations and management personnel, including portfolio managers, to be informed regarding the risk profile of the products that they are overseeing or managing and to conduct investment operations accordingly. Transparency and disclosure are enhanced if management is actively involved in creating and updating risk disclosure. As discussed throughout this article and in others, senior management is ultimately responsible for setting the company's risk standards, and thus a regular review of risk disclosure is useful in encouraging management to effectively articulate those standards. Identifying important potential risks and providing clear information about those risks is a necessary part of a company's risk disclosure process.

While applicable legal requirements, such as those imposed by the Investment Company Act or the Investment Advisers Act, often contain some built-in risk management architecture, recent developments should provide an incentive for investment management firms to bring these programs to the next level with respect to being more comprehensive and better integrated, as well as developing more formal reporting and oversight structures.

Conclusion

Risk management in the financial services sector has been subject to increased scrutiny following recent market events. While practices vary widely by firm, studies have shown that many firms have not yet fully developed comprehensive, enterprise-wide, risk management programs. While applicable legal requirements, such as those imposed by the Investment Company Act or the Investment Advisers Act, often contain some built-in risk management architecture, recent developments should provide an incentive for investment management firms to bring these programs to the next level with respect to being more comprehensive and better integrated, as well as developing more formal reporting and oversight structures.

*This article is based on an article that originally appeared in the July 2009 issue of *The Investment Lawyer*.

1 For example, a bill recently introduced by Senator Christopher Dodd, the Chairman of the Senate Banking Committee, would create a new "Agency for Financial Stability" to monitor systemic risk, and the Treasury Department's June 2009 Financial Reform Proposal would establish a Financial Services Oversight Council, chaired by the Secretary of the Treasury, to monitor systemic risk.

2 Senior Supervisors Group, "Observations on Risk Management Practices during the Recent Market Turbulence," March 6, 2008 (SSG Report). Note that the period covered by this study concluded at year-end 2007.

3 *Id.*

4 Similarly, other commentators observed that most firms did not have fully developed risk management programs in place during the recent financial crisis and utilized silos rather than an enterprise wide risk management approach. *See, e.g.,* S. Bainbridge, "Caremark and Enterprise Risk Management," UCLA School of Law, Law-Econ Research Paper No. 09-08 (March 18, 2009) (*citing* Betty Simkins & Steven A. Ramirez, "Enterprise-Wide Risk Management and Corporate Governance," 39 *Loy. U. Chi. L. J.* 571, 577–586 (2008).

5 Speech by SEC Staff: "Risk Management for Broker-Dealers," 2007 AICPA/FMD National Conference on the Securities Industry, New York, Nov. 28, 2007.

6 Deloitte Center for Banking Solutions, "Risk management in the age of structured products: Lessons learned for improving risk intelligence."

7 Rule 38a-1 under the Investment Company Act and Rule 206-4(7) under the Investment Advisers Act.

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