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In this issue



Dechert LLP

## Challenge and Opportunity:

### International Regulatory, Legal and Other Developments Affecting Hedge Funds, Hedge Fund Managers and Their Strategies

by **Stuart Martin** and **Jennifer O. Epstein**

*This article first appeared in the* BNA International Report—Taxation of Investment Funds 2009. *Since its publication, developments in Europe have continued apace as Member States prepare for the G20 summit to be held in London on 2 April 2009. The following preface summarizes those developments.*

### Preface

Amongst the myriad of publications on the reform of the regulatory system is the European Commission's feedback statement and summary of responses (Feedback Statement) to its consultation on hedge funds (Paper). The main areas of consultation included systemic risks; market integrity and efficiency; risk management; and transparency toward investors and investor protection. The UK's Financial Services Authority (FSA) and H.M. Treasury published a joint response to the Paper and whilst they believe that there is a case for oversight of all entities that could contribute to macroprudential risk, they make it clear that, in their view, the individual risks posed by hedge funds are not unique and "regulatory interventions focused specifically on the sector are unlikely to be effective".

The Feedback Statement sets out the main messages emerging from the Paper. These are that:

(i) Hedge funds are complex products and as such are best reserved for sophisticated investors.

(ii) Many respondents felt that there were "inherent difficulties" in a regulatory response that took a "one size fits all" approach. Most respondents favoured an international or global approach to a purely European response.

(iii) Respondents generally had concerns in relation to the need for more effective monitoring of the impact hedge funds have on financial stability and market efficiency through risk management systems, organisational requirements and investment techniques such as short selling.

(iv) Respondents generally believed that supervisory authorities should have more information on hedge funds to monitor the systemic effect their activities have on markets.

These issues were discussed at a high level conference in Brussels at the end of February.

Charlie McCreevy, the European Commissioner for Internal Market and Services, made an opening speech to the conference in which he pointed out that hedge funds were not central to the current crisis. However, he went on to say that, "Hedge funds don't need to bring down a large bank before they become a source of systemic risk... In troubled markets, hedge fund trading has not always been the stabilising force that we expected. Instead, hedge funds have found themselves caught between a rock and a hard place – investor redemptions and tighter leverage have led to forced selling of assets, fuelling price declines. This is forcing us to think about the 'systemic-ness' not of individual hedge funds – but of hedge funds in the aggregate."

The discussions and responses to the Paper will contribute to the proposals on the regulation of hedge funds and private equity funds that the Commission intends to present in April. In addition, the responses will form the basis of the European input in this area for the G20 summit.

The de Larosière report produced by a high level group chaired by Jacques de Larosière at the instigation of the President of the European Commission, José Manuel Barroso, has considered the requirements of a new regulatory agenda, stronger co-ordinated supervision and effective crisis management procedures. Whilst the report notes that hedge funds did not play a major role in the economic crisis, the report calls for greater transparency. It states that at the very least, supervisors need to know which hedge funds are of systemic importance and should be aware of strategies, risk structure and leverage of systemically important funds. The report calls for the introduction of a formal authority to register these funds for the purposes of macro-prudential oversight and financial stability.

Industry groups are also anticipating change in this area. The Alternative Investment Management Association has announced a new transparency initiative and supports the principle of full transparency and supervisory disclosure of systemically significant positions and risk exposures by hedge fund managers to their national regulators.

We understand that that the UK Hedge Funds Standards Board and the U.S. President's Working Group are working together to produce a coherent approach to best practice standards.

The International Organisation of Securities Commissions (IOSCO) is continuing to carry on its work in this area through its task forces. In particular, the IOSCO task force on short selling expects to publish a consultation paper shortly.

The FSA has published the Turner Review, a regulatory response to the global banking crisis, as requested by the UK Chancellor. In his review, Lord Turner states that he believes that "the appropriate approach to hedge funds is that:

> Regulators and central banks in the performance of the macro-prudential analysis role...need to gather much more extensive information on hedge fund activities...and need to consider the implications of this information for overall macro-prudential risks.
>
> And regulators need the power to apply appropriate prudential regulation (e.g. capital and liquidity rules) to hedge funds..., if at any time they judge that the activities have become bank-like in nature or systemic in importance."

"People should be very frightened of the FSA."

Hector Sants of the FSA indicated in a speech that he is on track to radically reform the supervision practices of the FSA, making supervision more intrusive and direct. He also commented that, "There is a view that people are not frightened of the FSA. I can assure you that this is a view that I am determined to correct. People should be very frightened of the FSA."

In addition two tax bills that would affect hedge funds and hedge fund managers have been introduced in the United States. The first tax bill would make carried interests taxable as ordinary income. The second, called the Stop Tax Haven Abuse Act, would impose new anti-money laundering, disclosure and reporting requirements on hedge funds as part of an effort to stop tax evasion through offshore accounts, transactions and entities.

It appears from the issues discussed above that, although hedge funds are generally not seen to have been the root cause of the economic crisis, further regulation is inevitable and we will be closely monitoring these developments.

***The full text of the article in* BNA International Report—Taxation of Investment Funds 2009 *follows*.**

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# Challenge and Opportunity:

## International Regulatory, Legal and Other Developments Affecting Hedge Funds, Hedge Fund Managers and Their Strategies

Since the summer of 2007 the world has been grappling with a gathering economic storm initiated by sub-prime lending problems in the United States. These problems initially affected the valuation, liquidity and market value of a wide range of asset backed securities and other financial products. This resulted in a continuing and accelerating impairment of the balance sheets of banks, the reduction of market confidence in a number of banking institutions and a reluctance of banks to lend to each other and the market. This lack of confidence led to the collapse into administration and insolvency of Lehman Brothers which in turn further undermined confidence in banks generally.

As a result of these developments, governments around the world have been forced to take urgent action to secure the survival of the banking sector through various recapitalisation and bail-out plans. These initiatives continue but as we write it is clear that the crisis of confidence has moved into the general economy turning a global banking crisis into a severe economic downturn of an order and magnitude not witnessed in at least a generation.

During this period hedge funds and their managers have faced the challenges posed by an increase in redemptions as investors have sought to raise liquidity to meet their own liquidity obligations at the same time as underlying liquidity in assets has diminished, the availability of leverage and financing has severely reduced and the costs of financing leverage through margin and collateral charges have increased. This has forced many managers to take steps to manage liquidity offered to their own investors in order to balance the interests of redeeming and continuing investors. This has in turn affected the liquidity of funds of hedge funds and forced a number of funds in this sector to impose constraints on their own liquidity.

The crisis of confidence has moved into the general economy turning a global banking crisis into a severe economic downturn of an order and magnitude not witnessed in at least a generation.

Hedge funds have also faced unprecedented government intervention in short selling activities. In addition, as part of the response of governments around the world to the perceived failings in prudential and non-prudential regulation of banks, the hedge fund industry is facing the possibility of greater regulation of its activities.

This article seeks to highlight some of the principal affects on hedge funds of the current financial crisis, give an overview on the current moves towards greater regulation and draw some tentative conclusions as to the future.

## I. Impact of the global economic crisis on hedge funds and hedge fund managers

### A. Liquidity management

Hedge funds cover a variety of different asset classes and their strategies exhibit differing levels of liquidity. However, it is a feature of mainstream hedge funds that they are to a greater or lesser degree open-ended with subscriptions and redemptions being effected on prescribed dealing days at prices calculated with reference to net asset value.

A feature of the current financial crisis has been an increase in the level of redemptions faced by hedge funds accompanied by a decrease in subscriptions and therefore an increase in net redemptions. Whilst periods of net redemptions are not an unusual feature of open-ended funds, the problem for hedge funds has been the unprecedented decline in liquidity in world markets. As less liquid asset classes have become more difficult to sell, particularly in larger lot sizes, and traditionally liquid asset classes have become less liquid, the normal redemption policies adopted by hedge funds have come under pressure.

In the face of these difficulties hedge funds have sought to use a variety of methods to "manage" their liquidity. The traditional means of managing liquidity through suspensions and the imposition of gates have on the whole proved less relevant than would have been anticipated prior to the crisis. As a result, hedge funds have adopted a number of other means of returning available cash assets to investors in a manner which seeks to treat redeeming and continuing investors fairly.

One example has been the payment of redemption proceeds partly in cash and partly *in specie* or in kind where the *in specie* or in kind assets distributed as redemption proceeds are shares in a special purpose vehicle or, at the election of the investor, a run off or redemption class of the fund which has an economic interest in that portion of the fund's assets suffering from impaired liquidity. Following the disposition of the underlying less liquid assets of the fund, cash proceeds are then distributed to investors holding shares of the special purpose vehicle or the run-off/redemption class shares, as applicable, by means of a dividend or a compulsory redemption.

Other solutions have included offering investors the choice of receiving a run-off/redemption class which seeks to return cash as underlying assets are realised or, in the alternative, affirmatively electing to continue with the Fund subject to an extended lock up and revised liquidity terms. In other circumstances lock-ups have been adopted following affirmative investor votes.

Whilst periods of net redemptions are not an unusual feature of open-ended funds, the problem for hedge funds has been the unprecedented decline in liquidity in world markets.

The lessening of available liquidity has caused particular problems for fund of hedge fund managers. As the available liquidity of the underlying funds in which they invest has reduced, a number of funds of hedge funds have been forced to extend notice periods and adopt similar liquidity management techniques to those adopted by the funds in which they are invested.

These developments have already led to managers reviewing the hedge fund model in terms of liquidity profile and redemption terms particularly for new funds seeking to invest in distressed asset classes.

### B. Closures of funds, reduced seeding opportunities and managed accounts

In view of the liquidity problems in world markets and the increase in net redemptions, there has been an increase in the number of hedge fund closures. The need of institutional investors (including funds of hedge funds) for liquidity may well have contributed to the closure of funds with more liquid strategies.

In addition, the ability of new, start up managers to attract launch funding has reduced. This is not surprising given the liquidity difficulties being faced by fund of fund managers and the lack of certainly created by the financial crisis.

However investors remain willing to commit to hedge fund strategies, particularly where the potential to achieve value is perceived to exist, for example in distressed asset classes. Some institutional investors are seeking greater transparency through managed accounts whilst hedge fund managers themselves are seeking to secure greater certainty of investor commitment to their strategies through extended lock ups.

*continued page 27*

# Developments in Disclosure Reform: A Global Perspective

*Disclosure reform has been a hot topic among regulators in a variety of jurisdictions. Reforms are aimed at improving investor access to fund information and providing greater transparency in disclosure. Overall, there has been a focus in jurisdictions worldwide on the development of a more investor-friendly disclosure framework. The following series of articles provides a summary by Dechert lawyers regarding recent developments in a number of jurisdictions, looking in particular at developments in the United States and those associated with UCITS IV.**

## Disclosure – United States



by **John V. O'Hanlon, Amy McDonald** and **Stephanie A. Barkus**

### Mutual Fund Prospectus Enhancements

On January 13, 2009, the Securities and Exchange Commission ("SEC") published a release (the "Release") that adopts final rules revising the mutual fund disclosure framework to include a standardized fund summary for each fund offered in a prospectus. The rules also provide a new option for satisfying the prospectus delivery obligation, by allowing mutual funds to furnish investors with a summary prospectus ("Summary Prospectus") in hard copy, provided that the full statutory prospectus is available on the mutual fund's website. Also adopted in the Release are amendments to certain provisions of Form N-1A relating to exchange-traded funds ("ETFs"). These amendments are intended to provide investors who purchase shares of ETFs with more useful information regarding such funds. The effective date for the rules and amendments in the Release is March 31, 2009. The compliance date for the filing of a registration statement is either January 1, 2010 or 2011, as outlined in the Release.

The new rules are intended to improve investor access to information contained in mutual fund disclosure documents. The new fund summaries provide a standardized plain English format for key information investors may use in making investment decisions. The fund summaries are intended to make comparisons across funds and across mutual fund complexes easier and more accessible to investors. The Summary Prospectus delivery option aims to provide concise and accessible key information to investors, while maintaining the availability of the more fulsome disclosure provided by the statutory propectus, and avoiding the costs associated with delivery of hard copies of the full statutory prospectus.

The standardized fund summary, which is identical in content to the Summary Prospectus, prescribes specific topics in a designated order. A separate summary must be included for each fund offered in a prospectus. These items, and the prescribed order, are as follows: (1) investment objectives, (2) fee table, (3) principal investment strategies, risks and performance, (4) investment advisers and portfolio managers, (5) purchase and sale information, (6) tax information, and (7) financial intermediary compensation. The disclosure in fund summaries may not include information in addition to the above permitted items. Information provided in the summaries does not, however, have to be repeated elsewhere in the prospectus. If the information for the last three items (purchase and sale information, tax information and financial intermediary compensation) is identical for all funds covered by the prospectus, this information can be presented one time, at the end of all of the fund summaries. Each fund in the prospectus must have its own separate, self-contained presentation of the summary disclosure in plain English. A fund's summary may, however, reflect multiple classes of the fund.

The second set of rules contained in the Release permits, but does not mandate, the use of a Summary Prospectus to meet the statutory prospectus delivery obligation. If used, a Summary Prospectus must include the information (noted above) contained in the fund summaries in the statutory prospectus. The cover page of the Summary Prospectus must also include information regarding the availability of the full statutory prospectus, how to access the statutory prospectus via the internet, and how to request via the internet, telephone or email, a copy of the statutory prospectus and other fund documents. A fund may

satisfy the delivery requirement by providing the Summary Prospectus in electronic form consistent with existing SEC guidance, which typically requires affirmative consent from the recipient.

The third set of rules contained in the Release addresses the requirements in Form N-1A pertaining to ETFs, which are funds that are structured as mutual funds but neither issue nor redeem individual shares at net asset value. Instead, ETFs issue and redeem blocks of shares called “creation units” to and from financial institutions. The amendments serve to focus the disclosure provided in ETF prospectuses on the needs of secondary market investors rather than the financial institutions that purchase the creation units directly from ETFs. The rules eliminate the provisions requiring ETF prospectuses to disclose information on how investors may buy and redeem shares directly from the ETF and instead permit ETFs to include only information pertaining to investors purchasing and selling individual shares on secondary markets, through a broker-dealer. ETFs, however, are still required to disclose in the Statement of Additional Information how creation units are offered to the public. Notably, ETFs may not rely on the new provision if they have creation units of less than 25,000 shares.

## XBRL

On February 11, 2009, the SEC published a final rule requiring mutual funds to provide risk/return summary disclosure in their prospectuses (both statutory and summary) in interactive data format using eXtensible Business Reporting Language (“XBRL”). The provision of information in XBRL format is expected to make risk/return information easier for investors to access and to analyze, to assist in automating regulatory filings, and to increase the accuracy and reduce costs of mutual fund disclosure. The rule will become effective on July 15, 2009, and the date for compliance with the rule is January 1, 2011.

XBRL is the latest SEC initiative aimed at promoting efficient and transparent capital markets by decreasing the time and expense of accessing disclosures filed with the SEC. XBRL filers will be required to electronically tag the information provided in the risk/return summary section of their prospectus, including investment objectives and strategies, costs, risks, and past performance. Potential investors will then be able to compare this information across funds and across mutual fund complexes in a centralized and uniform manner.

The rule proposal regarding XBRL was released on June 10, 2008. One of the primary concerns of those who commented on the rule proposal was the assignment of legal liability surrounding publishing risk/return summary disclosure in XBRL format. Many thought the rule proposal did not adequately address the potential liability of mutual funds that provide XBRL information. The final rule provides expanded protection from liability for XBRL filers. New rule 406T of Regulation S–T addresses XBRL liability and lays out limited liability provisions for XBRL filings. Rule 406T will remain in effect until October 31, 2014, after which an XBRL filing will be subject to the same liability provisions as the related official filing.

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* Amy McDonald and Stephanie A. Barkus coordinated the series of articles in this multi-jurisdictional survey.

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# Disclosure – Europe: UCITS IV

by **Karen L. Anderberg***

The European Union, as part of a larger overhaul of the regulatory framework for undertakings for collective investment in transferable securities ("UCITS"), has adopted measures aimed at improving and simplifying the disclosure of key information to investors. The European Parliament approved the amended Directive on Undertakings for Collective Investment in Transferable Securities ("UCITS IV") on January 13, 2009. While UCITS IV remains subject to approval by the European Council, this approval is considered a formality. UCTIS IV provides for implementation by EU member states ("Member States") by July 1, 2011.

UCITS IV makes a number of significant changes to the UCITS framework. In particular, UCITS IV amends provisions relating to cross-border mergers of UCITS; provides for master-feeder UCITS funds; simplifies the cross-border notification process; provides for a management company passport, whereby a management company can manage a fund established in a different jurisdiction; and eliminates the simplified prospectus, which was criticized for often being too long, and replaces it with a document called "Key Investor Information."

UCITS IV amends provisions relating to cross-border mergers of UCITS; provides for master-feeder UCITS funds; simplifies the cross-border notification process; provides for a management company passport . . . and eliminates the simplified prospectus.

Articles 78 through 82 of UCITS IV outline the requirements with respect to the Key Investor Information document. The directive requires that the Key Investor Information document include information, written in non-technical language, about essential elements of an investment such that investors can reasonably understand the nature and risks of the investment. In particular, the following elements relating to a UCITS must be disclosed: (1) identification of the UCITS; (2) a brief description of its investment objectives and policy; (3) information about its past performance or performance scenarios, as applicable; (4) costs and charges associated with the fund; and (5) information about the risks associated with the fund's investments and the fund's risk/reward profile. UCITS IV specifies that investors should be able to understand these elements without referring to other documents. It also directs the European Commission to adopt measures further defining the information to be provided in general and in certain specific cases, as well as regarding the form and presentation of the Key Investor Information document, which should be uniform to allow for comparison.

Provision of the Key Investor Information document to investors will be required "in good time" before they purchase shares of a fund. Key Investor Information can be delivered by paper copy or via website, but a paper copy must be available free of charge on request. It must specify how an investor can obtain more information regarding an investment, including its prospectus and annual and semi-annual reports. Information in the document must be fair, clear, not misleading, and consistent with the prospectus. Civil liability will not be incurred for the Key Investor Information document unless it is misleading, inaccurate or inconsistent with the prospectus, and the document must include a warning to this effect.

The Key Investor Information document is similar to the Summary Prospectus in the United States in that it aims to improve investor access to information through the presentation of disclosure in a brief, standardized format written in non-technical language. Both the Key Investor Information document and the U.S. Summary Prospectus represent efforts to ensure that investors are receiving the essential information necessary to make an informed investment decision and also to assist investors in making comparisons across funds and across fund complexes.

* Amy McDonald and Stephanie A. Barkus also contributed to this article.

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# Disclosure – Luxembourg


by **Marc Seimetz** and **Antonios Nezeritis***

## Implementation of UCITS IV

UCITS IV, upon approval by the Council of the European Union, will require implementation by the Member States through national legislation. Considering its general awareness of the importance and positive influence of a well-functioning EU internal market for the Luxembourg fund industry, it is anticipated that Luxembourg will be among the first jurisdictions that will implement UCITS IV. The following is a summary of the issues Luxembourg is facing with respect to implementation.

Under UCITS IV, a management company will be allowed to provide the full range of collective portfolio management services to UCITS established in another Member State pursuant to the management company passport. Such services can be provided on a remote basis or by the establishment of a branch of the management company in the host Member State (which would not be subject to any authorization or additional capital requirements in the host Member State). The impact of such management company passport for Luxembourg is unclear. Whereas foreign promoters who wish to set up a Luxembourg UCITS currently create a Luxembourg management company or appoint an existing Luxembourg management company, it is likely that some of these promoters may wish to use a management company of their own jurisdiction in order to manage the Luxembourg fund in the future, which may cause a loss of business for the Luxembourg fund industry. On the other hand, it may also facilitate the choice for a Luxembourg UCITS for foreign promoters who already have a management company in their home Member State.

Cross-border mergers between all types of UCITS will be allowed and recognized by each Member State under UCITS IV. As a result of these new rules, it will be possible to merge UCITS without unanimity voting requirements, which will most certainly have a positive impact on cross-border mergers. Furthermore, the wording of the constitutive documents of a UCITS needs to be thoroughly revised to include the necessary provisions in order to enable such cross-border mergers. Luxembourg is also in favor of the new rules for cross-border master-feeder structures to facilitate the effective operation of the internal market and to ensure the same level of investor protection throughout the EU.

Considering its general awareness of the importance and positive influence of a well-functioning EU internal market for the Luxembourg fund industry, it is anticipated that Luxembourg will be among the first jurisdictions that will implement UCITS IV.

Regarding the replacement of the simplified prospectus by the Key Investor Information document, Luxembourg welcomes the idea of creating a comprehensive tool that will help retail investors reach informed investment decisions and that will replace the current simplified prospectus, which has proven to be of limited use to investors and a source of unnecessary costs for the industry. Except for some guidelines issued by the Committee of European Securities Regulators in relation to the information to be contained in the Key Investor Information document, implementing measures are still necessary in order to harmonize and determine its final content. It therefore remains to be seen if the Key Investor Information document will indeed be an improvement as compared to the simplified prospectus.

Under UCITS IV, measures will be taken to remove administrative obstacles and delays at the level of the national regulators. This move has been greatly welcomed by the industry although it is not expected that the speed of registration of foreign UCITS in Luxembourg will be affected, as the Luxembourg regulator is already very flexible and efficient where UCITS notification procedures are concerned.

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## Disclosure – Germany

by **Angelo Lercara**

As a consequence of the current financial crisis, the German government published a draft Act on 18 February 2009 that would amend the existing Bond Act so as to, among other matters, require additional disclosure in bond terms of the issuer's obligations, and strengthen the rights of investors in cases of alleged erroneous investment advice. The current Bond Act regulates the rights of bond investors, including their ability to approve amendments to bond terms during extraordinary events or due to the insolvency of the issuer. The German government appears to view the recent crisis as having exposed the rules as inflexible and overly restrictive from a bondholder's or noteholder's perspective. In the government's view, it is therefore necessary to amend the rules in order to create an efficient and flexible framework for matters requiring approval of bondholders and to align the rules with internationally recognized standards. Furthermore, the government has emphasized the need for a better transparency as to issuers' obligations. The draft Act therefore sets out mandatory minimum requirements for disclosure of issuers' obligations in bond terms.

The draft Act also seeks to address the disclosure requirements of investment advisers in light of the financial crisis. The Act would introduce a requirement to maintain appropriate advisory records. Such records would be required to include the basis of the advice and when it was rendered, information relating to the client's understanding of risk on which the adviser's recommendations are based, the clients' requests or specifications and their weighting for the recommendation and details of the recommendations themselves as well as the reasons for the recommendations made. A copy of the record must be provided to the client. The records are intended to ensure that investors can appropriately assess possible civil claims for erroneous advice. The Act would also ensure that the German Regulator, BaFin, is able to easily assess whether the regulated entity is complying with the respective MIFID rules.

The draft is at an early stage and needs to be discussed and approved by the German Parliament (*Bundestag*). It is intended to be enacted during the current legislative period, which ends in September 2009.

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## Disclosure – Belgium

by **Pieter Kortbeek**

### XBRL and the Path to UCITS IV

The EC directives on annual accounts, consolidated accounts and auditing, as well as the transparency directive, the market abuse directive and the prospectus directive, have been implemented into national law by the European Member States. As a result, they now possess an impressive regulatory apparatus for financial disclosure that aims to contribute to the efficiency of the financial markets. In Belgium, this process was guided by the Belgian financial supervisor (the "CBFA"), working in close relationship with the Committee of European Securities Regulators.

Given the need to make increasingly voluminous data available to all market participants, ongoing debate and initiatives are taking place, both at the European and Belgian levels, regarding the use of XBRL. In Belgium, interesting developments are taking place. For example, since 2007, all annual accounts by Belgian companies have to be filed with the central bank in XBRL format. To date, 75% of the companies have achieved this goal. The central bank now envisages making the technology available to the public to permit all investors to search and make calculations. Some of the capabilities that could be introduced would allow business partners to determine, on the basis of their own calculation models, the failure risk of those with whom they are engaging in negotiations or maintaining credit lines. By establishing the technical possibility of performing these "private credit ratings," annual accounts will become more effective as instruments to protect business partners.

With respect to UCITS investment funds, the recent approval by the European Parliament of the proposal for the UCITS IV directive is considered by the Belgian fund industry to be an important step forward toward a true level playing field in this area, resulting in new business opportunities and a reinforced attractiveness of UCITS. For investors, UCITS IV is likely to bring an increased choice of funds and a greater ability to make informed investment decisions. Much is to be expected from the Key Investor Information that replaces the simplified prospectus, as it will result in product information that is short, focused and presented in a way that allows comparisons to be easily made between offerings. Until the arrival of national UCITS IV implementation, the current Belgian prospectus regime will be maintained based on the federal act of July 20, 2004 on UCITS, the Royal Decree of March 4, 2005 and CBFA circulars.

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## Disclosure – Hong Kong and Singapore

by **Kher Sheng Lee***

### Enhanced Disclosures and Investor Protection

In October 2008, Hong Kong's Securities and Futures Commission ("SFC") issued a circular (the "Circular") requiring all issuers of retail investment products to review their risk disclosure and product descriptions in existing fund offering and promotional documentation, and to consider their adequacy in light of the market turmoil triggered by the collapse of Lehman Brothers. The Circular requires that marketing materials issued be "clear, fair and present a balanced picture with adequate and prominent risk disclosure in compliance with all applicable regulations."

In a letter dated December 5, 2008 sent to issuers of SFC-authorized products (the "Letter"), the SFC provided the first set of guidelines on the interpretation of the Circular, and the SFC's expectations on disclosure levels in marketing materials and offering documents. The guidance applies to retail mutual funds, investment-linked assurance schemes and, to a certain extent, products offered under the Mandatory Provident Fund schemes (mandatory retirement savings schemes applicable to most employees in Hong Kong).

The following points extracted from the Letter are of particular significance to retail mutual fund issuers and distributors:

- "All principal risks should be prominently disclosed."

The SFC expects that risk disclosures must be in plain language and must be presented in such an obvious manner that ordinary layperson investors cannot have reasonably ignored them.

- "Key product features and risks should now be presented in a few key bullets in a text window appearing on the front cover of the offering document or marketing brochure."

The SFC expects the key features and risks to be summarized for investors upfront; for example, the worst case scenario that the investors should be aware of should be included.

- "Financial or other incentives in investing in a product should not be used or presented in such a way that is likely to divert or mislead investors' focus from the proper consideration of the product."

The trend is being echoed in Singapore, where the Monetary Authority has proposed various initiatives to improve effective disclosure to investors of unlisted investment products. These include supplementing offering documents with a "Product Highlights Sheet" (similar to the Key Investor Information document proposed under UCITS IV) which will set out key information in a clear, concise Q&A format using plain language, and for which issuers will be responsible for both origination and on-going compliance. Where the product is a "complex investment product"[1] the offering document, Product Highlights Sheet and all marketing and advertising material must clearly state that the product is a complex investment.

[1] This is a new category of investment product with embedded derivatives (derived from the EU MiFID definition of "complex products") and which includes funds with an "investment approach directed at delivering returns from investments in derivatives" as well as those investing in structured products.

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# SEC to World: "Don't Forget to Register"

by **Elliott R. Curzon** and **Edward L. Pittman**

*Non-U.S. issuers, traders, investment bankers and other financial services providers who do business in the United States must be mindful of broker-dealer registration requirements.*

## Background

Recent turmoil in the financial markets and a new pro-enforcement Securities and Exchange Commission ("SEC") have changed the regulatory landscape for most participants in the U.S. financial markets. In addition to the scandals and insolvencies that have highlighted the systemic risks associated with the global nature of the securities markets, the SEC is demonstrating an increased interest in the activities of non-U.S. offshore financial market participants that may be operating in the United States without complying with broker-dealer registration requirements.

Global cooperation among securities regulators may be at a new high as a result of coordinated efforts to implement measures to stem short selling and address uncertainty in settlement systems. However, last year's efforts by former SEC Chairman Christopher Cox to facilitate cross-border transactions by recognizing comparable regulatory structures in other countries appears to be on hold. And, the SEC's new Chairman, Mary Schapiro, already has signaled that at least some of the international initiatives commenced by the SEC under Chairman Cox may be delayed in favor of renewed efforts to police the activities of non-U.S. market participants operating in the United States.

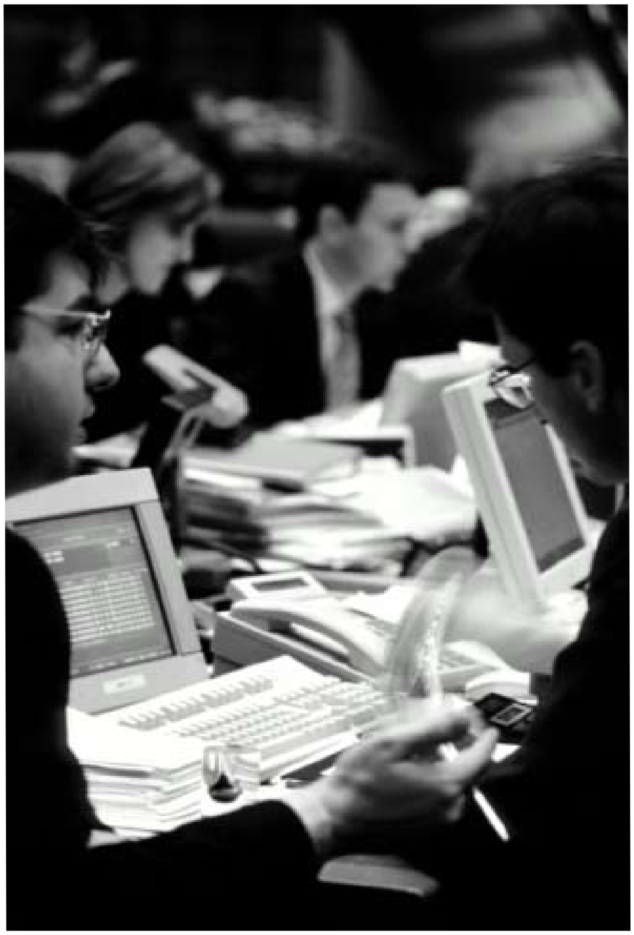
Despite recent proposals to modernize regulation of global transactions, the U.S. registration regimes applicable to persons participating in the offering of securities, including individuals associated with corporate issuers and hedge funds, have remained static. Moreover, the SEC recently announced almost unprecedented enforcement actions against two non-U.S. firms for failing to register in the United States as broker-dealers. The collapse or near-insolvency of major global financial institutions, and the pricing, creditworthiness, and counterparty issues involving U.S. and offshore securities products, is likely to result in further SEC enforcement interest. Every non-U.S. firm doing business with U.S. investors, from offshore issuers of funds and other specialized or alternative investment products; the managers of those products; traders; merger, acquisition and business combination specialists; and research and other financial services providers should be prepared to face increased scrutiny by U.S. regulators. And, while these comments are focused on non-U.S. persons, they apply equally to U.S. persons engaged in similar domestic activity.

The collapse or near-insolvency of major global financial institutions, and the pricing, creditworthiness, and counterparty issues involving U.S. and offshore securities products, is likely to result in further SEC enforcement interest.

The United States takes a broad view of its regulatory interests. The SEC's interest generally does not extend to instances in which a U.S. person initiates a transaction or a relationship with an offshore firm. However, contacts with U.S. investors that are initiated by offshore firms and individuals and are designed to solicit transactions in securities – either by individuals or institutions – may require U.S. broker-dealer registration. From the perspective of the regulators, registration is necessary to assure that such entities comply with U.S. regulations designed to prevent overreaching, safeguard customer funds and securities, and permit the SEC and other U.S. regulatory authorities to examine the operations of the soliciting entity.

### Issuers and Hedge Funds Offering Securities in the United States

While most people think of broker-dealers in the context of secondary market transactions, the U.S. broker-dealer registration regime also applies to issuers and their employees who offer financial products or services to U.S. persons. Often, the employees of issuers, including hedge funds and their managers, play an integral role in raising capital. In many cases, they are unaware that if they receive sales-based compensation or are active in calling on U.S. investors, they may be required to register in the United States



as broker-dealers. In fact, often, they may be under an erroneous impression that because the securities themselves need not be registered in the United States, they may engage in selling activities through private placements or offerings limited to institutions, without registering as broker-dealers. However, *qualifying the security for sale to particular investors does not qualify the salesman*. The registration or exemption of the security does not determine whether the individuals involved in the sales effort need to be registered as *broker-dealers*. Broker-dealer registration is triggered by engaging in the business of offering or facilitating a securities transaction, or participating at key points in a securities transaction.

## Investment Banking Activity in the United States

Non-U.S. investment bankers who engage in merger and acquisition services involving U.S. companies as purchasers or sellers, or who assist in placing securities with U.S. institutional investors, often are advised that they should be registered as broker-dealers in the United States if they wish to offer these services. Moreover, as explained below, the companies and issuers who engage these professionals also may have a stake in assuring that the transactions are conducted in conformance with U.S. broker-dealer registration requirements. While registration may not be required in every instance, it is important in each case to examine the nature of the conduct and determine whether the entity would be considered to be "engaged in the business of effecting transactions in securities" within the United States. Persons participating in asset sales as opposed to mergers or acquisitions involving the exchange of securities are not required to register as broker-dealers. In addition, very limited merger and acquisition services may be permitted without registration, or conduct occurring on an isolated basis may not require registration.

## Providing Brokerage, Trading, or Research Services in the United States

The U.S. appetite for global investing and the sheer size of the U.S. market has encouraged offshore brokerage firms to reach out to U.S. institutions to offer market-specific knowledge and execution capabilities, as well as research, designed to develop a trading relationship. As noted above, relationships generated by U.S. institutional investors generally will not subject a non-U.S. entity to the broker-dealer registration requirements. However, if a non-U.S. firm solicits[1] institutions and investors in the United States by, among other things, making sales calls or providing research, then the firm must generally register as a broker-dealer. An SEC rule provides a conditional exemption from broker-dealer registration for non-U.S. firms that affiliate themselves with U.S. registered broker-dealers. While the SEC had proposed expanding the terms of the exemption to permit offshore firms to more freely contact certain institutional investors without registering in the United States, at least for the time being that proposal may be a casualty of the recent financial market problems that, among other things, have revealed some confusion among U.S. investors about the safety of their cash and securities held by non-U.S. firms.

An equally serious problem may arise if the non-U.S. broker has a registered broker-dealer affiliate operating in the United States, and if the U.S.-registered firm establishes the customer relationship and then permits unsupervised contacts with a non-U.S. trading desk. Recent SEC enforcement actions have highlighted this issue. For example, in December 2008, the SEC brought an action against CentreInvest, a Russian broker-dealer with a U.S.-registered broker-dealer subsidiary, for effecting securities transactions in the United States without being registered, and against its U.S. subsidiary for aiding and abetting the violation. In this case, the SEC alleged, among other things, that representatives of the U.S.-registered broker-dealer solicited U.S. investors on behalf of the Moscow-based parent.

Another problem can arise in instances in which a non-U.S. entity seeks to leverage customer relationships with its U.S.-registered affiliate. One large non-U.S. firm recently was subject to significant sanctions by the SEC for not registering in the United States, when, among other things, its representatives traveled to the United States on a regular basis, and made presentations to U.S. institutional investors and high net worth clients in meetings that were arranged by the registered U.S. affiliate. The non-U.S. firm also sent representatives to client events, organized by the U.S.-registered affiliate, with the purpose of generating offshore business. While, from a business perspective, it may make sense to leverage client relationships in the United States, or to have U.S. institutions speak directly with the non-U.S. trading desk, care must be taken that these contacts do not present jurisdictional issues under the U.S. registration regime.

### Risks of Not Registering as a Broker-dealer

The risks of selling securities while not registered can be severe: SEC enforcement action can bring fundraising to a screeching and unpleasant halt. Monetary penalties, restrictions on future activity, regulatory disclosures and bad publicity for the issuer, manager, banker or the fund can make future fundraising, engagements and employment difficult. Unregistered brokers in recent settlements with the SEC have been forced to disgorge profits earned from their activities over many years, and in some cases, have received additional fines that represent multiples of their earnings while unregistered. As noted above, U.S. affiliates also may be charged with aiding and abetting the registration violations if they are complicit in making introductions or provide other assistance. For an issuer, manager, or banker that is a public company or its subsidiary, these events may also require formal disclosure in public filings.

In addition, failure to register may expose the firm to civil remedies in lawsuits brought by investors. Such remedies might include voiding existing obligations, recapturing commissions, and possibly rescinding completed transactions – in effect giving the investor a put to the issuer. The same laws that require a non-U.S. broker to register if it does business in the United States also permit rescission of contracts or agreements with brokers that violate the law by not registering. The right may last up to two years from discovery that the purchase or sale was made through an unregistered broker-dealer or up to five years from the date of the purchase. Recent market and economic conditions may encourage investors to seek these remedies.

The risks of selling securities while not registered can be severe.

### Conclusion

The globalization of world markets is unlikely to be halted by recent events. However, the SEC may put the brakes on initiatives that would have eased access by non-U.S. firms to U.S. investors. For the time being, it also appears that the SEC is increasing its emphasis on enforcing the U.S. broker-dealer registration requirements in the context of non-U.S. firms doing business with U.S. investors. Offshore private funds, investment bankers, and brokerage firms that offer products or services in the United States may be subject to increased scrutiny by the SEC, and should carefully consider whether their activities in the United States require U.S. broker-dealer registration.

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[1] The SEC interprets the term "solicitation" very broadly.

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## Hong Kong/Greater China Developments

### The Minibond Saga Continues

by **Angelyn Lim** and **Kher Sheng Lee**

After the collapse of Lehman Brothers in September 2008, callable credit-linked notes and other similar structured products that had been sold in Hong Kong and other countries in the region under the name "Minibond" were impacted by the global credit crunch, which caused collateral for these Minibonds to lose all, or a significant portion of, their value.

Following a flood of more than 27,000 investor complaints to the Hong Kong Securities and Futures Commission ("SFC"), and the matter becoming gradually politicized due to the number of retail investors affected in Hong Kong and protesting in the streets, the Hong Kong Monetary Authority ("HKMA") and the SFC initiated separate investigations into the sale of Minibonds to Hong Kong retail investors, and the impact of the subsequent failure of such products.

The most common complaints received by the regulators alleged that:

(a) the products had been misrepresented to investors as low-risk alternatives to deposits, and their risks and complexity had not been properly explained by distributors;

(b) the products were too complex and risk disclosures had been ineffective in alerting investors; and

(c) as a result of the above, and the failure of promoters, brokers and banks selling the products to conduct proper customer due diligence, inexperienced retail investors were left holding products not suitable to their investment profile, in which they would not have invested had they been aware of the true nature of the products.

Despite the fact that, in many cases, the investors had signed a statement to the effect that they "had read and understood [the] programme prospectus and this issue prospectus", many complainants maintained that they had, in fact, neither read nor understood either document. The complaints brought to the fore the extent to which distributors were able to rely on the caveat emptor risk statements commonly contained in product offering documentation, as well as representations made by investors in the application forms (that they had received, read and understood the contents of the offering and constitutive documents of the product).

Promoters and distributors of retail products in Hong Kong are subject to certain codes of practice and guidelines issued by the SFC. Relevant among these is an obligation for distributors and investment advisers to conduct independent due diligence (regarding both client and product) to seek to ensure product suitability before making any investment recommendations. As described below, this obligation became the focus of the regulators, as well as aggrieved investors. As investigations progressed, it became clear that such obligation unfortunately had not been an area of focus, or of sufficient focus, by most of the affected distributors of the Minibonds.

In early October 2008, the SFC issued a written reminder to issuers of retail investment products, regarding their duty to ensure that "their offering documents remain up-to-date and contain sufficient information necessary for investors to make an informed investment decision.... [M]arketing materials issued must be clear, fair and present a balanced picture with adequate and prominent risk disclosures in compliance with all applicable regulations."

In mid-October, the SFC announced it would investigate the selling practices, and alleged mis-selling of Minibonds, by 24 banks in Hong Kong. Intermediaries were also reminded in late October to accelerate their internal mis-selling inquiries.

In December 2008, the HKMA and the SFC issued their respective reports on the investigations which they had completed. The SFC's recommendations included:

1. a review by the regulators, together with the relevant government authorities, of the existing regulatory structure, in view of the increasing complexity of financial instruments not properly covered or regulated by existing legislation, codes of practice or other guidelines; and the possible establishment of one integrated "super" regulator along the lines of the FSA in the UK;
2. a review by the regulators of investment product selling practices at commercial banks;
3. a requirement for enhanced risk disclosure statements in offering documents and marketing materials of retail products;[1]

4. a review by the SFC of the definition of "professional investor" under the securities legislation, given that such category of persons would not be afforded the protection extended to retail investors and because past fact situations have shown that investors who may, technically, satisfy the asset worth threshold of a "professional investor" may, in fact, be a "retail investor" in all other respects; and
5. a requirement that commissions earned by brokers be disclosed.

Penalties for misconduct, which may be meted out by the SFC, include public reprimand, fine, suspension or removal from the list of registered/licensed persons (banks are registered persons in Hong Kong).

Over the course of the last quarter of 2008, when investigations (and the public outcry) were on-going, a number of banks reached settlement agreements with individual aggrieved investors, most of whom were either elderly, mentally challenged or otherwise reasonably unlikely to have agreed to invest in a high-risk investment, given their investor profile.

Sun Hung Kai Investment Securities Limited ("SHK"), a prominent local securities house, sent waves through the local market in late January 2009 (following an SFC investigation into SHK's selling practices) by agreeing, pursuant to a settlement agreement with the SFC, to make a voluntary offer to purchase all outstanding Minibonds bought by SHK's eligible clients, at a price equal to the principal amount which had been invested by each client (an aggregate sum of approximately HK$85m (approximately US$11 m)). In the settlement agreement, SHK did not admit any wrongdoing or liability in connection with the original sale of the Minibonds.

The SFC issued a reprimand to SHK and a condition that, if the same concerns about SHK's selling practices were to arise within 18 months following SHK's internal control procedures enhancement exercise (itself to be completed within six months of the settlement agreement), SHK's regulated activity licences would be partially suspended for three years and it would not be permitted to sell or distribute unlisted or structured products or provide advice on the same during that period. SHK also voluntarily engaged an independent audit firm to review its internal control and compliance issues.

Of the SFC's recommendations listed in their investigative report, the impact of the review of investment product selling practices at commercial banks, and the requirement for enhanced risk disclosure statements in offering documents and marketing materials of retail products, are already being felt in the market, in the heightened internal control procedures and disclosure. Commercial banks now have until 30th September 2009 to separate traditional banking activities (e.g. receipt of deposits) from retail securities business, preferably also segregating the risk analysis and product promotion processes. Banks have until 30th June to install recording systems to record client conversations on investment products, and such recordings must now be maintained (like other customer records) for a minimum of seven years after they are created. While these measures may not necessarily prevent another Minibond episode from occurring, it is the general consensus that a major contributory factor to the current episode was the lack of effort by the Minibond promoters (a majority of which were commercial banks) to ensure product suitability for the retail investor.

The general feeling among non-bank licensed industry participants (including investment managers, advisers, distributors and other intermediaries) is that, after the dust has settled, the result will be a more level playing field between the registered persons (largely banks whose primary regulator at the moment is the HKMA) and the licensed persons (whose primary regulator is the SFC), so that the same set of regulatory requirements and ongoing obligations will apply to all participants.

While there are now also proposals to increase the asset threshold requirement of individual and corporate "professional investors" and to increase the attention paid to investor education initiatives, the general consensus is that it is unlikely that Hong Kong will see the birth of its own integrated super-regulator any time soon.

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[1] For a more detailed discussion of the enhanced risk disclosures, please refer to the Dechert OnPoint dated January 2009, available at http://www.dechert.com/library/FS%20_1_01_09_Hong_Kong_Securities.pdf.

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## Hong Kong and Shanghai Exchanges Sign Cooperation Pact

by **Keith T. Robinson** and **Derek B. Newman**

Hong Kong Exchanges and Clearing Limited ("HKEx") and the Shanghai Stock Exchange ("SSE") recently signed a "closer cooperation agreement" ("Cooperation Agreement") whereby each exchange will focus on improving cooperation with respect to information sharing, product development and personnel training. The move is expected to better facilitate the domestic and international fund-raising needs of Chinese companies, while helping Hong Kong to solidify its status as the leading international financial center for investors accessing mainland Chinese markets, and for Chinese companies accessing non-Chinese investors and markets.

As noted by Ronald Arculli, chairman of HKEx, at the signing ceremony, the Cooperation Agreement will "eliminate potential regulatory and operational arbitrage by aligning rules and regulations, as well as the operations of markets and exchanges in the Mainland and Hong Kong." Through closer cooperation, the SSE hopes to leverage HKEx's familiarity with international standards and best practices, and its general experience in dealing with global investors and issuers. Conversely, HKEx expects closer cooperation to lead to a better understanding of the needs of Mainland investors and intermediaries and, as a result, to strengthen its position as a platform for investment out of China via the latter's Qualified Domestic Institutional Investor ("QDII") program. The QDII program permits selected Chinese commercial banks and fund management companies, among other institutions, to raise domestic assets for investment in overseas markets.

In terms of product development, HKEx and the SSE will work to develop a variety of new products, such as China A share ETFs and SSE-listed REITS. In addition, the two exchanges will cooperate to expand the availability of China A share-based derivatives, such as futures and options, and other derivative instruments, which will benefit a wider range of market participants. Currently, access to renminbi denominated A shares by non-Chinese investors is limited. These developments should allow greater and more efficient access by such investors to the A share market and also allow better management of the risk of their A share exposure.

The Cooperation Agreement is the latest step in a trend of increasing collaboration between the two exchanges. In May 2002, HKEx and the SSE signed a memorandum of understanding, and have more recently entered into a market data collaboration program. Although the SSE has indicated that market stabilization will continue to be its first priority for 2009, it anticipates moving forward with its cooperation with HKEx and the exchanges' joint product development objectives.

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# The German Investment Risk Limitation Act

## Amended Notification Requirements for Holdings in German Listed Companies


by **Angelo Lercara** and **Nicole N. Alexander**

The Act to Limit the Risks Associated with Financial Investments, the Investment Risk Limitation Act (the "Act"), aims to create further transparency in the German capital markets. The Act introduces changes to, *inter alia*, the German Securities Trading Act ("WpHG"), the German Securities Acquisition and Takeover Act ("WpÜG"), the German Works Constitution Act ("BetrVG") and the German Civil Code.

The Act was published in the Federal Law Gazette on 18 August 2008, with its provisions entering into force in three phases on 19 August 2008, 1 March 2009 and 31 May 2009.

The most significant changes came into effect in the first phase on 19 August 2008. This phase introduced amendments to: (1) the BetrVG, providing a company's Finance Committee with extended information rights in relation to takeovers, and (2) the WpÜG and the WpHG, adjusting the scope and definition of "acting in concert", providing for easier identification of registered shareholders and imposing limitations on the sale of loans in order to protect retail clients.[1] The second stage, which came into force on 1 March 2009, amended the share notification requirements in the WpHG by requiring notification of both actual voting rights and rights to acquire voting interests on an aggregated basis. Finally, amendments requiring disclosure of the objectives and the origin of those acquiring significant voting holdings will come into effect on 31 May 2009.

### Notification Requirements – changes with effect from 1 March 2009

Previously, the WpHG contained separate notification thresholds for the holding of: (1) financial instruments that include a vested right to acquire voting shares of an issuer; and (2) the actual holding of voting rights of an issuer. However, these notification thresholds were not aggregated. Therefore, if a shareholder held a percentage of voting shares and also the right to acquire further voting shares, provided both percentages were below the respective notification thresholds, no notification was required, even if the aggregate exceeded either threshold.

The Act now requires notification of the aggregate of actual voting rights and rights to acquire voting shares. Thus, in determining whether a notification requirement arises, a shareholder must consider both the percentage of shares it has a right to acquire and the percentage of shares it actually holds. If the aggregate percentage exceeds either of the relevant thresholds, notification will be required. Where a shareholder has already issued a notice that it exceeded a relevant threshold, subsequent notification of the aggregated voting interests will not be required until a further notification threshold is met or exceeded. These changes are intended to increase transparency of financial holdings.

The Act is to be regarded as a further step in creating transparency in the German financial market and as enabling the public as well as issuers to obtain a better overview of shareholdings, in particular of activist investors.

### Disclosure Regarding the Acquisition of Voting Rights – change with effect from 31 May 2009

In an effort to mirror the disclosure regimes in the United States and France, the Act will also impose a requirement for shareholders to disclose via the issuer the origin of and the objectives behind the shareholder's holding in the issuer once the holding exceeds a threshold of 10 per cent. Such notification is required to be made within 20 trading days after the threshold was crossed. If the shareholder's underlying objectives change following a disclosure, the shareholder is required to provide an updated disclosure in a timely fashion. The Act identifies certain objectives that, if present, must be disclosed including:

- generating profits or implementing strategic objectives;
- obtaining further voting rights within the next twelve months;
- influencing the make-up of the issuer's administrative or supervisory bodies; and
- introducing a substantial change to the issuer's capital structure or dividend policy.

The issuer, for its part, is required to publish the disclosure or, if relevant, any failure to disclose.

There are certain exemptions from the disclosure requirement for investment companies, investment stock corporations and foreign management companies within the meaning of Directive 85/611/EG in relation to Undertakings for Collective Investment in Transferable Securities (the "UCITS Directive"), as well as in respect of thresholds crossed as a result of an offer within the meaning of section 2 paragraph 1 of the WpÜG. In addition, issuers may provide in their articles of association that such disclosure obligations are not applicable.

### Transitional Provisions

The Act contains transitional provisions for notifications pursuant to the aggregation requirement. Under these provisions, no notification is required in respect of existing aggregated holdings exceeding any threshold with the entering into force of the Act on 1 March 2009. Notifications will, however, be required where a new threshold is met or exceeded in respect of an aggregated holding following 1 March 2009.

### Conclusion

According to the German legislator, the Act is to be regarded as a further step in creating transparency in the German financial market and as enabling the public as well as issuers to obtain a better overview of shareholdings, in particular of activist investors.

[1] For a more detailed discussion of the changes that entered into force in August 2008, please refer to the Dechert OnPoint dated November 2007, available at http://www.dechert.com/library/FS_Update13_11-07.pdf..

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# Tax Developments

## Flat Income Tax in Germany

by **Thomas Gierath**

Germany has enacted a new 25% flat rate income tax on capital gains and income derived from capital investments of individual investors with effect from 1 January 2009. This article provides an overview of how this substantial revision to the previous regime, and other related changes, will affect German investors in private equity funds, investment funds and other capital instruments.

### Private Equity Funds

Prior to the changes, investments by German private investors in private equity funds, which are typically transparent, were able to benefit from a tax exemption on gains arising on the sale of portfolio companies where their investment represented less than 1% of the underlying equity, and provided that the fund held the shares in the relevant portfolio company for a period of at least one year.

The new law eliminates this tax exemption and imposes tax on capital gains of German private investors from private equity funds irrespective of any holding period. In cases where the investment represents less than 1% of the underlying equity, capital gains from the disposal of portfolio companies will be taxed at the rate of 25%. In contrast, holdings in portfolio companies (including indirect holdings through funds) representing 1% or more of the underlying equity are deemed to be "business assets" and are subject to a different tax treatment as described under "Changes for Business and Institutional Investors" below.

The new law only applies to gains from portfolio companies that the private equity fund has acquired after 31 December 2008. Capital gains from companies acquired before that date remain subject to the previous laws. Thus, the former tax exemption is still available in respect of portfolio companies acquired before 2009 where the fund satisfies the one-year holding period.

### Investment Funds

Under the previous laws, German private investors in investment funds (e.g. UCITS, hedge funds) were able to benefit from an exemption in respect of capital gains arising on the disposal of investment fund units where the units were held for at least one year.

The new laws have now removed this exemption in respect of units purchased after 31 December 2008, making capital gains of German private investors arising on the disposal of such units taxable at the 25% flat tax rate.

Further, under the previous regime, investors were only taxed on dividends and interest received by the fund where such dividends and interest were actually distributed to investors; however, distributions of capital gains on portfolio investments by the fund to the investors were tax free. The new laws eliminate this exemption, thereby subjecting distributed capital gains to taxation. This change applies only to capital gains in respect of portfolio investments purchased by the fund after 31 December 2008. Thus, capital gains from investments purchased by the fund prior to 2009 and distributed to the investor remain exempt from tax.

Investment funds will, as under the previous laws, continue to benefit from the ability to accumulate capital gains on shares and other capital instruments. Such gains may be re-invested by the fund without any charge to tax. Any taxation of such gains will occur only when distributed to the investor or on a disposal of the fund units by the investor.

Generally, capital gains arising on the disposal of investment units purchased before 2009 are not affected by the new law, and will be free of tax if held for longer than one year. It is important to note, however, that there are exemptions to this grandfathering rule. In particular, capital gains on German or non-German "special funds", broadly speaking privately offered investment funds which impose eligibility criteria such as minimum subscription amounts of €100,000, are subject to the new flat rate income tax if the units were acquired after 9 November 2007. According to a new circular issued by the German Federal Ministry of Finance, the same will apply to German private investors in other investment funds (including funds available to the general public), if the fund has fewer than ten investors and the investor in question subscribed for investment units worth at least €100,000.

### Bonds and Notes

In contrast to other capital instruments, German private investors will benefit from the application of the new flat income tax rules to returns (e.g. interest) on bonds or corporate notes.

Previously, interest payments to German private bond investors were taxed at the individual tax rate of the investor (up to 47.5%). Under the new laws, such returns are now taxed at the lower flat 25% tax rate. Also, due to this lower taxation of interest income, investments by German investors in closed end mezzanine funds may benefit from the new laws.

A contrary treatment applies to investments in corporate notes where the investor bears the risk of losing the entire investment (i.e. where there is no claim for the return of principal). Previously, capital gains from such notes were tax-free provided the investor held the note for at least one year. Under the new laws, capital gains from notes purchased after 31 December 2008 are subject to income taxation irrespective of the holding period. A transitional rule will also apply this tax treatment to notes purchased after 14 March 2007 where the capital gains are received after 30 June 2009.

## Changes for Business and Institutional Investors

The new flat rate income tax does not apply to individuals where the relevant holding is a "business asset". Income and capital gains from business assets are generally subject to income and German trade tax at the individual tax rate of the investor. Previously an exemption was available in respect of 50% of capital gains from investment fund units and private equity fund investments. The new laws have reduced this exemption to 40%, thereby subjecting 60% of such income to tax at the individual tax rate of the investor.

The new flat tax rules do not affect the taxation of investment income received by German institutional investors that are corporations. As previously, 95% of the capital gains of such investors from investment units and private equity fund investments are tax-free, and their interest income is taxable at the regular corporate income tax rates.

## Flat Rate Income Tax as Withholding Tax

The new flat tax rate is 25% but in addition there is a 5.5% solidarity surcharge on that rate, and a church tax, where applicable. The tax is charged on the gross investment income and no related costs are tax deductible, other than a small annual lump sum allowance against all investment income (€801 per year, or €1,602 in case of married couples).

In general, the tax will be withheld by the payer of the income, normally the fund itself or a paying agent. In the case of foreign investment income (e.g. capital gains on investment units held through a foreign broker), an individual investor must include such income on his or her regular tax returns. For individuals whose income tax rate is below 25%, he or she can elect on his or her tax return to have the lower rate apply resulting in a tax refund.

With the new flat rate income tax, Germany has adopted a simplified taxation system for income derived from capital investments and capital gains of German individual investors which applies at a relatively low rate.

Where a single investor holds multiple capital instruments through one bank or broker, the bank will set off capital profits and losses in calculating the withholding tax paid to the tax authorities. Unused tax losses can be carried forward into the next year (and to unlimited years thereafter, if necessary), but cannot be carried back. Losses from capital instruments held in deposits at other banks will not be set off by the bank. Instead, the investor can set off such losses against other investment income by including them on his or her regular tax return. Due to the technical separation of investment income from the rest of taxpayer income, losses from investment income can only be set off against other investment income.

## Conclusion

With the new flat rate income tax, Germany has adopted a simplified taxation system for income derived from capital investments and capital gains of German individual investors which applies at a relatively low rate. In this respect Germany has now converged with counterparts with similar tax regimes. The changes are, however, disadvantageous for certain individuals due to the removal of the tax exemptions for investors in private equity funds and investment funds.

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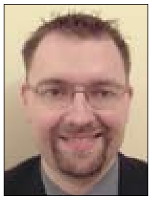

# Luxembourg 2009 Tax Reform

by **Marc Seimetz** and **Pascal Bouvy**

A law dated 19 December 2008 has introduced tax changes for Luxembourg companies, with effect from 1 January 2009.

## Corporate income tax rate decreased by one percent

In May 2008, the government announced that the global corporate income tax rate (corporate income tax and communal tax) should be reduced progressively over time to 25.5%. As a first step, the global corporate income tax rate was reduced from 29.63 to 28.59% with effect from 1 January 2009.

## Abolition of the contribution duty

The 0.5% Luxembourg contribution duty (*droit d'apport*) on the contribution of share capital was calculated on the value of the assets contributed to a Luxembourg company on incorporation and subsequent share capital increases (other than in cases of mergers and qualifying contributions in kind – see below). For investment funds, the contribution duty was fixed at 1,250 Euros.

The contribution duty was abolished with effect from 1 January 2009. A fixed registration duty of 75 Euros has been levied since that date on the registration of the incorporation of, or amendment to the articles of association of, a civil or commercial company having its statutory seat or its central administration in Luxembourg. The same duty is levied on the registration of the transfer to Luxembourg of the statutory seat or central administration of a civil or commercial company.

This change also resulted in the abolition of the fixed contribution duty of 1,250 Euros payable by investment funds.

### Share merger exemption

Previously, a company that received a contribution in kind of shares in another EU company, against the issuance of new shares in its own capital, could be exempt from contribution duty under certain conditions. One of the conditions was to hold the shares received for at least five years.

As from 1 January 2009, companies no longer need to hold on to these shares for a minimum period. The commentaries to the law specifically mention that the five year claw-back period no longer applies, even if such transactions took place before 1 January 2009.

This change also resulted in the abolition of the fixed contribution duty of 1,250 Euros payable by investment funds.

### Contribution of real estate properties located in Luxembourg

Specific rules apply to the contribution of real estate properties located in Luxembourg:

- Contributions remunerated by shares will be subject to a 0.6% registration duty and a 0.5% transcription tax.
- Contributions remunerated by means other than shares will be subject to a 6% registration duty (sometimes 9% for Luxembourg city) and a 1% transcription tax.

Transfers made in the context of a corporate restructuring (i.e. contributions of all assets and liabilities, contributions of one or more branches of activities, as well as contributions of all assets and liabilities of a wholly-owned subsidiary) are exempt from proportional duties. The transfers must, however, be mainly remunerated with securities that represent share capital of the companies involved.

## Withholding tax on dividends

The exemption for dividend withholding tax is extended to distributions made to "fully taxable" entities that are resident in a country with which Luxembourg has concluded a double tax treaty.

"Fully taxable" means subject to a corporate income tax similar to the Luxembourg corporate income tax. Such a tax is similar to the Luxembourg corporate income tax if it is mandatory and if the effective tax rate is at least half of the Luxembourg corporate income tax rate (not including the communal tax, i.e. 10.5% as from 1 January 2009) and applied on a taxable basis that is determined following rules which are similar to those applicable in Luxembourg.

The rules applicable in respect of Luxembourg investment funds remain unchanged, so that there will normally be no application of a withholding tax in Luxembourg, subject to certain exceptions (among others, under the EU Savings Directive).

### Double tax treaties

During the last quarter of 2008, Luxembourg initialed double tax treaties with Albania, Armenia and Kyrgyzstan. On 10 December 2008, the Luxembourg Parliament (*Chambre des Députés*) adopted the double tax treaty between the Grand Duchy of Luxembourg and the Hong Kong Special Administrative Region.

### International Financial Reporting Standards

Some provisions of the initial draft bill of the tax law would have adapted the tax legislation in order to take into account the balance sheet of companies using International Financial Reporting Standards ("IFRS"). These provisions have not been adopted. This followed the financial crisis, which itself was followed by amendment to IFRS by the International Accounting Standard Board. In order to make sure that the IFRS tax measures to be introduced are adapted to all financial situations, the Luxembourg Government decided to review and amend, where necessary, the measures initially drafted. It is expected that a new draft law will be issued in the near future.

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## New UK Regime for Offshore Funds

by **David Gubbay**

The UK's offshore fund tax rules are changing. Subject to the outcome of a final consultation, with effect from 1 October 2009, offshore funds will be able to elect for "reporting fund" status. This article explains that the proposals will change the existing "distributing fund" regime and identifies the key issues which offshore funds and their managers should be considering at this time. These developments will be of major importance in enabling UK resident investors in offshore funds to obtain favourable capital gains tax treatment for their investments in such offshore funds. The changes should also provide for a less burdensome certification process and greater certainty for funds and their investors.

### Current "Distributing Funds" Regime

Under the existing regime, unless an offshore fund is certified by HM Revenue & Customs ("HMRC") as a distributing fund, UK investors are subject to income tax rather than capital gains tax ("CGT") on any gain arising from the disposal of their interests in the fund. Since the current highest marginal rate of income tax of 40% is significantly higher than the flat CGT rate of 18%, obtaining distributing fund status is of crucial importance to most UK individual investors. This importance will increase further if the Government implements its plan to increase the highest marginal income tax rate to 45% with effect from 6 April 2011. Distributing fund status is also particularly attractive to UK investment trusts and authorised investment funds, who are exempt from CGT but not income tax.

In order to achieve distributing fund status, a fund must physically distribute at least 85% of its income (but generally not gains on the sale of investments unless those gains are trading profits). Furthermore, a distributing fund may not at any time during an accounting period have more than 5% of its assets invested in other offshore funds that are not themselves certified as distributing funds or capable of being so certified. The fund must make an application to HMRC for distributing fund status each year, and approval is granted retrospectively by HMRC.

## New Definition of "Offshore Fund"

The Government proposes to change the definition of "offshore fund" for tax purposes so that the tax definition of offshore fund will be detached from the current regulatory definition of "collective investment scheme" and will instead follow a "characteristics" based test.

It is intended that the new definition will apply from 1 October 2009 (in tandem with the reporting fund rules), subject to transitional rules. Broadly, from 1 October 2009, "offshore fund" for UK tax purposes will encompass any non-UK tax resident company, trust or other vehicle where the participants do not have day-to-day control of the management of the property, and a reasonable investor would expect to be able to realise any investment based entirely or almost entirely by reference to the net asset value of the property or an index of any description.

Offshore funds and their managers will thus need to carefully consider how the change in definition may affect them, especially for those funds that are not currently "offshore funds" but that may be caught by the new definition.

The change in definition should not impact upon offshore vehicles within the current definition of "offshore fund" except in unusual circumstances. However the new definition may bring some offshore vehicles currently outside the scope of the offshore fund rules (such as certain closed-ended vehicles) within scope, and there is currently some uncertainty about the scope of the new rules. The Treasury has provided initial guidance on how the change in definition will apply to certain vehicles. Vehicles which are transparent for income and capital gains purposes will remain outside the scope of the new definition, as will certain capital only arrangements (which do not or would not give rise to income at a fund or individual investor level) and property investment vehicles such as REITs (though not Property Authorised Investment Funds ("PAIFs")). On the other hand, certain fixed capital companies which track net asset value, some unit trust arrangements and exchange traded funds may be caught by the new definition. It should be noted that the draft legislation and accompanying HMRC guidance are not completely clear on some aspects and it is hoped that further clarification will be forthcoming when the legislation is finalised.

Investors in existing offshore arrangements may be affected by the change in definition, particularly where the change results in the vehicle being brought into the offshore funds regime. To prevent existing investors in such funds being disadvantaged by the change in definition, the Government intends to implement grandfathering provisions so that investments made in such funds prior to 1 October 2009 will remain outside the offshore funds rules. Investments made on or after 1 October 2009 will be subject to new rules. Investors should be aware that different tranches of investment in the same fund may therefore be treated differently for tax purposes depending upon the date of investment.

Offshore funds and their managers will thus need to carefully consider how the change in definition may affect them, especially for those funds that are not currently "offshore funds" but that may be caught by the new definition.

## New "Reporting Fund" Regime

The proposed changes to the offshore fund rules will replace "distributing fund" status with "reporting fund" status. Ultimately the new rules will achieve the same objective as the old, namely to determine the circumstances in which investors in offshore funds can benefit from CGT treatment.

Although some areas of uncertainty still remain (that it is hoped will be dealt with before the legislation is finalised) it is envisaged that the changes will provide for a less burdensome certification process and greater certainty for funds and their investors. This should make reporting fund status more accessible to funds that have previously been unable to satisfy the distributing fund requirements and accordingly increase their attractiveness to UK investors.

The key changes from the distributing fund rules are as follows:

- Instead of having to distribute income, funds will be required to report to UK investors and HMRC 100% of the income attributable to their investors (with a 10% margin for genuine error). There will no longer be a need to physically distribute income but rather there may be deemed distributions or a combination of physical and deemed distributions. A UK investor in a reporting fund will be taxable on its share of income in the reporting fund whether or not such income is actually distributed.

- Reporting funds will be required to prepare accounts in accordance with international accounting standards or UK or other generally accepted accounting practice (including IFRS). Reportable income will then be determined based on the "total recognised income and expense for the period" or its equivalent, adjusted for capital items and certain special classes of income. The capital items to be adjusted are primarily to reflect net gains and losses realised on investments, and are to be determined using the most recent Statement of Recognised Practice relating to authorised investment funds issued by the Investment Management Association. However, the new rules have done nothing to prevent offshore funds from being treated as trading in their underlying investments, and funds will thus have to continue to determine if they are carrying out a trade in their underlying investments for UK tax purposes and, if so, any gains arising would be reportable income. This compares unfavourably with the position for UK authorised investment funds, in particular in light of the recent proposal to legislate a "white list" of investments for such funds which would provide certainty and always ensure capital treatment.

- The investment restrictions currently applying to distributing funds will be abolished. This will make it easier for funds of funds to achieve certification as reporting funds. Where a reporting fund invests in other reporting funds it will receive information from those funds to enable it to calculate its own reportable income. Where a reporting fund invests in non-reporting funds (or reporting bond funds) it will either treat that fund as though it were a "notional reporting fund" (if sufficient information is available to make a calculation of its reportable income) or calculate a "fair value" of its investment (if sufficient information is not available) which will mean it will record any gain or loss in value over the year as income or loss as appropriate. As a practical matter, however, it may prove administratively complex for some funds of funds to determine their reportable income where they have invested in a wide variety of reporting and non-reporting funds.

- Managers of offshore funds will be able to obtain forward looking certification of a fund as a reporting fund which will continue to apply until the fund chooses to leave or is removed from the regime. This is unlike the current distributing fund regime where certification must be sought annually and retrospectively which can cause uncertainty for investors.

- Breaches of the rules will not necessarily cause the fund to lose reporting fund status. It is only where there is a serious breach, or persistent breaches, that this will be the case. This is unlike the current distributing fund rules where a simple breach can lead to loss of distributing fund status.

- There will be transitional provisions, to allow existing distributing funds to become reporting funds, and for investors to continue to receive CGT treatment.

- Where a fund moves from being a non-distributing or non-reporting fund to a reporting fund, investors will be able to make an elective deemed disposal of their interest in the fund as previously categorised. Whilst this may crystallise an income tax charge at the time of the deemed disposal, investors will then become entitled to CGT treatment on an eventual disposal of their interest in the reporting fund.

## Next Steps

Offshore funds and their investment managers should consider the applicability of the new offshore fund definition and reporting fund proposals to their arrangements. In particular, attention should be given to the benefits of seeking reporting fund status compared to the burden of complying with the necessary conditions and procedures.

Dechert LLP are taking part in the current consultation process on the draft rules and will provide updates as and when further information becomes available.

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## UK Telephone Monitoring: Dos and Don'ts

by **Renzo Marchini**

On 6 March 2009, many "Authorised Persons" (within the meaning of the Financial Services and Markets Act 2000) became subject to chapter 11.8 of the Conduct of Business Sourcebook ("COBS") issued by the Financial Services Authority ("FSA"), which requires the recording of "relevant telephone conversations" and "relevant electronic communications".

At the same time, the firms to which COBS 11.8 applies will need to continue to comply with the general privacy requirements already part of English law. There are two principal legal areas of relevance; namely, the law on "interception" of communications stemming from the Regulation of Investigatory Powers Act 2000 ("RIPA") and data protection law as set out in the Data Protection Act 1998 ("DPA"). These laws seek to balance regulatory requirements and objectives, such as quality control, against the need to protect employees as well as external persons from "snooping" and misuse of data. The changes to COBS do not mean that firms can ignore these requirements.


### Changes to COBS

As a measure to tackle market abuse, Chapter 11.8 of COBS requires certain firms to take reasonable steps to record relevant telephone conversations (in addition to other forms of electronic communications including email, text message, fax and instant messaging). The rule applies, generally, to those firms that receive client orders and negotiate, agree and arrange transactions across the equity, bond and financial commodity and derivatives markets. A "relevant" telephone conversation is one that concludes an agreement of the sort mentioned above, or is carried out "*with a view* to the conclusion" (emphasis added) of such an agreement. Records of the conversations must be retained for six months following the date of the recording. Conversations conducted by a firm on a mobile communication device are not subject to the requirements of COBS 11.8, although this position is to be reviewed by the FSA in late 2009.

### Outsourcing

At the same time as introducing this change to COBS, the FSA has amended Chapter 8 of its rules on Senior Management Arrangement, Systems and Controls ("SYSC"), that deals with outsourcing, to make clear that if a firm chooses to outsource the recording of conversations, such outsourcing will not be a "critical or important function" and will not, therefore, be subject to the more onerous requirements of Chapter 8 of SYSC which had been introduced by MiFID.

### Regulation of Investigatory Powers Act 2000

Notwithstanding these new requirements, firms will still need to comply with RIPA. This restricts the circumstances where a person may make an "interception of a communication" (which includes the recording of calls required by COBS 11.8). An interception is, broadly, unlawful (criminal, even) unless the consent of both the caller and recipient is obtained, or unless the communication falls within an exception defined in the Telecommunications (Lawful Business Practice) (Interception of Communications) Regulations 2000 (the "Regulations"). Under the Regulations, the relevant exceptions are where monitoring or recording communications is carried out:

- to ascertain compliance with regulatory requirements, practices or procedures;
- to ascertain or demonstrate employee standards;

- for the purpose of preventing or detecting crime;
- for the purpose of detecting unauthorised use of the telecommunications system; or
- to ensure the effective operation of the system.

In addition, monitoring (but not recording) communications may be carried out without consent:

- for the purpose of determining whether they are communications relevant to the business; or
- to monitor communications to confidential anonymous counseling or support helplines.

In addition, in all cases where consent is not obtained, the interception must be of a communication *relevant to the business*.

It appears therefore, that compliance with COBS 11.8 will be excepted from criminality under the Regulations, where the communication is relevant to the business. However, there are two traps:

First, a business must not intercept or record private communications. It is easy to envisage this occurring inadvertently in the course of a permitted interception or recording. Where this is the case, there is no offence under RIPA if the situation is unavoidable in the context of permitted monitoring. In other words, if in the course of the monitoring (or the playing back of a recording) it becomes apparent that the monitored communication is in fact private, the interception (or playing back) should cease.

Second, consistent with the situation under the data protection regime, below, an employer must make all reasonable efforts to inform employees that an interception of their telecommunications may take place; and this is so even where there is a requirement in COBS to record.

## Data Protection Act 1998

The recording of communications mandated by COBS 11.8 is also governed by the DPA, as the information recorded will be "personal data" of the parties to the call (as the recording could be used to identify the caller).

As such, the data protection principles set out in Schedule 1 of the DPA must be adhered to. In particular, all processing of personal data must be "fair". The one difficult issue here is that to be "fair" the following information must be provided to the individual, "so far as is practicable":

- information regarding the identity of the "data controller" (broadly, the party "processing" the data) and the purpose for which the information is being processed; and
- further information as is necessary, having regard to the specific circumstances in which data is processed, to enable the processing to be "fair".

Both the requirement that information only be provided "so far as is practicable" and the vague requirement to provide information which is "necessary" to be "fair" require an exercise of judgment and explain why many firms provide notices of recordings of calls.

The analysis above applies to employees as well as external persons, and both should be fully apprised of the fact of recording.

## Summary

Firms should be aware that new obligations apply to them with regard to the recording of communications, and that these new obligations must be balanced with their existing legal commitments to privacy and data protection. The essential points to bear in mind are set out below:

- Relevant communications should be recorded and the recordings kept for six months.
- The privacy of private communications should be respected.
- Where a telephone call is monitored/recorded under COBS 11.8, or pursuant to another exception to RIPA, there is no need to tell external callers that calls will be monitored/recorded. However, where such calls are recorded, it is a suggested good practice to bring this to the caller's attention, in order that the data is processed in a manner that is "fair".
- Employees should be informed about the way in which data relating to them is dealt with; written policies on what an employee is and is not allowed to do with the provided communications systems are always best practice.

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## Challenge and Opportunity

*(continued from page 4)*

**C. Short selling: regulation by reaction?**

As the "credit crunch" developed into a wider "financial crisis" in the late summer of 2008, concerns as to the exposure of banks to sub-prime or difficult to value securities and the actual value of such securities contributed to a reduction in investor confidence in banking stocks.

This lack of confidence was also accentuated (and perhaps in large part caused) by the lack of willingness of banks to lend to each other. This put severe pressure on bank funding models and cash flow and further undermined investor confidence in banking stocks. Almost certainly as a result of this, and siren calls that short selling was the actual cause of this lack of confidence (a forensically unlikely analysis), regulators moved swiftly. In September and October 2008, the Financial Services Authority (FSA) and the Securities and Exchange Commission (SEC) both took action to further regulate short selling.

In the United Kingdom the additional regulation came in the form of an outright ban on creating or increasing net short positions in certain UK financial sector companies and a requirement for the daily disclosure of all net short positions in excess of 0.25 per cent of the ordinary share capital of a UK financial sector company. The original FSA order expired on January 16, 2009, but the reporting requirements have since been extended and remain in effect until June 30, 2009.

Almost certainly as a result of this, and siren calls that short selling was the actual cause of this lack of confidence (a forensically unlikely analysis), regulators moved swiftly.

In the United States the SEC imposed two temporary requirements: a ban on short selling certain "covered securities" which included 799 financial sector companies and required weekly disclosure of any new short positions created during each day of the prior week. Both of the temporary measures have since expired. The SEC subsequently adopted rules designed to further curb abusive short selling.

Following the actions of the FSA and the SEC, many other regulators around the world, including those in Australia, Belgium, Canada, France, Germany, Ireland, Luxembourg, the Netherlands, Portugal, Spain, Switzerland and Taiwan also adopted additional regulations to curb naked short selling and other potentially abusive short selling and/or to ban short selling of certain securities. The regulators in some other countries, however, have taken no action to change their rules regarding short selling in light of the financial crisis. For instance, in Hong Kong short sales are permitted only with respect to a list of approved issuers, which is updated on a quarterly basis. Hong Kong continues to hold to this policy. As regulators around the world re-examine their short selling rules, they will be looking closely at all of the possible approaches.

**D. Lehman and custody**

The collapse of Lehman Brothers had a seismic effect on the financial community and raised questions about the ring fencing of safe custody arrangements and client money held with custodians. These questions have particular relevance in relation to the hedge fund model whereby assets are generally custodied with the prime broker. Under these arrangements the prime broker normally has powers of rehypothecation which allow the prime broker to in effect move the relevant assets from the client's prime brokerage account to its own account. This generally makes the custody client a general creditor of the prime broker in respect of the rehypothicated assets.

This point has been well understood by market participants for many years and fully disclosed in hedge fund offering memoranda. Indeed certain listing authorities have for many years sought to impose minimum credit ratings for prime brokers. In addition certain regulators and most hedge funds have imposed or negotiated percentage limits on the ability of prime brokers to rehypothecate assets.

When Lehman failed, the risks associated with rehypothecation, which seemed remote because it was generally considered unlikely that a government would let one of the large banks fail, became a unwelcome reality overnight.

We also expect pressure to mount on regulators and governments to provide better governmental systems and controls to enable them to intervene to prevent another banking failure of the size of Lehman Brothers.

There will be a long debate over whether the fundamental failure of regulation and the greatest systemic risk caused during the crisis was the U.S. government's failure to save Lehman. However this failure, the consequent lack of certainty as to the status of client money and assets at Lehman and the slow pace of the administration has clearly been unhelpful.

Industry participants are already moving swiftly to adopt more insolvency remote custody arrangements. We also expect pressure to mount on regulators and governments to provide better governmental systems and controls to enable them to intervene to prevent another banking failure of the size of Lehman Brothers. As a first step in this direction the FSA is introducing new liquidity rules to ensure, *inter alia*, that centralised group liquidity arrangements do not operate to the disadvantage of UK affiliates whereby custody services can continue to operate outside the scope of any future administration and to define more tightly the manner in which assets are held.

## II. Regulation and change

**A. Pressure for greater regulation**

As part of the response of governments to the financial crisis, the leaders of the G20 agreed on 15 November 2008 that:-

> *"all financial market products and participants should be regulated or subject to oversight, as appropriate to their circumstances".*

The action plan adopted by the G20 foresees that by March 31, 2009:

> *"private sector bodies that have already developed best practices for private pools of capital and/or hedge funds should bring forward proposals for a set of unified best practices. Finance Ministers should assess the adequacy of these proposals, drawing upon the analysis of regulators, the expanded [Financial Stability Forum], and other relevant bodies".*

The G20 announcement and timetable is currently driving the speed of the various consultations being conducted in relation to hedge funds.

**B. IOSCO Task Forces**

In response to the stated G20 aims and objectives, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) has established three task forces with a view to providing input to the G20 summit in Spring 2009. The Task Forces have been established to consider the following issues:-

- Short Selling: The Task Force on short selling is tasked with working to eliminate gaps in the various regulatory approaches around the world to naked short selling, including delivery requirements and disclosure of short positions. This Task Force is also examining how to minimise adverse impacts on securities lending, hedging and other types of transaction critical to capital formation and reducing market volatility. This Task Force is chaired by the Securities and Futures Commission of Hong Kong.

- Unregulated Financial Markets and Products: This Task Force is examining ways to introduce greater transparency and oversight to unregulated market segments such as the OTC markets and other structured financial products. This Task Force is co-chaired by the Australian Securities and Investments Commission and the Autorité des Marchés Financiers of France.
- Unregulated Financial Entities: This Task Force is examining issues surrounding unregulated entities such as hedge funds, including the potential development of recommended regulatory approaches to mitigate risks associated with their trading and traditional opacity. This Task Force is chaired by the CONSOB of Italy and the UK's FSA.

Given the membership of IOSCO reflects the principal national market regulatory authorities, the views expressed on each of these topics will be of relevance to the future regulation and operation of hedge funds.

**C. EU initiatives**

On December 1, 2008 Charlie McCreevy, EU Commissioner for the Internal Market and Services, announced a wide ranging consultation on Hedge Funds. The consultation on hedge funds (the Paper) has been launched with a view to the Commission completing a wide ranging examination of the issues relating to hedge funds so that this can be fed into the EU response to the G20 initiatives on private pools of capital referred to above. Contributions from stakeholders were invited by the end of January 2009 and it is intended the results will be discussed at a high level conference to be held in Brussels in February 2009. In addition, any conclusions arising from the consultation are intended to serve as the basis for an appropriate regulatory initiative from the Commission to the European Parliament.

It is clear from the Paper that the EU Commission believes that there are areas where market failures have been clearly identified and that work is underway on measures intended to rebuild confidence in these aspects of the financial system. However, the Paper acknowledges that there are other areas where there is as yet no clear consensus on whether regulatory change is needed or if it is what solutions should be considered. The Paper states that the hedge fund sector is one area "where the need for further work – starting with an analysis of self regulatory actions – will be needed".

The Paper states that the European Commissions' previous analysis of the risks presented by hedge funds to the European Financial and Economic System suggested that all significant risks were adequately addressed by a combination of EU legislative measures, national regulation and self regulatory codes. It acknowledges that in many respects these safeguards have withstood the pressures unleashed by the current financial turmoil.

However, whilst the Paper states that the benefits of hedge fund activity to the functioning of financial markets have been recognised, it notes that questions have also been raised as to the limited extent to which hedge fund managers and the hedge funds themselves are subject to regulation or direct macro – prudential oversight. The Paper acknowledges that these concerns were raised in the Reports to the European Parliament with Recommendations to the Commission

on Hedge Funds and Private Equity (A6 – 0338/2008) and on Transparency of Institutional Investors (A6 – 0296/2008), (the so called Rasmussen and Lehne Reports).

The Paper covers a wide variety of issues. Key themes can be summarised as follows.

***1. Scoping the issues***

The Paper identifies a hedge fund as a collect investment vehicle which focuses on the delivery of absolute returns, whose strategies typically translate into relatively high and systemic use of leverage through borrowing, short selling and derivatives and whose investor base is confined to institutional or other sophisticated investors (which it suggests has to date encouraged regulators to exempt hedge funds from many investment protection and disclosure requirements). The Paper also identifies the principal actors in the hedge fund sector to be: (i) the hedge fund manager; (ii) the fund itself; (iii) the administrator; and (iv) the prime broker. It also recognises the diversity of regulation applicable internationally to these actors and that many hedge funds are domiciled in offshore jurisdictions. In this regard the Paper recognises that European hedge fund managers compete with other funds and managers around the world and acknowledges that any policy response must take the pronounced international character of the hedge fund market into account.

The Paper asks for contributions as to whether such an analysis is sufficient to distinguish hedge funds from other leveraged institutions or funds. Do the distinct features of hedge funds justify a targeted assessment of their activities? The Paper also asks for contributions as to whether, given the geographical spread of hedge funds and their mangers, a purely European response on its own would be effective.

***2. Systemic risks***

The Paper acknowledges that hedge funds have not traditionally been considered to be of systemic relevance given that losses incurred and the risk of failure is borne directly by investors and counterparties. Accordingly, it suggests, the need for capital reserves is not part of the regulatory tool box of hedge funds or indeed other investment vehicles.

The Paper asks whether in view of recent events affecting the financial system this assessment should be revised. It also raises the question of whether indirect regulation of hedge fund leverage through prudential requirements on prime brokers is of itself still sufficient to insulate the banking system from the risks of hedge fund failure.

***3. Market efficiency and integrity***

The Paper acknowledges that it is commonly held that hedge fund activities contribute to the efficient functioning of the financial markets by deepening liquidity and enhancing price discovery.

The Paper raises questions as to whether there are situations where short selling can lead to distorted price signals and where restrictions on short selling might be warranted. It also asks whether there are circumstances in which short selling can threaten the integrity or stability of financial markets and asks whether it makes sense in this context to tighten controls on hedge funds as opposed to a general tightening of market abuse disciplines and whether alternative approaches are required.

The Paper recognises that European hedge fund managers compete with other funds and managers around the world and acknowledges that any policy response must take the pronounced international character of the hedge fund market into account.

***4. Management of micro-prudential risks***

The Paper also focuses on the internal processes of hedge funds. In particular, the manner in which they manage their risks, value their asset portfolios and avoid potential conflicts of interest or other risks to investors. The Paper notes that the Financial Stability Forum has previously called on the hedge fund industry to deliver improvements with respect to risk management processes and valuation techniques. It also acknowledges that in response the industry has developed self regulatory codes which detail recommended practice.

However, the Paper states that it is not yet clear that these have had a material impact on the robustness of the internal processes of hedge funds, particularly in stress conditions. The Paper accordingly asks whether the internal processes of hedge funds should be improved, particularly with respect to risk management. It also asks whether an appropriate regulatory initiative should be designed to complement and reinforce industry codes to address risk management and administration.

***5. Transparency towards investors and investor protection***

The Paper notes that although investors in hedge funds have traditionally been institutions or wealthy individuals with the capacity to understand and to bear the investment risk, the investor base has expanded to include pension funds and public institutions. It acknowledges that the exposure of European retail investors to hedge funds and funds of hedge funds remains limited. It notes that the disclosure practice in relation to hedge funds is typically driven by contractual arrangements between the fund and its investors, particularly in the case of professional investors. These investors often request information as part of their due diligence. It further notes that in some jurisdictions information obligations have been included in self regulatory standards such as those overseen by the Hedge Fund Standards Board in the United Kingdom.

Nonetheless, the Paper specifically asks whether the information investors receive on a pre-contractual and ongoing basis is sufficient and whether a regulatory response is needed to complement industry codes from a transparency perspective. It also asks whether it is considered a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures.

In his speech to the Monetary Affairs Committee (ECON) of the European Parliament on December 1, 2008, Commissioner McCreevy stated that the most concrete input he is looking for from industry participants and bodies is on the contagion and systemic risks to the financial markets of hedge funds if the existing regulatory framework surrounding hedge funds and banks continues.

It should be noted that the fact that Commissioner McCreevy is undertaking a consultation at all has been the subject of a stinging open letter to President Barroso from, amongst others, Poul Rasmussen, to the effect that another consultation on hedge funds is not required but rather concrete proposals and actions as requested by Parliament.

**D. Self regulation**

In the face of greater pressure calling for the regulation of hedge funds, their managers and/or strategies, the existence and effectiveness of self-regulatory codes takes on an added importance.

In 2007, a number of UK hedge fund managers joined together to form the Hedge Fund Working Group (HFWG) with the goal of establishing voluntary best practice standards for the hedge fund industry. Underlying this effort was the desire to have the hedge fund industry agree to raise its own standards and therefore address any perceived future need for regulators to impose regulations on hedge funds and further regulations on hedge fund managers.

In January 2008, the HFWG released its final report which included best practice recommendations in the areas of disclosure, valuation, risk management and governance and recommendations for hedge funds as shareholders of other companies. Subsequently, the Hedge Fund Standards Board (HFSB) was set up as custodian of the standards and to monitor conformity to the hedge fund best practice standards.

In the United States, the President's Working Group on Financial Markets (President's Working Group) also released best practices for the hedge fund industry in 2008. The best practices for hedge fund managers covered five areas: disclosure, valuation, risk management, trading and business operations and compliance, conflicts and business practices. The report released by the President's Working Group acknowledges that the best practice recommendations in the report may ultimately serve as the basis for a subsequent legal framework. Whether that turns out to be true remains to be seen.

A little over one year after the standards published by the HFWG were introduced, 36 hedge fund managers have signed up to comply with them. It may well be that in the face of further threatened regulation more managers will seek compliance with voluntary standards.

However, one hurdle to compliance with the voluntary codes in both the United States and the United Kingdom is that the various voluntary codes arose from different regulatory backgrounds and, as a result, reach slightly different conclusions on similar topics. The HFWG acknowledged in its January 2008 report that it was important to continue to work toward a common set of standards .Any common standards will need to encompass the contributions of the many industry groups that have provided thought leadership in this area, including Association of Investment Companies, the Alternative Investment Management

Association (AIMA), IOSCO, the President's Working Group, the CFA Institute and the Managed Funds Association.

**E. Greater regulation of short selling**

The debate around the world continues regarding whether short selling should be permitted and under what circumstances. As indicated above, the European Commission is currently reviewing the submissions it has received in response to its Consultation Paper requesting input from market participants on various topics, including the role of short selling in the marketplace and the effects that short selling can have on markets. The European Parliament has expressed its intention to regulate short selling in the context of a larger plan to regulate hedge funds. In the United States and elsewhere around the world regulators are considering whether further or other regulations of short selling should be imposed. As indicated above, IOSCO has designated a particular Task Force to look at this issue for the purposes of providing input to the G20 initiatives. The EU consultation on hedge funds also partly focuses on this area.

Although the FSA is a member of the IOSCO Task Force considering short selling, as well as a working group established by the Committee of European Securities Regulators (CESR) which is looking at short selling regulations, on 6 February 2009 the FSA has also published its own discussion paper (the Discussion Paper) proposing regulatory changes to its own short selling regime.

The Discussion Paper looks at some of the potential restraints which could be placed on short selling. These include a ban on the short selling either of all stocks or financial sector stocks, the prohibition of short selling of companies engaged in rights issues and other constraints. The FSA does not think that any direct constraints on short selling are currently justified.

The regulatory changes contemplated include extending the current reporting requirements to cover all UK incorporated issuers, instead of limiting the requirement to companies in the UK financial sector, increasing the reporting threshold to 0.5% (up from 0.25%) of a company's issued share capital for net short positions, and imposing further reporting obligations each time an increased net short position passes through an increment of 0.1%.

The FSA has requested comments by 8 May 2009 and intends to use this feedback in the meetings being held by the IOSCO and CESR Task Forces considering short selling regulation.

For hedge funds that use short selling as a strategy, the financial crisis has presented some opportunities, but the resultant patchwork of regulation has also created challenges whether portfolio management related or compliance related or both. As the regulation of short selling continues to evolve, there will continue to be strategic and regulatory challenges for hedge funds using short selling as a strategy. Although industry participants may have differing views about how short selling should be regulated, many people agree that it would be preferable for there to be some level of uniformity in the regulation of short selling.

**F. Legislative action to regulate hedge funds and their managers**

A glimpse of a possible future of hedge fund regulation in the United States was offered on January 29, 2009 with the introduction of a bill in the United States Senate calling for the adoption of the Hedge Fund Transparency Act of 2009 (the Senate Bill).

Unlike previous attempts at regulation of the hedge fund industry in the United States, the Senate Bill focuses on the hedge funds themselves rather than the regulation of hedge fund managers. The Senate Bill would require the registration of hedge funds with more than US$50 million of assets or assets under management. Registration would entail, at a minimum, making an annual electronic filing to make certain disclosures, many of which are already required by the Form D required under Regulation D under the Securities Act of 1933. If the Senate Bill were passed in its current form, hedge funds would also be required to make an annual electronic filing (which would be public) including the name and address of each beneficial owner of interests in the fund as well as the name and address of the fund's primary prime broker and primary accountants. The Senate Bill would also require such funds to disclose any affiliations the hedge fund has with other financial institutions and would require hedge funds to adopt anti-money laundering compliance programs. The approach being taken in the Senate Bill seeking to register hedge funds is a very different approach from that previously taken in the United States or currently being taken by other regulators.

A bill recently introduced in the United States House of Representatives, the Hedge Fund Adviser Registration Act of 2009 (the House Bill), takes a much more traditional approach to trying to regulate hedge funds.

The House Bill, if enacted in its current form, would eliminate the "private adviser" exemption from registration under the Investment Advisers Act of 1940, as amended. Currently, private advisers who advise fewer than 15 clients (or for non-US investment advisers, fewer than 15 US clients), do not hold themselves out as providing investment advisory services, and do not advise an investment company registered under the Investment Company Act of 1940, as amended, are not required to be registered as investment advisers. The House Bill would eliminate this exemption.

The approach being taken in the Senate Bill seeking to register hedge funds is a very different approach from that previously taken in the United States or currently being taken by other regulators.

The House Bill differs from the SEC's previous rule requiring hedge fund managers to register in that the SEC's prior rule had the effect of non-US hedge fund managers having to count US investors in non-US hedge funds as US clients on a look through basis for purposes of determining whether they qualified for the private adviser exemption. Under the House Bill by itself, a non-US hedge fund manager providing services exclusively to non-US domiciled hedge funds would not need to register as an investment adviser even if one or more of the funds had US investors. However, it is not clear at this point whether the Senate Bill would require the registration of the hedge fund manager under those same circumstances if the funds were larger than US$50 million even though the House Bill on its own would not.

The Senate Bill and the House Bill are both still subject to Congressional review and debate and may or may not be signed into law in their current form or, indeed, in any form. The existence of these Bills, however, will certainly have a place in discussions as to the nature of any governmental regulation of hedge funds and hedge fund managers.

Certain members of the European Parliament are actively calling for the regulation of hedge funds, not just the regulation of the hedge fund managers and the prime brokers. While the European Commission in early February 2009 finished collecting responses to its recent consultation paper on hedge fund regulation, some members of the European Parliament disagree with the approach being taken and are calling for more immediate action to be taken to regulate hedge funds.

#### G. A greater emphasis on due diligence and transparency

Regardless of whether one looks at it through the lens of a self regulatory scheme or government regulation, it is clear that key investor themes going forward will be due diligence and transparency.

There is no doubt that the fallout in relation to Bernard Madoff in the United States will enhance the desire of institutional investors in funds generally to conduct detailed due diligence and obtain greater transparency. It is important to note that the exposure to Madoff is not purely a hedge fund phenomenon and has also affected non hedge fund strategies and products.

Hedge fund managers will, therefore, need to give additional thought to the amount of transparency that is appropriate in the circumstances. Certainly the self regulatory codes published by the HFSB and the President's Working Group define the level of transparency that is considered sound practice, but individual hedge fund managers will need to decide whether more transparency might be appropriate under the circumstances.

Similarly, managers of funds of hedge funds will be reviewing their own due diligence procedures and the guidance by the Investors' Committee of the President's Working Group and guidance released by IOSCO, AIMA or other industry groups. Changes to due diligence procedures are likely to increase calls for hedge funds to provide greater transparency.

Regulators around the world are without doubt considering whether and to what extend there should be a voluntary or mandated minimum levels of transparency. As the industry and regulators continue to grapple with the questions of due diligence and transparency, there will continue to be an active debate.

## II. The future

#### A. Hedge fund developments

It is too soon to draw any firm conclusions about the future structure of hedge fund products. Much will ultimately depend on the future liquidity of world markets and how quickly liquidity and investor confidence returns. That said, there is clearly still a large and attractive market for traditional hedge fund structures where these invest in liquid strategies. Such funds should fundamentally be able to continue to function on the current open-ended basis with regular subscriptions and redemptions. Clearly promoters will look carefully at redemption notice periods and fee provisions as well as seeking to build into fund structures provisions which ensure that in stressed markets funds can operate and manage liquidity in a manner which seeks to be fair to both redeeming and continuing investors. In addition, promoters are likely to look at greater investor commitment of capital in terms of lock-ups.

For funds which invest in less liquid assets or strategies, there will clearly be a wish to adopt side pocket or reduced liquidity terms which reflect the maturity period of the underlying assets in the fund. There are numerous ways of achieving such structures already in use by many hedge fund promoters. However, we would expect to see some hedge funds adopting much more of a closed-ended/private equity approach in terms of lock-up periods, investment periods and capital return models in relation to these strategies. This is particularly true of funds investing in distressed and less liquid opportunities. In this sense hedge funds may move closer to private equity models although the type of structures investors will require will be of a more structured and radical nature than those currently offered within the private equity space. We therefore expect to see more of a convergence of these models and in many cases movement from traditional private equity structures themselves to more hybrid and developed fund structures.

We also expect to see increased use of managed accounts for large institutional investors seeking access to hedge fund strategies.

Although hedge funds will continue to target institutional investors, it is also clear that the abilities of hedge fund managers in the derivatives area will increasingly be relevant to UCITS structures seeking to achieve absolute returns. We also look forward in the United Kingdom to the FSA's response to their consultation on Funds of Alternative Investment Funds.

**B. Regulation or self-regulation**

It is difficult to anticipate where the G20, European Union, IOSCO and other initiatives relating to the regulation of financial market participants including banks and hedge funds will ultimately lead.

What is clear is that there will be greater co-ordination between governments and international regulators as to the regulation of managers managing hedge funds and the application of codes relating to short selling and market abuse. In terms of regulation, a consensus may develop towards adopting a more universal regulatory and prudential regime for investment managers rather than a regime requiring hedge funds themselves to be registered and regulated save to the extent strategies are aimed at more retail based investors and are based onshore. To the extent there is a concern that the regulation of hedge fund managers itself is insufficient, it should be possible for other areas relating to the operation of hedge funds to be covered by voluntary industry codes of practice. There may also be strong arguments in favour of a settled private placement regime for hedge and other institutional products. It may also be the case that indirect regulation of hedge fund strategies through counterparties and prime brokers will not be considered to have been deficient once the dust has settled and it becomes clearer what the real areas of concern are in terms of the stability of the financial system.

In this context, we wait to see whether the United States will in the final analysis adopt an approach similar to the House of Representatives Bill which seeks to regulate hedge fund managers as opposed to the current Senate Bill which proposes a registration process for hedge funds. It may of course adopt both approaches or neither approach. The jury is still out and may not yet have even convened.

In terms of funds of hedge funds and other institutional investors in funds and products generally (and it is not correct to focus purely on the hedge fund sector in this regard) due diligence and transparency will become increasingly important. Again, the development of industry codes in this respect is to be welcomed.

**C. Custody and client money**

Finally, following the Lehman collapse moves by regulators and the industry to seek to achieve greater protection for client money and assets will be welcomed. We expect in this regard that there will be a number of developments in the market relating to the nature and management of client money and assets.

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