DechertOnPoint

February 2012 / Issue 2

A legal update from Dechert's Financial Services Group

Dechert LLP

Financial Services Europe and International Update

Regulatory Developments

This update summarises current regulatory developments in the European Union and the UK focusing on the investment funds and asset management sectors, during the past three weeks.

EU Regulatory Developments

EMIR

Delays have occurred in the negotiations on the proposed European Market Infrastructure Regulations ("EMIR").

On 9 January 2012, the European Parliament has confirmed that it will now consider EMIR in its plenary session to be held from 13 to 16 February 2012.

DG MARKT's Management Plan for 2012: Financial Services Initiatives

The European Commission has recently published the 2012 management plan of the Internal Market and Services Directorate General (DG MARKT).

Amongst other things, the plan includes the following financial services initiatives:

- delivering amendments to the UCITS IV Directive (*2009/65/EC*) (see also the item below on EFAMA's proposals in this respect);
- delivering a legislative instrument on pre-contractual disclosures (that is, proposals on the regulation of packaged retail investment products (PRIPs), promoting robust investor protection, and providing a level playing field for the originators and distributors of retail investment products;
- continuing work on revising the Insurance Mediation Directive (*2002/92/EC*) to improve the functioning of the EU insurance market, making sure that consumers are better informed of the risks, costs and features of insurance products;
- continuing to build the supervisory and regulatory framework in the financial services sector;
- proposing measures for dealing effectively with future banking crises and starting work on a framework for crisis management resolution for non-bank financial institutions;
- preparing a communication on shadow banking, which will clarify the definition of shadow banking and provide a roadmap for the future regulation of the EU shadow banking system;
- intensifying efforts in the fight against money laundering by proposing a revision of the Third Money Laundering Directive (*2005/60/EC*); and
- setting global standards in financial regulation through co-operation and agreement with international partners.

The UCITS V Review

The European Fund and Asset Management Association ("EFAMA") has written to the European Commission in connection with the ongoing work of the Commission concerning the revision of the UCITS Directive ("the UCITS

V review") to ask that it takes into consideration a number of recommendations of the European funds and asset management industry, represented by EFAMA. These recommendations aim, in particular, at ensuring the effectiveness of some of the key measures adopted under UCITS IV.

Since the entry into force of the UCITS IV Directive, it has become apparent to EFAMA that some of the improvements brought by the UCITS IV Directive (such as master-feeder structures or the cross-border mergers regime, for example) cannot be used to their full extent because of a number of regulatory obstacles which were probably not sufficiently taken into account at the time of the adoption of UCITS IV in 2009.

In order to remedy this situation, EFAMA has worked on a number of technical recommendations set out below and has also included a number of recommendations aiming at ensuring consistency between the UCITS Directive and other EU regulations.

EFAMA also points out to the Commission that tax still remains a significant barrier to cross-border fund mergers. Indeed, from a UCITS' investors' viewpoint, the current Directive does not guarantee the tax neutrality of cross-border mergers irrespective of the legal type of vehicle (corporate type or contractual type funds). Further changes to the European tax and legal framework are therefore required to fully deliver on the benefits of UCITS IV.

EFAMA's recommendations to the Commission are:

1. *To enable UCITS investments in feeder funds the 10 per cent rule should be amended:* in accordance with Article 50(1)(e)(iv) of the UCITS Directive, UCITS (the "investing UCITS") are able to invest in another UCITS or other collective investment undertaking (the "target UCITS/CIU") only if, inter alia, the target UCITS/CIU has terms that prohibit more than 10 per cent of its value consisting of units of other CIS, ("the 10 per cent rule"). (The reason for this provision was to limit circularity of investment.) It was intended that UCITS be able to invest in feeder funds, as evidenced by the master-feeder provisions of UCITS IV. However, the 10 per cent rule currently prevents UCITS, such as funds of funds, from investing in feeder funds as those necessarily invest more than 10 per cent in another scheme (a feeder must invest at least 85 per cent in the master). This rule is considered to be seriously hampering the development of master-feeder arrangements with the consequent lack of realisation of economies of scale (and, hence, benefits to consumers) which UCITS IV was meant to deliver. EFAMA requests that the 10 per cent rule is amended to allow "look through" to the underlying master fund into which the feeder UCITS/CIU invests so that the 10 per cent rule applies to the master fund. (An alternative approach would be to amend Article 50(1)(e) so that it applies to investments into funds other than feeder UCITS and to add to Article 50 feeder UCITS as another category of permissible investment.)

2. *Merger notifications: notice to be given in writing to unitholders in the receiving UCITS is extremely costly:* UCITS IV was also meant to enable reduction of the number of sub-optimal and inefficient UCITS throughout the EU. However, under the Directive, notice of a prospective merger has to be given in writing to unitholders in the receiving UCITS regardless of the size of the merging UCITS.

   In practice it is extremely costly to meet these requirements, to the extent that the merger may no longer be cost-effective. There is a real risk that this efficiency could falter at the outset, if it is not recognised that the benefits of a merger could be outweighed by the costs of undertaking the merger in certain circumstances. Indeed, the notification requirements could have the unintended consequence of endangering domestic mergers in the future.

   If, for example, the merging fund has 100 investors and €1 million in assets and the receiving fund has 50,000 investors and €10 billion in assets, then there will be no material impact on the unitholders in the receiving fund. However, the costs of informing them would be so prohibitive that the merger would not be viable.

   The same issue arises in relation to liquidations/mergers/divisions of master-feeders. Given that master-feeder structures were not permitted in some EU jurisdictions prior to 1 July 2011, it is difficult to quantify the incremental costs of this requirement in this context; but it is certainly the case that the flexibility of the master-feeder structure is seen as one of the main ways in which UCITS managers can achieve economies of scale across the EU.

The real problem is the method by which this information has to be provided. When the Commission produced the draft Directive it introduced the requirement that the information had to be provided on paper or (where certain conditions are met) another durable medium. However, this method of communication which entails very high costs for the affected UCITS and their investors, appears not to be justified in all circumstances EFAMA does not see why the information requirements here should be provided in a different manner to any other information to the unitholders (for example, notices of a general meeting, notification of a change in the name of the fund, etc). Accordingly, EFAMA recommends that as regards mergers of UCITS, the initial approach when UCITS IV was being prepared, under which the provision of information to the unit-holders of the receiving UCITS was required only if the proposed merger would have substantial impact on their investments, should be re-examined in the light of the experience to date in order to enhance the efficiency of mergers without compromising investor protection. In addition, EFAMA suggests that circumstances requiring notification to unitholders in writing or by means of other durable medium is reviewed by the Commission having due regard to the need for both effective investor protection and cost efficiency in UCITS management.

3. *The need to clarify the framework for merging contractual funds:* EFAMA asks the Commission to review the UCITS IV rules on cross-border fund mergers because in practice, a cross-border fund merger can only be realised between two corporate type funds or two trust vehicles. However, whereas a cross-border fund merger between two contractual funds is more challenging, a cross-border merger between a corporate and a contractual type fund is simply not possible at present. EFAMA believes that a statement at EU level that in case of merger of a contractual fund, the law applicable to the merger will always be that of the merging fund would be helpful, and that it would also be very helpful if the Commission reviews the fundamental principles of civil and corporate law governing mergers, in order to come up with a procedure to make cross-border fund mergers practicable for all types of UCITS funds.

4. *Regulator-to-regulator notification should apply to changes to the initial notification letter:* currently, the simplified notification procedure relates only to notification of new funds, but does not apply to changes in legal documents or marketing of already notified UCITS. Any subsequent amendments to the original notification must be notified directly to the supervisory authorities of the host member state (Article 93(7), 3 sentence and 9 (8) of the UCITS Directive). Management companies are thus forced to maintain separate procedures for notifying new funds and filing changes to existing ones. This leads to duplication of administrative efforts and unreasonable cost increases for fund managers. Accordingly, EFAMA recommends that as the communication channels for regulator-to-regulator notification are already in place they should be utilised also for the purpose of notifying amendments to the original information.

5. *There should be no obligation to provide a KIID to professional investors:* the requirement to send a KIID applies to both professional and retail investors alike, despite the fact that the KIID was specifically designed for retail customers. In EFAMA's view this is unnecessary, particularly in view of the level of due diligence that any institutional investor would undertake before placing an order with a UCITS manager. Indeed, in its recent proposals for venture capital funds, the Commission notes that venture capital funds covered that would operate under the proposed passport system would not be obliged to face the traditional disclosure obligations and requirements linked to investor protection which would apply to an offer to retail investors (prospectus in accordance with Directive 2003/71/EC, KIID and MiFID standards). Venture capital investors are professional investors and are supposed to apply high standards of due diligence, while undertaking a thorough examination of any fund before they decide to make an investment. These investors are expected to monitor closely the activity of the manager of the venture capital fund and the evolution of their investments. Accordingly, EFAMA requests that the requirement for a KIID to be provided to professional investors in UCITS be removed.

6. *Exemption from the need to appoint a paying agent where a UCITS is being marketed solely to professionals: alignment with the AIFMD:* Chapter XI of the UCITS Directive sets out the process that needs to be followed in order for a UCITS to market its units cross border. Again, many of these provisions are designed for marketing to retail investors, for instance the requirement to appoint a paying agent under Article 92. This is time-consuming and costly. In many cases, UCITS will be marketed cross border to professional investors only, and such provisions are unnecessary. Accordingly EFAMA requests that the UCITS directive be brought into line with the AIFMD in this respect and, in particular, that Member States should not be allowed to require the appointment of paying agents where a UCITS is being marketed solely to professional investors. EFAMA also points out that in light of the development of new technologies, the practical justifications that prevailed when it was decided that each UCITS should appoint a paying agent probably no longer exist today and would therefore encourage the Commission to reconsider if there is still a real need to appoint a paying agent, even in the case of UCITS sold to retail investors.

7. *Alignment of UCITS Management Companies' services with AIFM Directive standards:* the scope of activities allowed for UCITS management companies should include the possibility of reception and transmission of orders in relation to one or more financial instruments. As AIF Managers may be allowed to provide for such reception and transmission of orders (Article 6 paragraph 4 of the AIFM Directive), EFAMA does not see why UCITS management companies should not be allowed to provide for the same service (otherwise, it would not ensure a level playing field between the two types of management companies). Accordingly, it recommends that UCITS management companies should be authorised to perform the activity of reception and transmission of orders in relation to one or more financial instruments.

8. *KIID – compliance with the Distance Marketing Directive:* the KIID was not drafted with the obligatory pre-sale requirements of the Distance Marketing Directive (the "DMD") in mind. Whilst the UK's FSA has noted this point and is now to require additional disclosures to be made to investors concerning information about consumers' rights to cancel, complaints procedures and compensation arrangements to be supplied around the same time as the KIID thus reflecting information required under the DMD (FSA COBS Rule 4.13 and COBS 5 Annex 1), EFAMA considers that it would be helpful that any future review concerning UCITS disclosure and PRIPs take account of different disclosure requirements so that consumers can benefit from a consistent approach broadly compliant with the DMD rather than managers having potentially to provide additional disclosures on a jurisdiction by jurisdiction basis.

Further Development of the Offshore Renminbi Market in London

On 16 January 2012, HM Treasury published a press release reporting on a speech made by the Chancellor of the Exchequer to the Asia Financial Forum on that date.

In his speech the Chancellor outlined the way in which the UK will collaborate with the authorities in Beijing and Hong Kong to further develop the offshore market in the Chinese currency, the Renminbi ("RMB"), in London. HM Treasury and the Hong Kong Monetary Authority ("the HKMA") are launching a joint private sector forum (the "London-Hong Kong Forum") to enhance cooperation between the UK and Hong Kong in this respect. Initially, membership of the Forum will be limited to representatives from financial institutions in both Hong Kong and London, including HSBC, Standard Chartered, Bank of China, Deutsche Bank and Barclays Bank. Representatives of other financial institutions may be invited as appropriate. The first forum meeting will take place in Hong Kong in May 2012.

The primary focus of the Forum will be to explore synergies between the UK and Hong Kong, specifically concerning clearing and settlement systems, market liquidity and the development of new RMB denominated products. The HKMA has announced it will extend the operating hours of its RMB payments systems by five hours, better to accommodate European transactions. This will make it easier for RMB transactions in London to be settled.

(In the summer of 2011, China and the UK agreed that the development of the offshore RMB market in London was welcome). According to this press release, the UK currently handles almost 30 per cent of all RMB foreign exchange trading and holds many billions of RMB deposits. The UK

Government's aim is for London to complement Hong Kong and become the leading western RMB hub.

Compromise Proposals on CRD IV

On 10 January 2012, the Danish Presidency of the Council of the EU published:

- a compromise proposal on the proposed CRD IV Directive;
- a compromise proposal on the proposed Capital Requirements Regulation ("the CRR").

Both compromise proposals are dated 9 January 2012 and have been prepared following discussions at Council working party meetings in 2011.

The proposed CRD IV Directive and the CRR will recast and replace the directives that currently comprise the Capital Requirements Directive (*2006/48/EC*) and *2006/49/EC*) and, amongst other things, will implement the Basel III reforms in the EU. (The Commission published its legislative proposals in July 2011.)

The Proposed EU Financial Transaction Tax: Latest Developments

In September 2011, the European Commission published its proposal for a Financial Transaction Tax ("FTT"). The proposed tax would be levied on transactions of shares and bonds at 0.1% and on derivatives at 0.01% where these were carried out by EU-based financial institutions.

A first exchange of views took place in the ECON committee of the European Parliament on 9 January 2012. The majority of the Committee came out in favour of a FTT, even if it were only implemented at the Eurozone level. However, some MEP's were critical of France's announcement that it would introduce a FTT unilaterally. One of the few MEP's to oppose the FTT, warned that it would lead to significant relocation of business, an issue which the rapporteur dismissed rather surprisingly, stating that the FTT would not lead to relocation of trades or loss of competitiveness in the EU.

While generally supportive of the Commission's proposal, the rapporteur said that she wanted to look into the possibility of using both the residency principle and the issuer principle for taxing transactions so as to ensure a level playing field. She also said that the rates proposed by the Commission were too low.

The Council working group examining the FTT had met on 3 January 2012, although progress during the meeting was slow, with the Council only looking at Article 1 and Article 2(1). Member States continued to have reservations about the economic impact of the proposal, despite the Commission reducing its GDP estimate to minus 0.3% down from minus 0.53%.

ECON is now arranging a public hearing on the proposals on 6 February 2012 and the rapporteur's report is scheduled to be presented to the Parliament on 28 February 2012, which will then put the proposal to a committee vote in early April and a plenary vote in June this year. The next Council working group meeting will take place on 6 March 2012, with a further meeting in June, before a discussion at the June ECOFIN meeting planned by the Danish Presidency.

Comments: Supporters of a so-called EU Tobin tax see themselves as the enemies of the financial services industry and supporters of the tax payer and seek to punish the industry whilst raising money for increased public expenditure (or if the EU's plan goes ahead, to finance the Commission itself).

They are correct that such a tax will hurt financial institutions, especially those trading on their own account, although many will simply relocate outside the EU. However, what they cannot seem to appreciate is that the FTT would also have an adverse effect on savers and pensioners by reducing their returns on investment. It is the end users that will end up picking up the cost of a FTT and intermediaries will tend to pass on these costs. A FTT will also reduce the prices of shares and other assets and increase the cost of capital for companies, thereby also reducing investment and jobs.

The Commission's proposal is for a 0.1 per cent tax on the value of equity and bonds transactions and a 0.01 per cent tax on all derivatives transactions. The tax will be applied whenever investors hand over money to an institutional investor (and whenever they withdraw funds), as well as on each transaction conducted on their behalf by fund managers.

The Alternative Investment Management Association (AIMA) has used IMF modelling to calculate that the FTT will reduce the market value of a typical stock (which changes hands every three and a half months on average) by 7.60 per cent and increase the cost of capital (for the company issuing the stock) by a significant 0.25 per cent. Investment managers will thus have an incentive to hold fewer equities and more derivatives (as a result of the bias in proposed

tax rates). Active fund managers will become less interested in holding boards to account as a result. Spreads will widen, price discovery will be stymied and volatility will increase.

In the case of the foreign exchange markets (which employ thousands in London) very important hedging and other services are provided to companies and wealth managers and approximately 45 per cent of currency trading takes place in the swaps market, which is also being targeted. Costs for all FX transactions would be increased by up to 18 times in the most heavily traded part of the market. A typical euro-dollar one week swap with a notional value of €25,000,000 between a bank and a pension fund currently has a transaction cost of €279, but under the EU plans, the dealer would suffer €2,500 of FTT as would the pension fund, an 18-fold increase in cost. It has been estimated that up to three quarters of trading could move outside the EU, global volumes will fall and liquidity will decline, increasing indirect transaction costs by up to an extra 110 per cent.

Even the Commission's own analysis has concluded the FTT would leave the EU worse off, yet it still supports the imposition of the tax. It is estimated it would raise €25bn-€43bn a year (depending on the extent of the collapse in trading), but would cut the GDP of the EU between 0.53 per cent (€86bn) and 1.15 per cent (€186bn). The British Government is right to oppose the FTT.

European Exchange Traded Funds

The Paris-based EDHEC-Risk Institute ("EDHEC") has recently published a paper available on EDHEC's website (www.edhec-risk.com) on the Risks of European Exchange Traded Funds.

Exchange traded funds ("ETFs") have traditionally been perceived as vehicles combining the diversified exposure of mutual funds with the low-cost, flexibility, ease and liquidity of trading enjoyed by publicly listed stocks, while also offering lower-expense ratios and better tax-efficiency relative to mutual funds. Most ETFs are passive, index-tracking investment vehicles, which as such, have transparent economic exposure and simple payoffs.

Product innovation in the ETF industry has led to the development of inverse and leveraged passive vehicles, of vehicles tracking strategies, and of outright active vehicles; these new forms of ETFs represent less than 5 per cent. of overall assets under management in the ETF industry, however.

The growth of ETFs and the legal limitations imposed on the fund structure in most jurisdictions, notably those relating to diversification and eligible assets, have also encouraged products structured as debt obligations to exchanges. As notes, these exchanged-traded products ("ETPs") tracking the performance of a single asset, a basket of assets or an index need not comply with fund rules and expose investors to the credit risk of their issuers.

Whilst ETFs are natural building blocks for investment by retail investors, the European ETF market is mostly institutional; retail participation is under-developed, not least because distributors have long been allowed to channel investors towards products with high commissions. However, European and member state level initiatives aimed at removing or disclosing conflicts of interest in retail distribution are expected to fuel investor interest in ETF markets. Against this background and in the context of the diversification of the ETP landscape, regulators have voiced concerns about the ability of retail investors to understand differences in product types, investment strategies and risks.

More generally, the rapid growth and innovations in the ETF market has led financial stability authorities and regulators to begin looking into the potential risks of ETFs as a matter of prudence. The key areas highlighted for attention have been counterparty risk, liquidity risk, systemic risk and possible detrimental impacts of ETFs on their underlying markets, potential risks of innovations such as leveraged and inverse ETFs, and the possibility of confusion between ETFs and other ETPs.

EDHEC believes that the debate on the risks of ETFs has started off on the wrong foot and that the initial confusion has been amplified and compounded by competing interests jockeying for position, with adverse impacts not only for the ETF industry but also for the ultimate goals of sound regulation. EDHEC has examined these issues and concerns and concludes that a number of clarifications regarding the risks of ETFs are needed as follows:

- ETFs are a sliver of the fund management industry and UCITS ETFs are highly-regulated; the overarching objectives of European regulators would be better served by generalising the high standards of protection afforded by the UCITS Directives and MiFID to the products that make up the bulk of retail investors' portfolios;

- the counterparty risk of UCITS ETFs is limited, in particular when it arises from OTC derivatives transactions;

- if anything, counterparty risk mitigation should be harmonised based on the former CESR rules applying to the use of OTC derivatives by UCITS; in any case, investors should be provided with the appropriate disclosures to be in a position to assess the counterparty risk assumed by UCITS and other investment vehicles;

- it makes little sense to classify instruments according to the tools they use to generate their payoffs - classifications should derive from their economic exposure;

- the advanced nature of the tools employed to deliver a payoff should not be confused with the complexity of the payoff itself; it is relevant to contrast UCITS tracking financial indices with other UCITS when considering restrictions on retail distribution; when drawing distinctions between products, a focus on the tools and techniques may create a false sense of security and exacerbate adverse selection and moral hazard phenomena;

- investors need more transparency and disclosure consistency with regard to the revenues and costs from ancillary activities;

- in the case of index-tracking instruments, investors need more information on the type of index that is tracked and how effectively it is being tracked;

- ETFs reflect the liquidity of the underlying to which they give exposure; and as with all open-ended funds, they are subject to liquidity risk: however, the investment policy restrictions and liquidity risk management requirements of UCITS limit both the risk and the severity of liquidity crises;

- there is little basis to be concerned by systemic risk in relation to ETFs: financial stability authorities should determine what system-wide disclosures they need better to assess systemic risk and identify problem areas rather than express vague concerns about segments of the financial industry that develop rapidly and require institutions active on those segment to dispel these concerns and clear up the confusion created amongst investors; the empirical evidence on the impact of ETFs on their underlying markets points to positive, rather than detrimental, effects;

- leverage and inverse ETFs deliver a multiple of the index they track at a prescribed horizon, typically a day, and are not buy-and-hold products for long-term investors: additional disclosures on their leverage policy and a risk warning on the consequences of holding these products beyond their prescribed horizon would probably be sufficient protections for retail investors; the contention that the rebalancing activity of these funds has significantly added to the end-of-the-day volatility in their underlying markets is not borne out by currently available empirical evidence; and

- there is a risk of confusion between different sorts of ETPs and, specifically, a risk that retail investors assume that all ETPs provide them with the same protections as UCITS ETFs; addressing this risk should be a priority for regulators and the idea of a product marker indicating UCITS compliance has merit.

IOSCO's Final Report and Principles on the Suspension of CIS Redemptions

On 19 January 2012, the Technical Committee of the International Organisation of Securities Commissions ("IOSCO") published its final report containing principles regarding the suspension of redemptions for open-ended collective investment schemes ("CISs") (i.e., all CISs offering a continuous redemption right).

IOSCO consulted on a draft version of the principles in a March 2011 consultation report. An Appendix to the final report contains a feedback statement on the public responses received by IOSCO on the consultation together with copies of these responses.

The aim of the final report is to set out principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning suspensions of redemptions. The seven principles set out in the final report are addressed to the entity or entities which are responsible for the overall operation of the CIS, in particular, its compliance with the legal and regulatory framework in the relevant jurisdiction. They are intended to reflect "a level of common approach" and to act as a practical guide.

The principles should be complied with whether activities are performed directly or through a third party. They are based on the CIS' responsible entity's (or entities') basic duty to manage CIS liquidity on an ongoing basis, in order to avoid suspensions to the extent this is possible. However, IOSCO makes clear that not all the principles are necessarily appropriate for, or apply to, specific non-retail CIS which are not offered to the public and are not subject to approval or registration, but

rather to specific rules under applicable national law and regulation.

IOSCO states that the principles should be implemented and respected by jurisdictions. They must be transposed within the context of the legal structures prevailing in each jurisdiction, which means implementation may vary across jurisdictions, depending on local conditions and circumstances.

UK Regulatory Developments

New HMRC Offshore Funds Manual

The new HMRC Offshore Fund Manual is now available on HMRC's website. The Investment Management Association is to engage with HMRC over the coming weeks to ensure that any teething problems with the new offshore funds rules not otherwise dealt with in the Manual are brought to light.

The Manual explains how UK resident investors in offshore funds are treated for tax purposes. It sets out the background to the offshore funds tax regime that applied to UK investors in offshore funds from 1984 onwards, and provides detailed guidance explaining how UK investors are treated under the replacement regime now contained in Part 8 of the Taxation (International and Other Provisions) Act 2010 and the Offshore Funds (Tax) Regulations 2009 (SI 2009/3001) as subsequently amended by SI 2009/3139 and SI 2011/1211.

HM Treasury Consultation on Contractual Schemes for Collective Investment

On 9 January 2012, HM Treasury published a consultation document on contractual schemes for collective investment. The Government had announced its intention to introduce a new, regulated, tax-transparent fund ("TTF") vehicle, principally to facilitate the setting up of pooled master-funds under the UCITS IV Directive (*2009/65/EC*) in the 2011 Budget.

This consultation outlines the Government's plans to introduce contractual schemes that will be transparent for UK tax purposes and will be capable of being used as UCITS funds. It focuses principally on the regulatory implications, in particular the necessary changes to the Financial Services and Markets Act 2000 ("FSMA") which will be made through the Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2012 ("the Contractual Scheme Regulations") (a draft of which has been published in the consultation document).

The Government proposes to lay draft affirmative regulations (i.e. the Contractual Scheme Regulations) under section 2(2)(b) of the European Communities Act 1972 i.e. exercising the right conferred by article 1.3 of the UCITS IV directive to establish undertakings for collective investment in transferable securities constituted in accordance with contract law (as common investment schemes managed by management companies).

The Contractual Scheme Regulations will make provision for two types of contractual scheme: the co-ownership scheme and the partnership scheme. In a co-ownership scheme the participants will own the assets beneficially as tenants in common (in Scotland, the assets are the 'common property' of the participants). The scheme is not a legally separate entity from the participants, so that assets are acquired, managed and disposed of directly on their behalf by the manager, whilst the depositary holds the legal title to the assets as a custodian. (The draft of the Contractual Scheme Regulation expressly disapplies a provision in s.237(1) of FSMA, under which a scheme structured in this manner would also be a unit trust scheme.) A partnership contractual scheme is to be constituted as a limited partnership under the Limited Partnerships Act 1907.

A contractual scheme is in essence a collective investment scheme that will be tax transparent under which the income and gains accrue to the investors directly as they arise.

As indicated above the main objective of introducing contractual schemes is to ensure that the UK is able to compete to win an appropriate share of European pooled funds as UK domiciled funds. (It should also help to consolidate the UK's position as the largest asset management centre in the EU).

Contractual schemes are expected to be attractive vehicles for UCITS funds to pool their investments cross-border in UCITS IV Master Funds. In addition it is expected that other investors, such as pension funds and life assurance companies, will also find contractual schemes attractive as pooled investment vehicles, which also provide economies of scale and as a result offer potentially enhanced investment returns because of a greater ability to diversify. (Tax transparency means that for direct tax purposes investors will be treated as if they had invested directly in the underlying assets and are subject to tax accordingly. The scheme itself will not be

subject to corporation tax, income tax or capital gains tax.)

An authorised contractual scheme, whether it is a co-ownership scheme or a partnership scheme, is to be available for NURs and QISs, as well as for UCITS.

The consultation period ends on 19 March 2012. The Contractual Scheme Regulations are intended to come into force in Summer 2012. Responses to the consultation will help to inform the final shape of the proposals and related legislation.

The FSA intends to carry out a separate consultation on the necessary changes to its Handbook of Rules and Guidance in Q1 of 2012.

FSA Policy Statement on Liens in Custody Arrangements

On 20 January 2012, the FSA published a policy statement on the rules on liens in custody arrangements set out in the Client Assets sourcebook ("CASS") (PS12/2), following its July 2011 consultation paper (CP11/15).

PS12/2 summarises feedback to the second part of CP11/15 and sets out the final CASS rules relating to custody liens. The FSA has amended these rules to provide for the taking of certain liens or rights over omnibus client accounts. It has also made amendments relating to liens or rights over assets held in overseas jurisdictions. The instrument implementing these changes, the Client Assets Sourcebook (Liens Amendment) Instrument 2012, is set out in an Appendix to PS12/2. It was made by the FSA board on 19 January 2012 and will come into force on 1 April 2012. The FSA has explained that this instrument does not differ significantly from the draft instrument it consulted on in CP11/15. In response to the feedback received, it has added some guidance and made minor amendments.

Firms must ensure that any custody agreements they enter into on or after 1 April 2012 comply with the new rules. Transitional provisions mean that firms have until 30 September 2012 to ensure that any custody agreements entered into before 1 April 2012 comply with the new rules. (However, the FSA advises firms to modify these agreements as soon as they are able to do so, and not wait until 30 September 2012.)

The FSA explains that it has not taken a position either for or against the use of omnibus accounts at custodians. However, in line with EU developments, it may at some point in the future investigate the use of such accounts and any risks arising from custody assets held in this manner.

FSA Discussion Paper on Implementing the AIFM Directive

On 23 January 2012, the FSA published a discussion paper on the implementation of the Alternative Investment Fund Managers Directive (2011/61/EU) (the "AIFM Directive" or "AIFMD") (DP12/1) which aims to develop a well-informed, proportionate and effective policy relating to the AIFM Directive and to assist stakeholders towards AIFM-readiness. (The UK is required to transpose the AIFM Directive by 22 July 2013.)

In DP12/1, the FSA welcomes comments on:

- implementation of the AIFM Directive in the UK;
- the scope of the AIFM Directive;
- operating requirements for AIFMs;
- management requirements for AIFMs
- transparency issues;
- depositaries; and
- marketing issues.

These are discussed in more detail below. On the whole, the FSA does not commit itself to any particular view at this stage, and the majority of the issues raised will also be subject to further legislation at the EU level and to ESMA guidelines and there will be further FSA and/or Treasury consultations. These will include the issue of how to translate the definition of "AIF" into UK law. In particular perimeter issues, such as the scope and implications of the express exclusions for "holding companies" (as defined in the AIFMD) and "joint ventures", are raised by the FSA but are not answered in the Discussion Paper. So as far as the AIFM exclusion for smaller funds is concerned the UK authorities now appear to be envisaging the possibility of a registration, rather than an authorisation, regime.

Potentially the most controversial proposal is forcing listed closed-ended investment companies or the investment trusts to be authorised as internally managed AIFs, despite the fact that they are already adequately regulated in the UK by the Listing Rules.

The FSA considers that over 1,000 UK firms and funds are likely to be within the scope of the AIFMD, including hedge funds, hedge funds of funds, private equity and venture capital funds, property funds, investment trusts, real estate investment trusts (REITs), FSA-authorised non-UCITS funds, pooled charity funds, commodity funds and infrastructure funds.

In more detail:

- **Implementation of the Directive:** the FSA draws attention to the following UK implementation issues:
  - issues that arise from the interaction between the current structure for regulating collective investment schemes ("CISs") under the Financial Services and Markets Act 2000 ("FSMA") and the AIFM Directive's requirements. For example, whether the (Regulated Activities Order) (SI 2001/544) should be amended to create a new regulated activity of managing AIFs and whether the definition of a CIS in S. 235 of FSMA needs to be amended;
  - the FSA believes that the majority of the AIFM Directive's provisions can be implemented in rules in the FSA Handbook, although some provisions (not yet fully specified) will need to be implemented by statutory regulations made by HM Treasury;
  - the FSA seeks views creating a new sourcebook (FUND) which will contain all fund management rules in place of COLL for both UCITS operators and AIFMs in future;
  - the Financial Conduct Authority is likely to become the competent authority for most, if not all, AIFMs.
- **Scope of the Directive:** UK fund managers whose regular business activities could fall within the definition of managing AIFs in the Directive should provisionally consider themselves to be AIFMs (and as such, subject to the AIFM Directive's requirements). In particular the FSA also focuses on:
  - holding companies: the exclusion of holding companies from the scope of the AIFMD may be relevant to UK firms carrying on the activities of investment management or trading through vehicles in corporate form;
  - joint ventures (JVs): the FSA seeks views on what criteria could be used to distinguish a JV from an AIF, particularly a JV in which not all the participants are involved in its day-to-day management;
  - family investment vehicles: the FSA seeks views on the features that distinguish a family investment vehicle from an AIF, and how it should define the required family relationship.
- **Operating requirements for AIFMs:** DP12/1 outlines the requirements of the AIFMD applicable to the operation of AIFMs, including due diligence, the appointment of counterparties and prime brokers, conflict of interest management, the fair treatment of investors, the remuneration of certain staff, risk management, delegation, and the requirement to hold capital and professional indemnity insurance (PII). Points of interest include:
  - the limitation on MiFID investment services and activities that an external AIFM may provide will result in changes for those firms currently authorised under MiFID;
  - what options the FSA has for implementing the remuneration requirements of the AIFM Directive, including either bringing AIFMs within the scope of the existing FSA Remuneration Code or developing a new code to apply specifically to them;
  - the categories of AIFM for prudential purposes, including internal AIFMs, external AIFMs, AIFM investment firms, UCITS AIFM firms and UCITS AIFM investment firms;
  - whilst the AIFM Directive allows regulators to permit AIFMs to provide up to 50 per cent of the required additional own funds capital by means of a guarantee, the FSA proposes only to develop rules that allow for the use of such guarantees if firms confirm it that they wish to use them;
  - the PII requirements, compared with those that the FSA applies to other firms;
  - the FSA's interpretation of Article 9 of the AIFM Directive means it does not expect to require internally managed AIFs to hold additional own funds capital based on the funds under management; and
  - the FSA expects not to introduce a fixed overheads requirement.
- **Management requirements for AIFMs:** DP12/1 also outlines the requirements of the AIFM Directive applicable to the management of AIF including the requirements for proper and independent valuation, liquidity

management, leverage and investment in securitisation positions.

- **Transparency issues:** DP12/1 considers the transparency requirements to be imposed on AIFMs under the provisions of the AIFM Directive on annual reporting, disclosure to investors and reporting to regulators.

- **The Depositary:** DP12/1 covers the AIFM Directive's requirements for depositaries, describing which entities may act as depositaries, the depositary's main duties of cash-monitoring, safe keeping of AIF assets, oversight functions, particular requirements for non-EU AIFs, segregation of assets by sub-custodians and depositary liability.

- **Marketing issues:** Both the marketing of AIFs to professional and retail investors are considered in DP12/1, including HM Treasury's provisional intention to continue to permit the marketing of non-EU AIFs managed by EU AIFMs and EU and non-EU AIFs managed by non-EU AIFMs, to UK professional investors, subject to compliance with minimum requirements specified in the AIFM Directive, resulting in many cases that the private placement of non-EU and EU AIFs managed by non-EU AIFMs in the UK will continue, although changes to the existing financial promotions regime are also likely to be made. **The UK authorities have still to consider under what conditions an AIFM will be entitled to market to UK retail investors however.**

Comments can be made in respect to the Discussion Paper to the FSA until 23 March 2012.

This update was prepared by Martin Day (+44 20 7184 7565; martin.day@dechert.com) and edited by Richard Frase (+44 20 7184 7692; richard.frase@dechert.com).

(Certain of the summaries of developments contained above have been based on the daily and weekly Financial Services updates provided by *Practical Law Company Limited*.)

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