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Third Quarter 2010

Financial Services Quarterly Report

In this issue

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From the Editors

Far-Reaching U.S. Financial Reform Legislation Impacts Financial Service Companies Both Within and Outside of the United States

"This law creates a new, more effective regulatory structure, fills a host of regulatory gaps, brings greater public transparency and market accountability to the financial system and gives investors important protections and greater input into corporate governance."

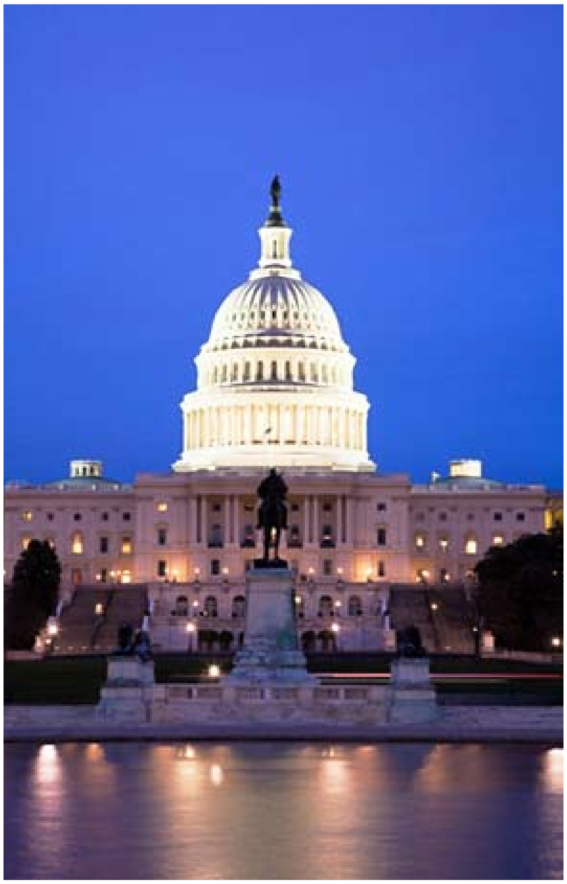
– Mary L. Schapiro, Chairman U.S. SEC

President Barack Obama signed into law on July 21, 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), thereby effecting the most sweeping changes to the U.S. financial regulatory system since the 1930s.

While the Act's principal focus is on U.S. financial services institutions and U.S. financial markets, a number of its provisions will impact non-U.S. financial services companies operating in the United States or providing products and/or services to U.S. clients and consumers. At the same time, wholesale changes to regulation of financial services are also taking place in Europe where, among a number of other regulatory initiatives, the Alternative Investment Fund Managers Directive (or AIFMD) is proposed to introduce a European regime for management and marketing of alternative investment funds. One of the most important challenges the global financial services industry will face in the next few years will be navigating safely through both sets of these new regulatory initiatives.

The Act is primarily focused on improving the regulation and supervision of the financial institutions that were viewed as triggering the 2008 financial crisis, namely banking institutions, as well as other firms that acted as major players in the derivatives marketplace or were involved in subprime lending and securitization of such loans. Nevertheless, the Act's extremely broad reach leaves very few financial services firms untouched.

The Act's provisions range from high-level structural changes, such as the creation of a Financial Stability Oversight Council and a Consumer Financial Protection Bureau, to detailed requirements for specified participants in the financial markets (including investment advisers, investment companies, broker-dealers and broadly defined "banking entities").



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The future regulations and studies, the substance and findings of which cannot be predicted, are likely to impact in a variety of ways, and for years to come, all participants in the U.S. financial markets.

The effects of the Act will be felt by entities beyond those currently registered with the Securities and Exchange Commission ("SEC") as investment advisers, investment companies or broker-dealers. Many unregistered investment advisers that manage private funds will now be required to register with the SEC and, together with currently registered advisers, will be subject to greatly increased regulation and SEC scrutiny. And, the so-called "Volcker Rule" adds restrictions that, with certain exceptions for permitted activities, prohibit a banking entity from engaging in proprietary trading and from acquiring or retaining an ownership interest in or sponsoring a hedge fund or a private equity fund.

In addition to implementing various new and amended statutory provisions, the Act defers many of the "details" of this comprehensive regulatory initiative to future regulations and studies by a variety of U.S. federal regulatory agencies. In this regard, the SEC has announced a new process to enable the public to comment even before the Commission proposes its regulatory reform rules and amendments, as well as new best practices for SEC staff when conducting meetings with interested parties "in order to ensure full transparency to the public."

There is a clear tension in the Act between the apparent desire to demonstrate Congress' tough stance on Wall Street while at the same time avoiding adverse impact of the reforms on the financial industry and the recovery in the broader economy.

The future regulations and studies, the substance and findings of which cannot be predicted, are likely to impact in a variety of ways, and for years to come, all participants in the U.S. financial markets. And there is a clear tension in the Act between the apparent desire to demonstrate Congress' tough stance on Wall Street while at the same time avoiding adverse impact of the reforms on the financial industry and the recovery in the broader economy.

For an extensive suite of publications prepared by Dechert attorneys regarding the impact of the Act on various financial services entities and products, please refer to those listed below (and future client alerts on U.S. and international legal developments on our website). We will continue to monitor and report on the rule-making process and related developments as provisions of the Act are implemented.

- Analysis of Financial Regulatory Reform Legislation for American Bankers Association, available at http://www.aba.com/RegReform/RR_TitleMenu.htm.
- New Registration Requirement in Dodd-Frank Legislation May Affect Advisors to State and Local Governments as Well as Persons who Solicit Public Pension Funds, available at http://www.dechert.com/library/FS_23_9-10_New_Registration_Requirement_in_Dodd-Frank.pdf.

Upcoming Seminars

Implications of The Dodd-Frank Wall Street Reform and Consumer Protection Act
OCTOBER 26, BOSTON
(CO-HOSTED WITH KPMG)

Panelists will discuss the implications of the recent financial services reform legislation, covering the most important regulations and recent developments.

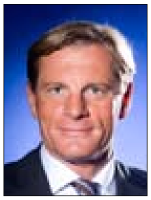
Shifting Investor Expectations and a New Regulatory Environment
OCTOBER 28, NEW YORK
(CO-HOSTED WITH KPMG AND BNP PARIBAS)

This program will educate investors about the implications of the recent financial services reform legislation.

For more information on these upcoming events, please contact Beth Goulston at beth.goulston@dechert.com.

- The Impact of the Financial Regulatory Reform Legislation on the Life Insurance Industry, available at http://www.dechert.com/library/FS_18_8-10_The_Impact_of_the_Financial_Regulatory_Reform.pdf.
- Réforme de la Législation Financière Américaine: Panorama des Dispositions Susceptibles d'avoir un Impact sur les Gestionnaires Financiers Français, available at http://www.dechert.com/library/FS_14-08-10-France-Reforme_de_la_Legislation_Financiere.pdf.
- Dodd-Frank: The Regulatory Reset of the OTC Derivatives Markets, available at http://www.dechert.com/library/FS_17_07-10_Dodd-Frank_The_Regulatory_Reset.pdf.
- Dodd-Frank's Limitations on Risk Taking: An Analysis of the Volcker Rule's Restrictions on Proprietary Trading and Investments in and Sponsorship of Hedge Funds and Private Equity Funds, available at http://www.dechert.com/library/FS_16_7-10_Dodd-Frank_Limitations.pdf.
- The Impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act on the Registration Obligations of Private Fund Advisers, available at http://www.dechert.com/library/FS-15-07-10-The_Impacts_of_the_Dodd-Frank_Wall_Street.pdf.
- The Impacts of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Registered Investment Companies and Advisers, available at http://www.dechert.com/library/FS--14-%2007-10-The_Impacts_of_the_Dodd-Frank_Wall_Street.pdf.
- The Impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Financial Services Companies Outside of the United States, available at http://www.dechert.com/library/FS_11-07-10-US_Financial_Reform.pdf.
- Dodd-Frank Wall Street Reform and Consumer Protection Act: Application to Public Companies, available at http://www.dechert.com/library/Corporate_and_Securities_SA_07-10_Dodd-Frank.pdf.
- Improvements to the Asset-Backed Securitization Process, available at http://www.dechert.com/library/Finance_and_Real_Estate_08-10_36_Improvements_to_the_Asset-Backed.pdf.
- Dodd-Frank Measures Affecting Credit Rating Agencies, available at http://www.dechert.com/library/Finance_and_Real_Estate-08-10-35-Dodd-Frank_Measures_Affecting_Credit.pdf.

Fund Raising for Alternative Investment Funds in Germany



by **Hans Stamm**

Increasing Demand by German Retail and Institutional Investors for Alternative Investment Funds

Notwithstanding the turmoil in the world's financial markets, it is widely expected that German and other European institutional investors will not reduce their allocation to alternative investments (such as hedge funds, private equity funds, real estate funds and renewable energy funds), but rather, will increase their exposure to this asset class in the medium- and long-term. Both the current low interest environment, as well as the growing payment obligations of corporate and public pension plans, have increased the pressure on institutional investors to diversify their investment portfolios beyond established asset classes in the capital markets.

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In the German market, the largest institutional investors include life and health insurance companies, corporate pension funds and pension funds for specific professionals (e.g., "*berufsständische Versorgungswerke*"). The most recently available report on the investment allocation by German life insurance companies provides evidence in this respect. The total investments by such companies in so-called "regulated investments" ("*gebundenes Vermögen*") amounted to approximately EUR 672.9 billion.[1] Their total exposure to so-called "risk assets" (which include stocks, mutual funds, subordinate debt, hedge funds and other private funds) amounted to approximately EUR 108.9 billion (i.e., around 16% of their total assets).

From a regulatory perspective, German life insurance companies may invest up to 5% of their regulated investments in hedge funds. This basket of eligible investments includes both direct and indirect investments in single- and multi-manager hedge funds. With respect to direct investments in hedge funds and other private funds, certain additional investment restrictions exist for German life insurance companies (e.g., investments in non-EEA domiciled hedge funds are not permissible). Under a recent amendment of the German Investment Ordinance ("*Anlageverordnung*")[2] that stipulates the scope of eligible investments for German life insurance companies, in addition to the 5% basket for hedge fund investments, a further basket of up to 5% of the companies' regulated investments may be invested in direct and indirect commodity-based investments.

Notwithstanding the turmoil in the world's financial markets, it is widely expected that German and other European institutional investors will not reduce their allocation to alternative investments.

The retail investor market has also seen a growth of interest in alternative investment products in recent years. The substantial part of this investor market is made up of German-domiciled, unlisted, closed-end funds (in the form of German law partnerships, "*KG*"). Although this segment of the German retail market has seen a fall in investments based on equity raised from retail investors (from approximately EUR 15.4 billion in 2008 to approximately EUR 9.4 billion in 2009), market participants are nevertheless maintaining a positive outlook for this segment of the industry.[3] In particular, investments in renewable energy (e.g., solar and wind farm projects), infrastructure and real estate are currently being sought by retail investors.

German Investment Act and Investment Tax Act Restrictions on Offerings to German Investors

For non-German-domiciled sponsors of alternative investment funds, various regulatory and tax rules should be taken into consideration when targeting German investors. Any alternative investment fund targeting German investors has to meet the requirements of the German Investment Act ("GIA") ("*Investmentgesetz*") that codifies, *inter alia*, the rules governing the marketing of funds to German investors. Even private placements are affected by the GIA, since most German institutional investors are only permitted to invest in funds that meet the standards set out in the GIA. Furthermore, any non-German fund that falls within the rules of the GIA typically will also be subject to the specific tax regime set out in the German Investment Tax Act ("GITA") ("*Investmentsteuergesetz*"), which affects the taxable income of any German tax-resident investor.

The GIA provides that any foreign investment fund qualifies as a "foreign collective investment scheme" if, notwithstanding its legal structure:

- It is an open-ended investment scheme (i.e., investors can redeem fund units on a regular basis at least every two years); or
- It qualifies as a regulated investment scheme (i.e., in its home jurisdiction, it is subject to regulatory supervision comparable to the supervision of German regulated funds);
- Its business purpose is to make collective investments (i.e., for the benefit of investors holding units in such scheme);
- It invests (directly or indirectly) in a portfolio of risk-diversified assets; and
- The assets held by the fund are comprised predominantly of so-called "eligible investments" (including assets that are defined as "eligible investments" in EC directive 2007/16/EC), which includes transferable securities (bonds and shares), derivatives, and both direct and indirect real estate investments.

In the hedge fund industry, various sponsors have recently offered European-based clones of their off-shore hedge funds in the form of so-called "NewCITS".

An explicit safe-harbor exemption from these requirements exists for certain "private equity funds", understood to include any funds that hold more than 20% of their investments in portfolio companies as an "active investor". However, a clear definition to distinguish such "private equity funds" from hybrid funds or hedge funds currently does not exist. As a consequence, many non-German hedge funds, real estate funds, renewable energy funds and commodity funds are subject to the rules of the GIA and GITA.

Even if the regulatory selling restriction regime of the GIA may not apply in the case of a private placement to certain institutional investors or in the case of a reverse solicitation, the specific tax regime of GITA may create a hurdle for attracting German investors. If a non-German fund does not comply with a specific German tax reporting regime as specified in the GITA (which includes preparing and filing German tax returns, calculating various sources of income under German tax law and publication of such taxable income on a regular basis and also upon any redemption or issuance of fund units), German tax-resident investors will be subject to a penalty tax regime. German tax-resident investors in the fund will be deemed to have received per unit taxable income at the year-end of the foreign fund, calculated as the greater of: (i) 6% of the fund's year-end per unit NAV, and (ii) 70% of the increase in the per unit NAV of the fund during the relevant fiscal year. Furthermore, upon any transfer or redemption of fund units, an additional deemed taxable income of 6% of the proceeds will be triggered for the German tax-resident investors. Although some non-German sponsors of hedge funds comply with such tax reporting and tax disclosure rules, many non-German fund sponsors are concerned about the administrative (and cost) consequences of these tax rules.

Alternative Marketing Through Fund-Linked Structured Products

In the hedge fund industry, various sponsors have recently offered European-based clones of their off-shore hedge funds in the form of so-called "NewCITS" (i.e., funds set up within the framework of the European Directive on (Transferable) Securities Funds (UCITS) that, subject to a notification in the respective jurisdictions, can be marketed across Europe). However, not all hedge fund and other alternative investment fund strategies can be replicated in such "NewCITS" (due to certain restrictions regarding eligible investments, investment strategies, use of OTC derivatives, etc.). Also, concerns have recently been expressed regarding the application of UCITS liquidity requirements to such hedge funds. Furthermore, the above-described German tax regime (GITA) also applies in respect of such NewCITS.

The specific German tax regime for foreign collective investment schemes (GITA) targeting German tax-resident investors, as well as certain regulatory benefits, may lead to a greater demand for fund-linked notes as a vehicle to raise capital from German investors.

As a consequence of the above-mentioned regulatory and tax restrictions, in recent years an increasing number of funds have raised capital from German investors by using structured products, particularly in the form of so-called "fund-linked notes". In these structures, German investors invest into a bond, whose payout replicates, on a synthetic basis, the performance of the respective foreign fund. Historically, this market arose around ten years ago, with various banks issuing notes that replicated the performance of a basket of hedge funds and marketing such products to German retail investors. Over time, "capital guaranteed notes" were developed that effectively combine a synthetic investment in a zero-coupon bond with an option based on the performance of the respective foreign funds. More recently, similar "Delta 1-" and "capital guaranteed" structures have been developed for German institutional investors. The report by the German regulator BaFin for 2009 refers to the fact that the majority of investments made by German insurance companies were in the form of such fund-linked notes.

Although the German regulatory and tax authorities as a matter of practice accepted these products for many years, the authorities recently each issued an official decree on the rules for accepting such products (BaFin in December 2008 and the German tax authorities in August 2009). Such products will be accepted from a German regulatory and tax perspective if: (i) the issuer of the note is not legally obliged to invest the issuance proceeds into the respective investment fund(s), and (ii) the investor, under the terms of the note, has only a contractual right for a payment that is referenced to the performance of the respective investment fund(s) (i.e., the investor does not have any direct legal recourse or any security right *in rem* with respect to the foreign investment fund(s)). As a consequence of these decrees by the German authorities, fund-linked notes may also now be issued by entities that are not banks. Since investors in the current financial climate are concerned with the credit risk of the issuer of any such notes, certain German- and Luxembourg-based service providers have developed structures to use special purpose companies (SPCs) as issuers of these notes.

Outlook

Fund sponsors (particularly large, non-German sponsors) with sufficient administrative resources may make further use of European-based NewCITS structures, typically in Luxembourg or Ireland. In addition, the specific German tax regime for foreign collective investment schemes (GITA) targeting German tax-resident investors, as well as certain regulatory benefits, may lead to a greater demand for fund-linked notes as a vehicle to raise capital from German investors. The administrative resources and timing involved for "wrapping" a hedge fund, or for any alternative investment fund strategy in the form of a fund-linked note, may be less burdensome than for other available structures. And, as with any structured product, these financial instruments offer flexibility in structuring specific pay-out terms (such as a full or partial capital guarantee) as well as beneficial liquidity terms.

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1 BaFin Annual Report 2009.

2 3rd Amendment of German Investment Ordinance ("*Anlageverordnung*"), dated 29 June 2010.

3 VGF Annual Report 2009.

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CESR's Advice on Complex Financial Instruments: The Implications and Outlook for UCITS

by **Declan O'Sullivan** and **Conor Durkin**

On 29 July 2010, the Committee of European Securities Regulators ("CESR") delivered its technical advice to the European Commission (the "Commission") in relation to CESR's review of complex and non-complex financial instruments for the purposes of the MiFID[1] "appropriateness" requirement. Despite calls (from various parties who made submissions to CESR during its consultation) to classify structured UCITS and UCITS that employ complex portfolio management techniques as "complex financial instruments", CESR did not recommend any change to the current categorisation of UCITS under MiFID as "non-complex financial instruments".

In practical terms, the distinction between complex and non-complex financial instruments matters, because the requirement to assess the appropriateness of a product or service must always be complied with where the investment product or service involves a complex financial instrument. An assessment of appropriateness does not need to be undertaken for "execution-only" (i.e., non-advised) services in respect of non-complex financial instruments.

This article examines how UCITS are categorised under MiFID, discusses the possible impact of any change to such categorisation and considers the future regulatory developments that may affect classification of UCITS under MiFID's appropriateness requirement.

Classification of UCITS Under MiFID

MiFID introduced a conduct of business regime whereby investment firms are required to assess the "suitability" or "appropriateness" of a service or product offered to clients. In broad terms, the purpose of the suitability and appropriateness assessments are to ensure that clients have the necessary experience and knowledge to understand the risks associated with an investment service or product—in particular, MiFID aims to prevent complex financial instruments from being sold on an execution-only basis to retail investors. Complexity of the service or product is the main criterion to be taken into account when assessing the suitability or appropriateness of such service or product for a client.

Suitability and Appropriateness Requirements

Whenever an investment firm provides investment advice or discretionary portfolio management only, the investment firm must obtain all necessary information regarding the client, its knowledge, experience and financial situation, in order to enable the investment firm to recommend only investment services or products that are suitable for the client.

With the exception of the provision of investment advice or discretionary portfolio management, an investment firm is required to obtain information regarding its clients, their knowledge and experience, so as to enable the investment firm to provide only those services or products that are appropriate for the client.

An investment firm is permitted under MiFID to provide products or services without having to comply with the suitability or appropriateness obligations, if the product or service consists of execution-only services, or the receipt and transmission of client orders relating to non-complex financial instruments.[2] This is known as the "execution-only exemption".

Article 19(6) of MiFID sets out a non-exhaustive list of financial instruments that are categorised as non-complex. Such instruments include, among others, shares admitted to trading on regulated markets, money market instruments, bonds or other forms of securitised debt and UCITS. By definition, UCITS are classified under MiFID as non-complex instruments and therefore fall within the execution-only exemption.

Financial instruments that are not defined as non-complex instruments under MiFID are subject to

an in-depth risk-based analysis for the purpose of determining whether the instrument should nevertheless be categorised as non-complex for the purpose of the appropriateness requirement. Article 38 of the MiFID Level 2 Directive[3] sets out criteria for determining whether or not an instrument should, on a risk-based assessment, be classified as complex.

CESR's Review of Complex and Non-complex Instruments Under MiFID's Appropriateness Requirement

On 14 May 2009, CESR issued a Consultation Paper that set out CESR's analysis of how various types of financial instruments, including UCITS, should fit within either the complex or non-complex categories of instruments for the purposes of the MiFID Directive's appropriateness requirement.

Since CESR commenced its consultation in May 2009, an increasing number of UCITS alternative products have been offered that pursue investment strategies usually associated with hedge funds. Many commentators have noted that some UCITS can be complex products and queried whether complex UCITS should be sold to retail investors. In these circumstances, the proper classification of UCITS under MiFID's appropriateness requirement has become a topical issue.[4]

In its consultation, CESR queried whether there should be any change to the treatment of UCITS under MiFID. Many correspondents argued that UCITS should not automatically be categorised as non-complex instruments given the underlying assets in which UCITS can invest in or to which they may have exposure. Fund associations, on the other hand, overwhelmingly supported no change to the current treatment, arguing that UCITS are conceived as retail products, strictly regulated and subject to stringent risk management rules, provide a high degree of investor protection and are well diversified liquid investments that do not involve liability exceeding the acquisition costs. Financial regulators in the European Union have indicated that they are generally open to a review of the treatment of UCITS under MiFID.

Response of European Regulators

The Autorité des Marchés Financiers ("AMF"), the French Financial Regulator, has commented that UCITS can be very complex products, and has called for the re-examination of the way UCITS are sold, in the context of CESR's review of MiFID's appropriateness requirement. The AMF would prefer UCITS to be placed in the category of financial instruments whose complexity is first assessed by an investment firm under Article 38, before determining whether the UCITS should be classified as complex or non-complex.

The Irish Financial Regulator has also acknowledged that there has been a rapid rise of UCITS using hedge fund strategies, and has indicated that if the matter is raised by the Commission, it would be happy to reconsider the treatment of UCITS under MiFID.

Impact of Changes

Changes to the categorisation of UCITS as non-complex instruments would be likely to cause UCITS significant difficulties in relation to sales and distribution activities. In particular, distributors, execution-only brokers, operators of fund super-markets and other providers of execution-only services, would be required to obtain detailed information in relation to the strategies employed by UCITS for the purpose of assessing on a risk-basis whether a UCITS is a complex financial instrument. If the UCITS is assessed to be a complex instrument, a further assessment would need to be made regarding the appropriateness of the UCITS for the client.

Several practical issues would arise if UCITS are not automatically permitted to avail of the execution-only exemption. For example: (i) should the UCITS itself, or its distributor, be required to make the determination as to whether or not an instrument is complex; (ii) should national regulatory authorities have any role in approving the categorisation of UCITS; (iii) how should information regarding the classification of UCITS be communicated to clients and should such information be included in the Key Investor Information document (that will replace the simplified prospectus); and (iv) how should firms involved in selling and distributing UCITS review, and possibly adapt, their procedures to map and classify their clients, as well as the UCITS transactions of their clients and, on the basis of such information, assess the appropriateness of UCITS for their clients.

Further Regulatory Developments

On 29 July 2010, after completing its consultation, CESR delivered its technical advice to the Commission. Although CESR's function was to carry out a review of the classification of various financial instruments under MiFID, CESR noted that UCITS are subject to a separate regulatory regime and indicated that recommendations for reform regarding the classification of UCITS would be outside the scope of its review.

On the same day, CESR also replied to the Commission's request for information regarding technical criteria to distinguish among UCITS as complex and non-complex instruments. On this subject, interestingly, CESR stated it "believes that there is a case for considering treating structured UCITS and UCITS that employ complex portfolio management techniques as complex financial instruments for the purposes of the appropriateness test (this is a concept that would need to be elaborated possibly through binding technical standards)" and invited the Commission to determine whether additional work should be undertaken by CESR in considering this question.

The Commission will now review CESR's technical advice before recommending changes, if any, to MiFID. It is expected that Commission will make its recommendations in early 2011.

Packaged Retail Investment Products

On a related topic, the Commission is currently preparing legislative proposals in relation to Packaged Retail Investment Products ("PRIPs"), and its work in this field is related to CESR's review of financial instruments (including UCITS) under MiFID. PRIPs are defined by the Commission as investment products that are broadly comparable for investors and can take a variety of forms. For example, PRIPs would include investment funds (including UCITS), structured securities, unit-linked life insurance products or structured term deposits. At present, retail PRIPs, such as those listed above, are regulated under separate Directives and there are inconsistent rules in relation to disclosure, selling and investor protection. The Commission's goal is to create a common basis for the regulation of key investor disclosures and selling practices at a European level, irrespective of the form in which a retail investment product is packaged or sold.

Based on its work to date, the Commission has proposed to develop a framework in relation to pre-contractual disclosures and selling practices. For selling practices (including the sale of UCITS), the Commission intends to use MiFID provisions on conflicts of interest, inducements, appropriateness, suitability and client disclosures, as the basis for developing a common PRIPs sales regime.

Conclusion

The question of the future treatment of UCITS under MiFID and the associated issue of how UCITS are distributed will be revisited in the context of the PRIPs reform that is being developed by the Commission. Investment firms providing execution-only services in respect of UCITS, particularly distributors, execution-only brokers and operators of fund supermarkets, should be aware that a change to the classification of UCITS under MiFID may mean that UCITS will no longer automatically benefit from the execution-only exemption. If the PRIPs reform results in a change to the classification of UCITS, investment firms would be advised to review their operating procedures so that the firms can either make a determination as to whether or not specific UCITS are complex financial instruments, or alternatively, assess the appropriateness of particular UCITS for their clients.

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1 Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments Directive ("MiFID"), which is a European Union law that provides harmonised regulation for investment services across the European Union. MiFID applies to all business firms that provide investment services in respect of financial instruments.

2 The service should be delivered at the initiative of the client, the client should be advised that the investment firm is not required to assess the suitability of the services and the investment firm should have in place an appropriate policy to manage conflicts of interests (ref. Article 19(6) of MiFID).

3 Directive 2006/73.EC of 10 August 2006 as regards defined terms, and organisational requirements and operating conditions for investment firms.

4 Although UCITS IV will result in significant changes to the UCITS regime, it does not touch upon the classification of UCITS under MiFID.

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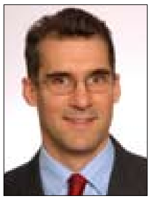
Revising the UK Remuneration Code: Considerations for Investment Managers



by **Jim Baird**

The United Kingdom Financial Services Authority (the "FSA") issued a consultation paper on 29 July 2010 proposing revisions to its remuneration code (the "Code"). The Code currently applies to approximately 27 larger firms but under the proposals would be extended to apply to approximately 2,500 financial services firms from 1 January 2011 (subject to some important transitional provisions).

These proposed changes to the Code are in essence the means by which the FSA proposes to implement the broader European proposals under the draft EU Capital Requirements Directive ("CRD3"), required to be implemented by the same date.

The Code would apply the broad principles under the CRD3 to most UK hedge fund managers and all UK managers of UCITS funds. UK domiciled groups must apply the Code globally with respect to all regulated and unregulated entities. In addition, UK subsidiaries of foreign domiciled groups must apply the Code to all global entities within their group or sub-group. Accordingly, a non-UK/EEA subsidiary or sister company of a UK subsidiary will be caught by the Code.

In large part, these difficulties derive from the origins of the Code as a model designed for the banking sector, which adapt less well in their application to the asset management sector (where different business models and systemic risk profiles prevail).

The provisions of the Code would include a requirement to defer 40% of variable remuneration for at least three years (increasing to 60% if variable remuneration exceeds £500,000), a requirement that 50% of variable remuneration be paid in shares (or other equivalent ownership interests) and a ban on guaranteed bonuses (except in certain limited circumstances). In addition, firms would have to consider adjusting the unvested portion of an individual's variable remuneration in certain circumstances (such as misconduct, failures of risk management or downturn in firm performance).

The Code presents a number of potential difficulties for the firms that will now fall within its scope. In large part, these difficulties derive from the origins of the Code as a model designed for the banking sector, which adapt less well in their application to the asset management sector (where different business models and systemic risk profiles prevail).

The FSA has stated that it is committed to applying a "proportionate" approach and the draft Code provides that the provisions should be applied in a manner proportionate to firms' size, internal organisation and complexity. However, as yet, the exact nature of the proportionate approach remains undetermined and the concern is that there will be insufficient flexibility due to the confines imposed on the FSA by CRD3.

For the many UK hedge fund managers for whom a limited liability partnership ("LLP") is the structure of choice, the Code will present particular issues. Members of an LLP pay tax on their respective shares of LLP profits in any particular year, whether or not receipt of some of the profits is required to be deferred. Therefore, there will be difficulties in aligning the timing of the tax burden with the receipt of the related profits for these individuals. In extreme cases, if the higher 60% level is deferred, and the marginal tax rate is 51%, a member could end up with insufficient profit to meet his or her tax bill in the current year.

On a related point, there is currently no clear distinction between staff and owners of an LLP, so, unless clarified, the latter would be subject to the Code in respect of their full profit share even if, in reality, this represents an equity investment rather than remuneration in the true sense.

LLPs will also have difficulty complying with the requirement to pay part of the variable remuneration in shares (as such entities do not issue shares). If alternatives, such as issue of shares in a fund, are adopted, this may expose staff to unintended levels of risk.

More generally, the Code does present problems in achieving the deferral and conditional vesting on the one hand, while achieving tax efficiency on the other. While firms will be anxious to avoid unfunded tax liabilities for staff in respect of deferred remuneration, the tax authorities are unlikely to embrace deferral of tax on this element of remuneration. In addition, if tax is imposed on the basis of the full deferred amount, some form of tax adjustment would be required where the variable remuneration is subsequently adjusted.

The Code therefore presents a number of practical difficulties, particularly for smaller firms, that may require considerable planning. These impacts, together with potential planning measures, are discussed in more detail in our *DechertOnPoint* "The FSA's Proposed Revision of its Remuneration Code" available at http://www.dechert.com/library/FS_Employment-08-10-FSA_Provised_Revision-SA.pdf.

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Marketing of Closed-End Investment Funds in France

by **Olivier Dumas**

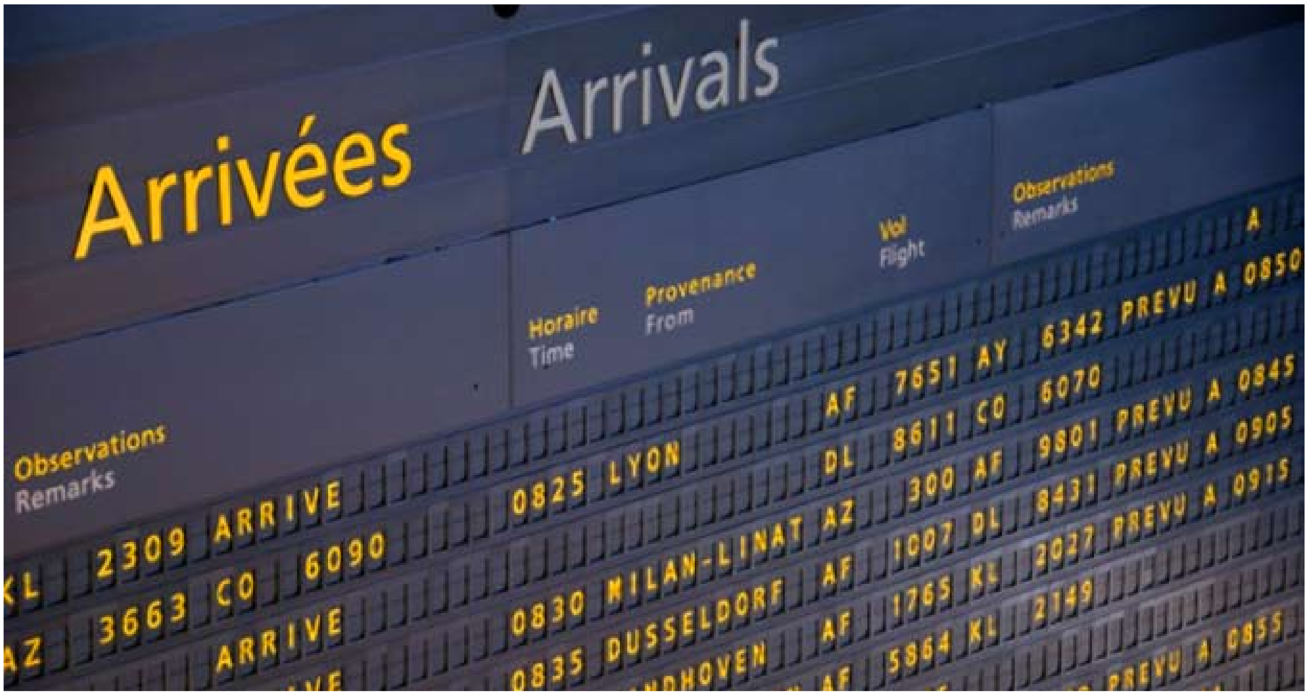
The draft European Directive on Alternative Investment Fund Managers (the "AIFM Directive") is expected to significantly modify the regulations that apply to the marketing and sale of closed-end funds in Europe. The AIFM Directive offers an opportunity for France to adopt a regulatory framework that, for the first time, covers this type of fund. It also offers France an opportunity to clarify and improve its rules relating to the marketing and sale of financial products generally.

Over the past decade, the French legislature has adopted various amendments to the legislation governing marketing and sale of financial products, either for domestic policy reasons, or in order to implement European Directives. However, this somewhat ad hoc approach has led to a disparate array of laws and regulations governing marketing, offering and sale of financial products. With the approach of the AIFM Directive, French rules on "canvassing", "financial advice" and "placement of securities" will need to be revised and consolidated.

Treatment of Closed-End Investment Funds and Open-End Investment Funds Under Existing French Regulations

There has been intense debate in the past months over the scope and terms of the AIFM Directive. These debates have highlighted the fact that neither France nor many other European countries have well established laws and regulations relating to closed-end investment funds. Despite the important role played by these investment funds in the economy, certain existing European regulatory frameworks, notably in France, are not well adapted to this type of fund structure.

Under French law, investment funds are not specifically defined by their object, purpose or form. Article L. 214-1 of the French Monetary and Financial Code ("CMF") includes a list of fund types that can be established in France and that are therefore recognized from a legal standpoint. This list, however, is very specific and does not cover in a more general way French or foreign fund entities that might pursue similar goals.



OPCVM (*Organisme de Placement Collectif En Valeurs Mobilières* – UCITS) are included in that list. Pursuant to the provisions of Article L. 214-4 of the CMF, these entities are not defined per se, but are characterised by the fact that their assets include transferable financial instruments, deposits and cash. Obviously, this is not an ideal definition of an "investment fund", since many operating companies also could fit such description.

Furthermore, Article L. 214-2 of the CMF, defines, but without any further elaboration, two types of OPCVM: SICAV (*Société d'Investissement à Capital Variable* – an investment company with variable capital) and FCP (*Fonds Commun de Placement* – a type of contractual fund prevalent in France and Luxembourg). In order to understand this limited legal framework, one must refer to the European UCITS Directive.[1] According to its provisions, a UCITS (or OPCVM) fund must be an "open-ended" entity (an entity that permits its investors to request the redemption of their units). Consequently, the OPCVM categorisation only applies to funds that invest in liquid assets and/or provide regular redemption rights.

European law further distinguishes between two types of open-end investment funds: investment funds known as "coordinated" and those known as "non-coordinated". Coordinated funds can be freely marketed in Europe (under a European "passport" such as that in the UCITS Directive); as long as they are approved by the regulator in their state of incorporation, they may be marketed in other European Member States without any authorisation or approval of the regulator(s) in these countries (but are required to submit a notification to said regulators). Non-coordinated funds can (within locally applied limits) be marketed in their state of incorporation, but can only be marketed in another European Member State after they have been authorised by that state's regulator (or, to the extent available in that state, pursuant to a private placement exemption).

Most of the investment funds regulated by the CMF are non-coordinated funds. Except for two recent exceptions,[2] this set of regulations does not encompass closed-end funds (entities that do not allow their investors to redeem their units with any regularity).

Yet, with regard to alternative management structures, many investment funds are closed-end funds, particularly those that invest in assets that are not generally considered "liquid"—such as securities in unlisted companies, real estate or infrastructure—and only offer limited liquidity to investors.

Until recently, the industry generally assumed that marketing of closed-end funds was regulated by the so called European Prospectus Directive"[3] which sets forth rules of very broad application for certain public offerings of securities and private placements (to qualified investors or restricted circles of investors), although it does not cover open-end funds. However, although French legislators and regulators have addressed open-end funds, they have not enacted specific regulations relating to the operation, management and marketing of closed-end funds, leaving these entities to be covered by general corporate law principles.

Evolution of French Regulations in Order to Allow Marketing and Sale of Foreign Closed-End Funds in France

There has been ongoing confusion in France about the various forms in which a closed-end fund may be organized, including structures such as an Anglo-Saxon limited partnership or investment companies. Prior to 1999, the French legislators, regulators and tax administrators did not have a clear view as to how to treat the investments of an FCPR (a form of closed-end contractual fund) in investment companies or non-corporate investment funds. Since 1999, these funds have been able to invest in closed-end investment funds, defined by Article L. 214-36 of the CMF as "rights representative of a financial investment in an entity . . . whose main purpose is to invest in companies whose securities are not traded on a market".

In another example, the French *Autorité des Marches Financiers* ("AMF") initially hesitated to approve various investment funds in the form of investment companies designed to provide investors with tax relief from "ISF" (*Impôt sur la Fortune* – French wealth tax), when such funds appeared on the market following the enactment of the TEPA law on 21 August 2007.[4] Some thought that this "ISF" investment holding company had been created by the legislature as a very simple organised form of investment club, whereas others understood it as an investment fund (a collective investment structure).

In recent years, a series of clarifications has been provided through modifications to the regimes applicable to transferable securities, financial instruments and lately, financial securities. Prior to these reforms, it was necessary to distinguish closed-end funds formed as corporations from closed-end funds formed as any other type of entity. Funds formed as corporations, either in France or abroad, were subject to the French marketing regulations pursuant to the Prospectus Directive. In that case, public offering or private placement rules applied.

In contrast, funds formed as another (non-corporate) type of entity, such as Anglo-Saxon limited partnerships (which are mostly creatures of contract and may not have legal personality), were not issuers of securities as interpreted under French law and thus did not fall within the scope of the public offering and private placement regulation.

Article L. 211-41 of the CMF now covers interests issued by Anglo-Saxon limited partnerships and treats them as issuers of financial securities. Consequently, the interests of these entities may now be sold in France pursuant to the Prospectus Directive (provided the relevant public or private placement conditions are satisfied) in a similar manner to funds formed as corporations.

Although French legislators and regulators have addressed open-end funds, they have not enacted specific regulations relating to the operation, management and marketing of closed-end funds, leaving these entities to be covered by general corporate law principles.

Some Restrictions in French Regulations Still Exist that Limit the Effective Marketing and Sale of Foreign Closed-End Funds in France

There are still obstacles to the marketing of foreign closed-end investment funds. In fact, such funds are generally marketed within the private placement framework, where the rules remain imprecise and inconsistent.[5] For example, with regard to "financial canvassing" (or solicitation), Article L. 341-10 of the CMF prohibits "canvassing" of investors by entities that issue unlisted securities (securities of unlisted closed-end investment funds, whether or not in corporate form).

In accordance with provisions of Article L. 341-2 of the CMF, canvassing regulations do not apply when canvassing is carried out with a limited number of investors or in certain circumstances, in particular when it is addressed to qualified investors. Unfortunately, there has been no harmonisation between regulation of private placements under Article L. 411-2 of the CMF and financial canvassing under

Article L. 341-2 of the CMF. As such, the industry generally considers that the prohibition imposed under Article L. 341-10 of the CMF does not apply in the context of a private placement carried out by way of canvassing. Obviously, clarification in this area would be helpful.

There are still obstacles to the marketing of foreign closed-end investment funds.

The regulations relating to financial securities marketing (and, in particular, providers of the investment service referred to as "unguaranteed placement of securities"), restrict the persons authorised to "sell" financial securities. Such persons are investment service providers regulated and approved by the Prudential Supervisory Authority (*Autorité de Contrôle Prudentiel* – "ACP") and certain other entities such as banks, insurance companies, OPCVM and portfolio management companies, as well as "*conseil en investissement*" and "*conseil en gestion de patrimoine*" (wealth management counselors) and authorised financial canvassing agents.

In theory, these rules apply only to "sales" on a regular basis. Therefore there is some uncertainty as to whether a closed-end fund, which "sells" its units directly or by way of its management entity on a non-regular basis would need to use an ACP-approved investment service provider.

In addition, it is unclear whether a closed-end fund would be required to use an ACP-approved investment service provider for a private placement to qualified investors. It is unfortunate that current applicable regulations on the matter do not provide specific answers, especially since, as for canvassing or financial investment advice, nothing seems to justify the requirement for intermediaries, especially heavily regulated intermediaries.

Master-Feeder Closed-End Fund Option

Finally, in order to invest in closed-end investment funds, qualified French investors can invest in French investment funds that are, in turn, entitled to invest in French or foreign closed-end funds. Those funds are either funds of funds (whose strategy is to invest in several funds) or feeder funds (whose strategy is to invest in a single master fund). In each case, these funds must be managed by a regulated French management company.

The "fund of funds" structure exists both for open-end[6] or closed-end[7] French funds that can invest in foreign funds, including those located in offshore countries.

However, the AMF has expressed concerns regarding the "feeder-foreign master" fund structure, indicating that a French fund should not be used to bypass the prohibition on marketing foreign open-end investment funds in France without the AMF's authorisation.[8] This position may be questioned in the case of French funds whose subscriptions would be limited to qualified investors. Although this position complies with the provisions of Article L. 214-1 of the CMF that prohibit the sale in France of foreign open-end funds without AMF authorisation, it does not seem adaptable to closed-end funds, notably the foreign ones, which are not regulated by the provisions of such Article.

Although it may be argued that a "master-feeder" structure should not deprive a French management company of its management capacities, this seems to be based upon an inaccurate view of the role of a management company of a fund of funds or a feeder fund, since both structures offer French qualified investors more safety for their investments than would a direct investment in foreign, open-end or closed-end, investment funds.

These concerns of the AMF appear to contradict somewhat the French position in the AIFM Directive debate, where it supports a rigorous European regulatory framework for the management and marketing of alternative investment funds, and in particular those that are closed-ended. Taking into account the relatively distant dates for the effectiveness of the AIFM Directive (perhaps a little more than two years), it may be hoped for a prompt clarification in this area, in order to substantiate France's objective of modernizing its financial markets.

Conclusion

The AIFM Directive is intended to provide a regulatory framework for the management and marketing of non-UCITS investment funds, including closed-end funds. When the AIFM Directive is finally enacted, it is certain that France will revise its rules relating to the marketing of investment funds, and notably those that are closed-ended. There is no doubt that this area would benefit from a bottom-up review in order to ensure that the various texts of laws and regulations are coherent and consistent. It may be hoped that this review can be achieved in the not-too-distant future.

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[1] Council Directive 85/611/EEC dated 20 December 1985 and amended by directive 2009/65 EC dated 13 July 2009. According to Article 2 of this directive, a UCITS is an entity:

– the sole object of which is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk-spreading, and

– the units of which are, at the request of holders, re-purchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such re-purchase or redemption.

[2] The contractual venture capital fund (*"FCPR Contractuel"*) was created in August 2008 and provided for under Article L214-38-1 of the CMF. It can be a fund considered to be closed-ended.

The investment company with fixed capital (SICAF) was created in January 2009 and provided for under Articles L214-151 et seq. of the CMF. The SICAF is specifically referred to in the context of closed-ended funds. Article L214-153 of the CMF specifies that "the shares of a SICAF or a closed-ended investment fund constituted on the basis of foreign law" can be sold through "canvassing" with qualified investors.

[3] Directive 2001/34/EC dated 28 May 2001, as amended.

[4] The TEPA law has introduced many reforms requested by the President of the French Republic after his election in 2007. The TEPA law provides, among other matters, for a tax reduction for French residents liable for ISF, if they invest in a venture capital fund (in the form of an FCPR or investment holding company).

[5] See Reply from the French Securities Commission (AMF) dated 13 July 2007 on consulting the European Commission on private investment.

[6] UCITS for hedge funds and contractual funds, pursuant to Art. 411-34 of RGAMF (General Regulation of the AMF).

[7] FCPR with simplified procedures or contractual structures.

[8] FAQ contractual funds monthly review AMF September 2005; FAQ contractual venture capital AMF 5/11/2008.

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The Introduction of Funds Re-domiciliation Legislation in Ireland

by **Declan O'Sullivan** and **Conor Durkin**

On 7 September 2010, the Companies (Miscellaneous Provisions) Act, 2009 (the "Act"), which provides for the efficient re-domiciling of offshore funds to Ireland, became effective. The Act permits offshore funds from Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Jersey and the Isle of Man to re-register as an Irish company, whilst preserving their legal identity. The process of migrating a fund to Ireland does not, under Irish law, involve a change in legal identity and should not result in a taxable event for the offshore fund and its investors. The new legislation makes the process of re-domiciling to Ireland easier and less costly than the traditional methods of merger or plan of reconstruction.

Opportunity to Reside in a Regulated Jurisdiction Using a Straightforward Process

The Irish legislation introduces an efficient means of re-domiciling an offshore fund to Ireland. In the past, re-domiciliations to Ireland were typically effected under a plan of reconstruction whereby a new fund would be established in Ireland and in exchange for the transfer of assets from the offshore fund to the new Irish fund, investors in the offshore fund would receive shares/units in the Irish fund and their existing holdings in the offshore fund would be cancelled. Under this process, however, the transfer of assets to the Irish fund could constitute a taxable event. Furthermore, the establishment of a new fund would require the execution of new contracts by the Irish fund and prevent reference to the track record of the offshore fund by the Irish Fund.

The new Irish re-domiciliation regime has many advantages, including the following:

- there is no transfer of assets or other taxable event as a consequence of the re-domiciliation;
- the fund will retain its corporate identity and its existing contractual arrangements;

- the existing track record of the offshore fund will be retained; and
- the procedure is relatively straightforward.

The new re-domiciliation legislation only applies to foreign funds that are established as corporate entities. Proposals are being developed at the industry level to develop an agreed-upon procedure intended to facilitate a speedy re-domiciliation of foreign unit trusts to Ireland.

Procedure

The re-domiciliation of an investment fund to Ireland involves a twin process. First, there is the legal process of registering the foreign fund with the Companies Registration Office ("CRO") in Ireland, by way of continuation as a company under the Companies Acts 1963-2009. Second, the foreign fund must go through the regulatory process that relates to the approval of the foreign fund by the Irish Financial Regulator as a regulated investment fund.

A foreign investment company wishing to migrate to Ireland would apply to the CRO to be registered as a company in Ireland by way of continuation. The process of registering the offshore fund is straightforward and involves the filing of relevant forms and declarations with the CRO. An application for registration should be made by filing with the CRO corporate documents such as the fund's articles of association, certificate of incorporation, particulars of directors and secretary, the application form and relevant statutory declarations. An application to the Financial Regulator should be made simultaneously with the fund's application to the CRO.

As part of the application, the CRO will require the fund to file a declaration of solvency. An auditor or other independent person located in the jurisdiction of the migrating fund is required to confirm that the director's declaration of solvency is reasonable. Depending upon the nature of the assets held by the migrating fund, this may require an audit to be carried out on the accounts of the migrating fund; this should be considered at the outset, particularly in relation to its impact on the timing of the re-domiciliation.

One condition of the Irish legislation regarding re-domiciliation to Ireland is that the migrating fund must obtain any consents or waivers required by contracts to which the migrating fund is a party. All agreements entered into by the migrating fund should be reviewed to ensure that the re-domiciliation of the offshore fund will not constitute a breach of contract or trigger an event of default or other termination event. Particularly in the case of prime brokerage agreements and ISDA agreements, the consent of the prime broker or counterparty in most cases should be obtained in order to ensure that the re-domiciliation is not interpreted as a breach of a representation or warranty, or does not result in a breach of the security arrangements entered into under the relevant agreement. The requirements for Irish regulated funds to have a custodian and the rules applying to Irish regulated funds with respect to prime brokers and utilization of assets will require detailed consideration by those considering re-domiciliation.

Furthermore, notice of the proposed re-domiciliation is required to be served on all creditors of the migrating fund. The purpose of this notice is to ensure that creditors can make any claims against the migrating fund before it moves out of its original jurisdiction. If a creditor has an unresolved claim against the migrating fund, this will prevent the migrating fund from completing a valid statutory declaration that forms part of the re-domiciliation application to the CRO.

The re-domiciliation procedure applies only for those jurisdictions that have a reciprocal re-domiciliation regime permitting outward and inward migration in a manner substantially similar to Ireland. These countries currently are Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Jersey and the Isle of Man. Other countries and jurisdictions may be added by order of the Irish Minister for Enterprise Trade and Innovation in due course.

Regulatory Approval of the Migrating Fund

The migrating fund must apply to the Financial Regulator for authorisation as a UCITS or an investment company under Part XIII of the Companies Act, 1990 (i.e., as a regulated investment fund). The work involved in obtaining regulatory approval of the migrating fund as a UCITS or an investment company will be similar to the establishment of a new fund and will involve amending or replacing the existing foreign fund documentation with documentation suitable for an Irish fund.

A comprehensive review should be undertaken of the investment strategies of the migrating fund to ensure that they are compatible with the UCITS rules, or Irish rules applicable to non-UCITS funds (whether retail, professional or qualifying investor fund).

There are many requirements with which Irish regulated funds are required to comply, such as: limitations on the ability to gate or restrict redemption requests, a restriction on the levels of subscription or redemption charges that may be charged to investors and the requirement to adhere to proper standards as regard the valuation of a fund's assets. Requirements of this nature will need to be reviewed and reflected in the prospectus of the fund when re-domiciled to Ireland. Although the requirements of the Financial Regulator may reduce operational flexibility, they are adopted in the interests of investor protection and fund managers should bear in mind that the principal rationale for re-domiciling an offshore fund to an onshore regulated jurisdiction will be to satisfy investor demand for enhanced regulation.

As part of the Financial Regulator's authorisation process, the entity acting as promoter and investment manager to the migrating fund will need to be authorised by the Financial Regulator to promote and/or act as investment manager to the fund when re-domiciled to Ireland.

Who Might be Interested in Change of Residence?

The legislation will be of interest to promoters of alternative investment funds, who are seeking to take advantage of the distribution opportunities afforded by the UCITS Directive. The trend of hedge fund managers establishing UCITS is well established. A straightforward re-domiciliation process offers such managers the opportunity to re-domicile offshore funds as UCITS, without having to set up a new fund. Establishing a new fund would require a fund manager to build a distribution network or spend some time marketing the fund and gathering assets. Re-domiciling an existing fund has the advantage of retaining existing clients, who will continue as shareholders in the re-domiciled fund. For fund managers, it may also reduce the so-called risk of "cannibalising fees" that some managers perceive may occur if separate offshore and onshore funds are maintained.

Managers preparing for the introduction of the Alternative Investment Fund Managers Directive ("AIFMD") might be interested in re-locating to a European domicile for the purpose of availing of the EU marketing passport contemplated by the AIFMD.

Most importantly, managers whose clients would prefer to invest in regulated funds should consider whether it is time to re-locate onshore.

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Retail Fund Authorization in Hong Kong: The Moving Goal Posts

by **Angelyn Lim**, **Kher Sheng Lee** and **Jessica Shao**

Introduction

On 25 June of this year, Hong Kong received a new Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (the "Handbook")[1] issued by the Hong Kong Securities and Futures Commission (the "SFC"). The Handbook is a consolidation of revisions made to the existing Code on Unit Trusts and Mutual Funds (the "Revised UT Code") and Code on Investment-Linked Assurance Schemes, and a new Code on Unlisted Structured Investment Products.

The Handbook comes after a public consultation period on proposed measures by the SFC to enhance protection for the investing public[2] and strengthen the existing regulatory framework. The Revised UT Code now forms the basis on which offshore funds will receive the SFC's stamp of approval in order to be distributed to the investing public of Hong Kong.

This article summarises the key revisions to the general authorization requirements for investment funds, and highlights points of note for asset managers considering applying for the authorization of one or more funds in Hong Kong, for retail distribution.

Key Revisions to the General Authorization Requirements

Information to be Disclosed in the Offering Document

Product Key Facts Statement ("Product KFS")

The Product KFS is intended to be a short (3–4 page) summary of the key features (and, in particular, the key risks) of the relevant fund, set out in plain layman language so as to be easily understood by the retail investor. The SFC has provided, on its website,[3] illustrative templates of the Product KFS for six different kinds of investment products (i.e., guaranteed funds, exchange-traded funds, index funds, investment-linked assurance funds, unlisted structured investment products and general funds).

The Product KFS will form part of the offering documents, although the SFC may, under exceptional circumstances, permit an exemption in relation to certain foreign funds (e.g., certain UCITS funds), on the basis of overriding legal requirements of the home jurisdiction of those foreign funds. However, immunity from, or disclaimers or limitation of, liability with respect to the Product KFS is not permitted—issuers will assume civil and/or criminal liability for any misrepresentations in the Product KFS, whether or not such Product KFS constitutes part of the offering document of the investment product.

The SFC has indicated that, in practice (possibly due to the current teething issues of introducing the Product KFS requirement), the SFC is prepared to adopt a very hands-on focused review of the Product KFS in a bid to ensure that it is, indeed, presented in language that will be easily understood by the lay investor. The Product KFS should not be regarded as simply a "cut and paste" job from the disclosures in the main Prospectus of the fund although its contents must, obviously, be consistent with those in the "main" offering document.

Although existing authorised funds, and funds whose applications for authorization had been submitted to

the SFC prior to 25 June 2010, were initially given until 24 June 2011 to produce their Product KFS, the SFC changed this position on 14 September 2010 to require certain funds, currently undergoing authorization, to produce a Product KFS now as part of the application process. This requirement applies to those funds that:

- have a more than 10% exposure of their net assets to investment in the domestic PRC market; or
- actively use derivatives as part of their investment strategy; or
- will be managed by an asset management group that has not previously been approved by the SFC to manage an SFC-authorized fund.

Collateral Policy and Criteria

The fund's selection criteria, nature and policy with respect to any collateral it holds (as well as a description of such collateral) must be disclosed in the fund's offering documents.

Risk Management Policy

The offering document must disclose the risk management policy (where appropriate) that has been put in place to deal with abnormal risks involved in the investment of a specialised fund.

Complaints

The offering document must disclose information regarding the issuer's approach to enquiries and complaints made by investors.

Limits on Investment in Other Funds

The previous strict 10% limit on investment in other collective investment funds has been expanded so that, while it still applies to investment in non-recognized jurisdiction funds that are not SFC-authorized, investment of up to 30% (of the fund's NAV) is now permitted in underlying funds which are "recognized jurisdiction schemes"[4] but not authorized by the SFC, and in excess of 30% for those underlying funds that are SFC-authorized.

An offering document is required to be produced in both the English and Chinese languages. Although the preparation of a Chinese-language annual report is optional for all SFC-authorized investment funds, issuers must disclose clearly in the offering documents whether annual reports and interim reports will be published in bilingual versions.

Multi-Manager Fund

The key qualification requirements applicable to all management companies of funds applying for authorization by the SFC are set out in Chapter 5 of the Revised UT Code.

With respect to multi-manager funds, generally, it is expected that at least three sub-managers will be delegated the investment management function in respect of a fund's assets. When considering the key personnel qualifications of such sub-managers, the SFC may take into account (on a case-by-case basis), when assessing the investment experience of the key personnel of the sub-managers, experience in areas other than in managing public funds. This should be welcomed by fund management groups generally as the SFC's previously strict adherence to the public fund management experience requirement had not always been easy to satisfy and, arguably, need not be insisted upon at the sub-manager level.

Also to be disclosed in the fund's offering document are the due diligence processes adopted by the management company in selecting and monitoring the sub-managers on an on-going basis.

Special Funds

New requirements relating to the authorization requirements for special funds like Structured Funds are set out in Section 8.8 of the Handbook, and Section 8.9 sets out the requirements for Funds that Invest in Financial Derivative Instruments (which are not UCITS).

General Points to Note

In the post-global financial crisis era, regulators around the world have seen fit to focus even more on enhanced measures to protect the small investor. The SFC has been no different. Particularly with the lessons of the Lehman Minibond[5] crisis, the SFC has substantially increased its attention on investment products aimed at the Hong Kong retail market (and their offering documents), as well as the conduct of distribution processes of market intermediaries when distributing such products.

Whereas, generally, this has resulted in a lengthened processing time at the application stage due to increased commentary from the SFC on the product offering documents (and now the Product KFS as well), this is particularly the case with funds whose investment strategies are focused on the Mainland China market. Given the current popularity of such

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products (including RMB-denominated products and those which invest primarily in Mainland China), the SFC has felt compelled to put such products under an even harsher supervisory light. Fund sponsors would be well advised to take these factors into account when planning the fund launch timetable.

Conclusion

The Revised UT Code was unveiled as one of a number of regulatory initiatives to enhance the protection of the Hong Kong investing public. Time will tell to what extent its goal will be achieved in practice.

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1 Available at: http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=10PR71.

2 For a discussion of other measures taken or contemplated by the SFC, please refer to http://www.dechert.com/practiceareas/practiceareas.jsp?pg=lawyer_publications_detail&pa_id=19&id=11962. For a discussion of a set of proposals issued by the SFC to enhance investor protection, please refer to http://www.dechert.com/library/FS_14_10_09_Hong_Kong_Proposes.pdf.

3 Please refer to the illustrative templates for Product Key Facts Statements in respect of General Funds issued by the SFC, available at: http://www.sfc.hk/sfc/doc/EN/intermediaries/products/pkfStatements/KFS%20UT%20General%20Funds%20Eng.pdf.

4 Please refer to the List of Recognized Jurisdiction Schemes issued by the SFC, available at: http://www.sfc.hk/sfc/doc/EN/intermediaries/products/schemesRegimes/RJS%20Eng.pdf.

5 For further information regarding the Minibonds and enhanced risk disclosures, please refer to "Hong Kong's Securities and Futures Commission and the Minibond Fallout" available at http://www.dechert.com/library/FS%20_1_01_09_Hong_Kong_Securities.pdf. and "The Minibond Saga Continues" available at http://www.dechert.com/library/Financial%20Services%20Report%20-%2003_09.pdf.

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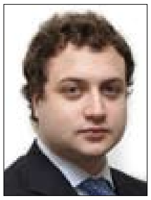
Russia Finally Adopts Law on Insider Trading



by **Kirill Skopchevskiy**

After more than ten years in the making, on July 27, 2010, Russian President Medvedev finally approved the Federal Law No. 224-FZ "On Insider Trading and Countering Market Manipulation and Amending Certain Russian Legal Acts" (the "Insider Trading Law"). The majority of the provisions of the Insider Trading Law will come into legal effect on January 27, 2011, with some exceptions, as set out below. Its provisions do not apply to the financial operations of the Russian Central Bank or to debt securities issued by the Russian State. The federal body responsible for its enforcement is the Federal Service for Financial Markets ("FSFM").

This article does not analyze the provisions of the Insider Trading Law that describe actions constituting "market manipulation" because these provisions are conceptually analogous to those that were already set forth in Articles 51(2) and 51(2)(1) of Federal Law No. 39-FZ "On the Securities Market", dated April 22, 1996 (as amended) (the "Law on the Securities Market"), with some differences in the exact language used in the drafting of the Insider Trading Law. The market manipulation provisions of the Insider Trading Law supplement and override the relevant articles of the Law on the Securities Market mentioned above.

The Insider Trading Law defines inside information as specific and concrete information that has not been disseminated or transferred (including information that constitutes commercial secrets, official secrets, bank secrets, correspondence and other secrets as provided by applicable law), whose dissemination or transfer may materially affect the price of a financial instrument, a currency or a good (an "Instrument"), and that is deemed to be inside information with respect to the certain category of insider with access to such information (collectively, "Inside Information"). Inside Information may include information concerning issuers, management companies of investment funds, unit investment funds, private pension funds, persons holding dominant positions in certain markets or Instruments.

Article 6 of the Insider Trading Law prohibits:

- using Inside Information for the purpose of undertaking operations on Instruments to which Inside

Information relates (using one's own or third-party accounts), apart from when performing a previously vested obligation to purchase or sell Instruments that arose before the person obtained the Inside Information;

- transferring Inside Information to third parties, unless the transfer is to a person on the relevant insider list in furtherance of the obligations established by applicable federal laws, or through employment or other contracts; or
- providing recommendations (or any other incentives) to, or obliging, third persons on the basis of Inside Information to purchase or sell Instruments.

A specific carve-out from these restrictions is made for journalists and the media in general who receive Inside Information for the purposes of public disclosure. Publishing or broadcasting Inside Information to the general public will not be deemed to be an unlawful use of Inside Information. However, under certain circumstances, journalists may be held liable for market manipulation; also, persons providing Inside Information to journalists may be liable for unlawful disclosure.

The Insider Trading Law sets out the types of persons and the legal entities that are deemed to be insiders for the purposes of the Insider Trading Law (the "Insiders") and further sets forth the types of information that are deemed to be Inside Information with respect to such Insiders. From July 30, 2011, all Insiders in the below list (1) through (13), except those in categories (9), (10) and (13), must maintain their own register of Insiders.

1. Issuers and management companies.
2. Persons holding dominant positions (more than 35%) on given markets and included in the relevant registry by the Russian Federal Anti-Monopoly Service.
3. Trading organizers (e.g., exchanges); and clearing, custody and credit organizations that settle trades performed via trading organizers.
4. Professional securities market participants and other persons engaged in operations with Instruments in the interests of their clients, who have obtained access to Inside Information.

The Inside Information of persons mentioned in (1) through (4) will be identified in a regulation which will be adopted by FSFM. Based on this regulation, the persons listed above will have to approve their own internal registers of Inside Information. As of the date of this article, FSFM has not yet adopted the said regulation on Inside Information. We can assume that this will be done by July 30, 2011, when these provisions of the Insider Trading Law come into legal effect.

5. Persons who have access to Inside Information deriving from the persons listed in categories (1) through (4) above on the basis of agreements, including auditors, appraisers, professional securities market participants, credit and insurance organizations.
6. Persons who possess at least 25% of the votes in the highest management bodies of the persons listed in (1) through (4) above, or shareholders of persons listed in (1) through (4) above who have access to Inside Information on the basis of federal laws or statutory documents.
7. Members of the boards of directors, management boards or persons performing the functions of the sole executive body (including management companies) or management companies of persons listed in (1) through (6) above and (11) and (12) below.
8. Persons who have access to information about mandatory, voluntary and competing offers to acquire shares of joint-stock companies, including persons who extend such offers, banks who act as guarantors under these offers and appraisal companies.
9. Federal, state and municipal bodies, offices of the attorney general, management bodies of state extra-budgetary funds and the Russian Central Bank. The following information constitutes the Inside Information of these insiders:
    - Information on the results of trades (tenders) approved by them;
    - Information obtained during inspections and the results thereof;
    - Information on decisions adopted with respect to persons listed in (1) through (4), (11) and (12) concerning the issuance, suspension and revocation of licenses (permits, approvals etc.) to perform certain types of activities;
    - Information on the imposition of administrative liability and other sanctions on persons listed in (1) through (4) and (11) through (13); and

- Inside Information approved by the regulations adopted by them.

10. Persons holding executive positions in and employees of the entities listed in (9) above who have access to Inside Information of entities listed in (9) above.

11. News agencies that disclose or provide information on the persons listed in (1) through (4) and (9) above.

12. Ratings agencies providing ratings on the persons listed in (1) through (4) above, as well as on securities.

13. Natural persons who have access to Inside Information of the persons listed in (1) through (8), (11) and (12) above, on the basis of contracts (including employment contracts).

Starting from July 30, 2011, the persons mentioned in (1) through (4), (11) and (12) above are obliged to publish lists of the information that constitutes Inside Information of these insiders on their webpages.

In addition to the exception for media/journalists mentioned above, the Insider Trading Law contains a number of other instances where a person (entity) will not be found liable for dissemination or transfer of Inside Information, even though his/its actions contain elements of violations as provided for in the Insider Trading Law:

- **General exception** – A person shall not be liable for the unlawful use of Inside Information or the dissemination of false or misleading information, if this person did not know and should not have known that such information constituted Inside Information and was restricted;

- **Exception for professional securities market participants** (Broker-Dealers, etc.) – These persons shall not be liable if acting pursuant to the instructions of third parties (the person giving such instructions will be liable); and

- **Exception with respect to the revocation of licenses** – A license of a professional participant in the Russian securities market may be withdrawn for the unlawful use of Inside Information and market manipulation only if the accused participants are unable to prove that they took all possible measures to prevent the violations.

The Insider Trading Law allows a party to seek damages resulting from the actions of the party responsible for the unlawful use of Inside Information and/or market manipulation. However, the Insider Trading Law provides in Article 7(8) that operations or transactions may not be deemed void solely because they involved the unlawful use of Inside Information or market manipulation; that is, the Insider Trading Law maintains that the remedy of damages is sufficient for persons who suffered from these unlawful actions and the underlying transactions shall not be unwound.

The adoption of the Insider Trading Law is long overdue and a very positive development for the Russian securities market.

The Insider Trading Law introduces two new articles to the Russian Criminal Code and the Code of Administrative Violations (the “CoAV”), imposing liability for market manipulation and the unlawful use of Inside Information. Criminal liability for the unlawful use of Inside Information will come into force as of July 30, 2013; criminal liability for market manipulation is already in force. Another article added to the CoAV penalizes the violation of the requirements of other applicable laws on insider trading and countering market manipulation; for example, the violation of disclosure requirements. These provisions will come into legal effect on July 30, 2011.

The adoption of the Insider Trading Law is long overdue and a very positive development for the Russian securities market. It is also a critical element in the ambitious plans of the Russian government and financial regulators to turn Moscow into a meaningful regional financial center and the Russian Ruble into a reserve currency for the world’s largest central banks. However, it is far too early to predict how the Insider Trading Law will be enforced and applied to real market situations. It still remains to be seen whether the adoption of the Insider Trading Law will lead to increased transparency and effectiveness in the Russian securities market.

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