DechertOnPoint

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A legal update from Dechert's Financial Services Group

EU and International Regulatory Developments

UK Regulatory Developments

Financial Services Europe and International Update

Regulatory Developments

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

EU and International Regulatory Developments

The Proposed EU Financial Transaction Tax: An Update

The European Commission on 28 September 2011 published a proposal for a financial transaction tax ("FTT") in the EU. The proposed tax would be levied on financial transactions of shares and bonds at a rate of 0.1% and on derivatives at a rate of 0.01% where the transaction was conducted by a financial institution established on the EU, regardless of where the transaction took place.

On 8 November 2011 the Commission's proposal was discussed at a meeting of ECOFIN. Whilst Member States agreed that the financial sector should make a contribution in return for the bail-outs during the financial crisis, discussion has polarised between France, Germany, Spain, Slovenia and Belgium who supported the tax and the UK, the Czech Republic and Bulgaria who strongly oppose the FTT. The UK branded the discussion a waste of time as there was nowhere near unanimity and time would have been better spent tackling the eurozone crisis. A majority of Member States (Luxembourg, Malta, Italy, Finland, Denmark, Latvia, Bulgaria, the Netherlands, Slovakia, Romania, UK, Czech Republic, Sweden, Greece) raised reservations about the impact the proposal will have, which requires further analysis and discussion at a technical level, and favoured a global tax.

The proponents of the tax have argued that financial transactions should be taxed like any other goods or services and that there is a need to harmonise transaction taxes across the EU to prevent double taxation and distortion in the single market. Most appear to be prepared to proceed at a eurozone level if agreement cannot be reached among the twenty-seven Member States, as is now the case following the recent Brussels EU summit.

Germany in particular has called for the FTT to be agreed quickly and has suggested that those Member States who wish to wait for a global FTT are simply using this as an excuse to do nothing. The German Finance Minister has indicated that Germany will be prepared to see the proposed FTT proceed at eurozone level only but cautioned those member states outside the eurozone against creating differences between those in and out of the single currency zone.

France has said that whilst a global tax was the ideal, an EU wide FTT could act as a trigger for this. The French Finance Minister also said there had been significant developments at the G20, where the USA, who had been staunchly against an FTT, were now saying that they agreed that the financial sector should pay for the crisis. France saw this as a step in the right direction towards global implementation of the tax.

The opponents of the FTT have raised concerns about the impact of the tax, including:

- the reduction of competitiveness of the EU in the global market;
- the increased cost of capital and the impact this would have on investment and growth;
- the increase of interest rates on sovereign debt;
- the significant risk of relocation;
- the likelihood that costs would be passed on to the customers, in particular pension funds; and
- the cumulative impact of the FTT and other regulatory measures (CRD4 and EMIR, for example) on the financial sector.

The UK, Luxembourg and the Czech Republic have argued that it is the wrong time to introduce an FTT. They point out that the discussion has also centred on the need to promote growth and jobs and to recapitalise the banks, but now the FTT is proposed this will reduce growth, cost jobs and make bank recapitalisation more difficult. Sweden and the Netherlands said that a FAT ("financial activities tax) would avoid many of these negative effects in place of a FTT.

There appears to be no consensus on where any revenues from the proposed FTT will be spent. Proponents of the FTT have said that this discussion could wait until the technical discussions on the tax are complete. However, the UK's Chancellor of the Exchequer has argued that there should be clarity about where the money was going as the revenues under the Commission's proposal (assuming any significant amount is actually collected after relocation of the financial services industry outside the EU) had already been proposed to be spent four times over — on the EU budget, member states' national budgets, fighting climate change and tackling poverty.

(Media reports that have subsequently appeared suggest that even if a FTT is imposed on eurozone members only, as it will still affect transactions passing through the UK and could be challenged by the UK as contrary to at least two of the EU Treaty articles).

Further Commission Proposals on Credit Rating Agencies

The EU introduced regulations in 2009 and 2010 in order to regulate the credit rating industry in the wake of the financial crisis. This required credit rating agencies ("CRAs") to be registered and supervised by ESMA and set out various conduct of business standards.

On 15 November 2011 the European Commission published a draft Directive and draft Regulation to regulate credit rating agencies in order to deal with outstanding weaknesses in the framework which have become apparent during the current euro debt crisis.

The key changes in the proposed Directive and Regulation are:

- in order to reduce over-reliance on credit-ratings, there will be a general obligation for investors to do their own credit assessments;
- both CRAs and rated entities will be required to disclose more information underlying ratings;
- CRAs will have to consult issuers and investors on any intended changes to their rating methodologies;
- EU Member States will be rated every six months and investors and Member States will be informed of the underlying factors and assumptions made in each rating;
- issuers will have to rotate every three years the agencies that rate them and complex structured financial instruments will require ratings from two rating agencies;
- ESMA will publish a freely available European Rating Index of all available ratings in respect of a debt instrument; and
- CRAs will be liable in cases where they infringe, either intentionally or with "gross" negligence, the EU's CRA regulations.

The notion of allowing ESMA to suspend sovereign ratings in exceptional circumstances, which Commissioner Barnier had been pressing for, has now been dropped from the proposals in the face of considerable opposition from other Commissioner. (However, it is to be given further consideration at a later stage).

The proposal will now pass to the European Parliament and the Council for negotiation and adoption.

ESMA's Final Advice to the European Commission on the AIFM Directive's Implementation Measures

Readers will recall that the Alternative Investment Fund Managers Directive ("the AIFM Directive") was the subject of a record of several thousand amendments during its legislative process in Brussels before being finally adopted and published in the Official Journal in July 2011. During this process, on 9 November 2009, the UK's Treasury Minister Lord Myners stated:

> *This is a very dodgy Directive that's been poorly constructed. It was produced in a hurry. It's a process that makes those who support the European Union embarrassed.*

Patrice Berge-Vincent of the French financial regulator, the AMF, stated a month earlier on 9 October 2009 that:

> *Almost all of the Directive's provisions need to be redrafted to make them appropriate, proportionate and adequate.*

Against this background, on 23 August 2011, ESMA published a further consultation on possible Level 2 implementing measures under the AIFM Directive which related to the rules for alternative fund managers ("AIFMs") and the treatment of third-country entities, the Commission having in December 2010 sent a provisional request for technical advice on the Level 2 measures to the former Committee of European Regulators (ESMA's predecessor). ESMA consulted on its draft advice in two stages. In July 2011 a consultation focused on the general provisions, authorisation, operating conditions, the depositary, transparency requirements and leverage. In August 2011, as indicated above, ESMA produced a further consultation. This focused on supervision and third-country entities.

ESMA's final advice, released on 16 November 2011, will be the subject of a separate more detailed *DechertOnPoint*, but covers the following matters.

General Provisions, Authorisation and Operating Conditions

Amongst other things, ESMA:

- clarifies the operation of the thresholds that determine whether AIFM is subject to the AIFM Directive;
- proposes to require AIFMs to have additional own funds or professional indemnity insurance ("PII") to cover risks arising from professional negligence; and
- notes that many of the proposals (in areas such as conflicts of interest, record keeping and organisational requirements) are based on equivalent provisions in MiFID (*2004/39/EC*) and the UCITS IV Directive (*2009/65/EC*).

Depositaries

The advice from ESMA sets out the criteria for assessing whether the prudential regulation and supervision applicable to a depositary established in a third country has the same effect as the provisions of the AIFM Directive. The advice identifies a number of criteria for this purpose, such as the independence of the relevant regulator, the requirements on eligibility of entities wishing to act as depositary and the existence of sanctions in the case of violations. The advice also covers the liability of depositaries.

Notably, ESMA proposes three conditions, at least one of which has to be fulfilled for an asset to be considered "lost" (which impacts on whether a depositary must subsequently return an asset) namely:

- that a stated right of ownership of the AIF is uncovered is unfounded if it either ceases to exist or has never existed;
- that the AIF has been permanently deprived of its right of ownership over the financial instruments; and/or
- that the AIF is permanently unable to directly or indirectly dispose of the financial instruments.

ESMA has also clarified which events will constitute external events beyond the reasonable control of the depositary and the objective reasons which will allow the depositary to contractually discharge its liability.

Transparency and Leverage

In terms of transparency, ESMA's advice specifies the form and content of information to be reported to regulators and investors, as well as the information to be included in the annual report.

ESMA also clarifies in the advice, the definition of leverage, how it should be calculated and in what circumstances a regulator should be able to impose limits on the leverage a particular AIFM may employ. Two calculation methodologies for leverage (the commitment and gross methods), together with an advanced method, are contained in the advice.

Supervision

ESMA envisages that the arrangements between EU and non-EU regulators should take the form of written agreements allowing for the exchange of information for both supervisory and enforcement purposes.

Comments: ESMA's advice (including appendices containing the cost/benefit analysis and feedback on the earlier consultation responses), totals over 500 pages. It is clear that inadequate time was given to ESMA for any proper analysis as to the need for, or impact of, the AIFM Directive itself. ESMA's consultation on its proposed advice was conducted over a two-month period during the summer of 2011 when many potential respondents will have been on holiday, but nevertheless extensive feedback was received on it.

The advice on **capital requirements** in particular is unsatisfactory since it subjects AIFMs to operational risk capital requirements which are based on a regime developed for large EU European banks and which does not apply (for good reasons) to discretionary investment managers. This is not only unjustified, but is also unnecessary, burdensome and expensive for the alternative fund management industry.

Elements of the **depositary provisions** in the advice are also unsatisfactory because the liability provisions still remain very onerous. Despite industry protests ESMA has required that to a large extent depositaries should become strictly liable for the acts and omissions of their sub-custodians. This will concentrate risks in depositary banks and have a significant effect on costs and on returns to investors. Indeed, on a worst case scenario, it could, *in extremis*, lead to a custodian bank insolvency in the European Union.

On **regulatory reporting**, whilst there has been some proportionality introduced with regard to size and type of fund, the current text does not go far enough.

As regards **delegation** of asset management, the requirement for "equivalence" of third country regulations has been replaced by a requirement for effective supervision by an independent competent authority. Third country authorities will be deemed independent if they comply with the Part II of IOSCO's Objectives and Principles for Securities Regulation and the Basel Committee's Core Principles. Whilst compliance with the IOSCO objectives seems unobjectionable, the Basel Committee's Core Principles are irrelevant in this context and may constrain delegation inappropriately.

On leverage, the requirement for reporting of gross leverage to investors still remains. ESMA appears not to have considered what scope exists for refining the definition of gross leverage to take account of netting.

Future Work Programme: The Commission will now prepare implementing measures having regard to the advice it has received from ESMA, unsatisfactory although some of it is. In a covering letter from ESMA to Commissioner Barnier ESMA indicates that it is currently working on, or will shortly begin working on, a number of further issues. These include:

- complementing the rules on the combination of additional own funds and PII through the development of detailed guidelines;
- complementing the advice on the advanced method for the calculation of leverage through the development of detailed guidelines;
- more detailed provisions on the exchange of information (such as the data format and conditions for secured data transmission);
- work on the regulatory technical standards on the types of AIFM required under Article 4(4) of the Directive;
- work with the European Banking Authority (EBA) on the guidelines on sound remuneration policies required under Article 13(2) of the Directive; and
- work on negotiating co-operation agreements to allow for the adoption of memoranda of understanding covering all EU regulators in time for the July 2013 deadline for implementation of the Directive.

The Commission is likely to produce its formal proposal for discussion in trialogues with the European Council and European Parliament by the end of March 2012, provided it does not become distracted by the Eurozone crisis. There are likely to be informal discussions between the Commission, Council and the Rapporteurs in Q1 of 2012, with the formal trialogues taking place in Q2, and adoption of the proposals in July 2012.

ESMA will also be publishing a proposal on scope in the first half of 2012, and will be working on guidelines on a range of issues during 2012, which include, remuneration, leverage and third countries as indicated above.

The FSA intends to publish a discussion paper on Level 1 implementation in January 2012.

Conclusions

The European Commission is under no legal obligation to accept any of ESMA's advice. Even if the funds industry is satisfied with some elements of the ESMA advice, it cannot be sure, until it is known what the Commission decides, whether this advice will be implemented. Indeed, consideration of the advice from ESMA by the Commission could not have come at a worse time, and could well be delayed as a result of work on the Eurozone crisis being given precedence. There is also the political risk that the Commission may ignore some of the advice from ESMA and substitute its own implementation proposals with a view to further restricting the alternative funds industry in Europe. Indeed, some commentators have suggested that there is evidence of a hidden agenda now developing within DG Markts in the Commission under Commissioner Michel Barnier which could facilitate this.

We began this summary with former UK Treasury Minister Lord Myners' comment on the AIFM Directive as it entered the legislative process in Brussels. We end with his comments made in the UK Parliament recently on Commissioner Barnier himself and which were reported in the *Financial Times* on 17 November 2011, the day after ESMA's advice to the Commission was released:

> *He came down the [Treasury] corridor and I was watching him. I was rather impressed that he stopped to look at every painting. I thought, this is a man with whom I share a common interest — until I realised that he was actually looking at his reflection in the glass on every painting, and adjusting his hair or toupée. This to me is a man with whom we should treat with a very long spoon.*

European Commission to Water Down Accountancy Profession Reforms and Publication of Proposals to Reform Statutory Audits

Media reports on 18 November 2011 confirm that Michel Barnier, the European Union internal market commissioner, has been prepared to water down ambitious reforms designed to break the grip of the Big Four accountancy firms, as he attempts to stave off a revolt among his fellow European commissioners. At least ten other commissioners are reported as having voiced concerns over some of his more radical provisions.

Serious concerns have been voiced to the Commissioner over the three most controversial elements of the audit proposal. These will force firms to abandon lucrative consultancy work, share their audit work with smaller rivals and introduce the so-called mandatory rotation rules which impose a nine year time limit on working for a large company.

The candidate proposal to be dropped is the requirement for joint audit, in which large companies would be forced to employ two firms to examine their books, including at least one firm outside the Big Four of Deloitte, PwC, Ernst & Young and KPMG.

Commissioner Barnier is now expected to press on with the remainder of this package, which he claims will restore trust in financial reporting by breaking the oligopoly that currently dominates the sector, and on 30 November 2011, the Commission published a regulation and an amended Directive to reform the audit market.

The background to this is worth reiterating. In force since 2008, the Statutory Audit Directive set out the duties of statutory auditors and introduced a requirement for public oversight of the audit profession and co-operation between regulatory authorities in the EU. However, the financial crisis has called into question the credibility and reliability of such audits in the Commission's opinion. Concerns have also been expressed around conflicts of interest as well as the concentration of the Big Four in the market, who conduct approximately 85 percent. of the audits of listed companies in a majority of EU Member States.

The new Regulation provides a harmonised framework of Public Interest Entities ("PIEs") and requires the supervision of audit networks at the EU level, which will be entrusted to ESMA. The proposed amended Directive will reform the rules for all audits, not just those of PIEs.

The key elements of these proposal are now as follows:

- **mandatory rotation of audit firms:** audit firms will be required to rotate every six years and cannot be re-engaged by the same client for four years thereafter, the period of rotation being extended to nine years where joint audits take place;

- **non-audit services:** audit firms will be prohibited from providing non-audit services to audit clients in order to avoid conflicts of interest;

- **European supervision of the audit sector:** the coordination of auditor supervision activities will be carried out by ESMA; and

- **an European passport for auditors:** audit firms will be able to provide services across the EU and will be required to comply with international auditing standards when carrying out statutory audits.

These proposals will now be considered by the European Council and the European Parliament.

Short Selling: European Parliament Resolution on Proposed Regulation

On 15 November 2011, the European Parliament passed a legislative resolution adopting, with amendments, the European Commission's proposal for a regulation on short selling and certain aspects of credit default swaps ("CDSs"). According to the provisional version of the adopted text, the European Parliament's amendments to the Commission's proposal include:

- the amendment of the definition of short sale in relation to a share or a debt instrument so as to exclude certain sales by either party under a repurchase agreement, a transfer of securities under a securities lending agreement or the entering into of a futures contract or other derivative contract whereby it is agreed to sell securities at a specified price at a future date;

- a new requirement that holders of significant net short positions keep records of the gross positions which make a significant net short position for a period of five years;

- the introduction of restrictions on entering into uncovered CDSs relating to an obligation of a sovereign issuer; and

- removal of the power of competent authorities (and the power of ESMA) to prevent persons entering into transactions relating to financial instruments or limit the value of transactions in the financial instrument that may be entered into in exceptional circumstances, although the equivalent power in relation to sovereign CDS transactions remains.

The Regulation must now be formally approved by the Council of the EU.

MiFID: European Parliament Hearing and Consultation

In force since November 2007, the original Markets in Financial Instruments Directive ("MiFID") governs the provision of investment services in financial instruments by banks and investment firms and the operation of traditional stock exchanges and alternative trading venues (the so-called multilateral trading facilities). Whilst MiFID created competition between these services and brought more choice and lower prices for investors, shortcomings were exposed in the wake of the global financial crisis. The Commission therefore published a consultation on the MiFID Review in December 2010 and tabled proposals to revise MiFID in October 2011. These proposals consist of a Directive and a Regulation and aim to make financial markets more efficient, resilient and transparent and to strengthen the protection of investors. The new framework also aims to increase the supervisory powers of regulators and to provide clear operating rules for all trading activities. The Rapporteur in the European Parliament for the review of MiFID has now launched a consultation based on a questionnaire to inform work on the review of MiFID.

On 5 December 2011 a hearing took place in the Parliament's ECON Committee in the context of the Commission's legislative proposals for a new Directive and a Regulation on MiFID and MiFIR 2. The purpose of the hearing was to examine what MiFID/MiFIR 2 needs to achieve in selected key areas to ensure stable, orderly and efficient financial markets and appropriate investor protection.

It appears that the main issues yet to be resolved in relation to the Directive's implementation concern data quality and consolidation, and the application of conduct of business rules. The most glaring omissions of MiFID were in relation to the application of price transparency provisions to non-equity markets and interoperability for post-trade provisions. It has also been argued that the failure to extend price transparency to bond markets was a missed opportunity which the European Commission should have corrected much earlier.

Other issues that were discussed at the hearing included position limits to curb speculation in the commodity markets. Some policymakers want permanent curbs, whereas the draft MiFID proposals provide for such intervention as a temporary tool only in volatile markets.

There were also divisions of opinion on when regulators should intervene if they think a financial product could be harmful to consumers — before or after it ends up on the market?

The Commission's proposals have been passed to the European Parliament and the Council for further negotiation and adoption and the deadline for submitting responses to the Parliament's questionnaire is 13 January 2012.

Venture Capital: Commission Proposal to Ease Access to Credit for SMEs

As a part of the Single Market Act published by the Commission in April 2011, the Commission identified improving access to finance for SMEs as a crucial part of its plan to relaunch the Single Market. The Commission set out its plans to put in place common rules for venture capital funds, enabling those established in one Member State to invest in any other Member State enabling innovative SMEs to be provided with funding combined with the necessary expertise and at an attractive price.

On 7 December 2011 the Commission published its strategy to promote better access to finance for SMEs with a EU action plan. This includes increasing financial support from the EU budget and the European Investment Bank and a proposal for a regulation setting uniform rules for venture capital funds.

The key elements of the proposal on venture capital are:

- a uniform single rule book governing the marketing of European venture capital funds;
- rules on the categories of investors which are eligible to invest capital in an European venture capital fund; and
- a European marketing passport for all managers of all qualifying venture capital funds across the EU.

This proposal will complement other legislative changes put forward by the Commission to improve access to capital markets by SMEs in MiFID, the Transparency Directive and the Prospectus Directive.

The Commission's proposal will now be discussed by the Council and the European Parliament.

On 8 December 2011, the European Commission published further materials on its action plan to improve access to finance for SMEs.

The action plan set out the various policies that the Commission is pursuing to make access to finance easier for SMEs. The financial services regulatory policy measures will include:

- a new EU venture capital framework to create a genuine internal market for venture capital funds (which the Commission invites the European Parliament and the Council of the EU to adopt as a legislative proposal by June 2012;
- a study, by the Commission, on the relationship between prudential regulation and venture capital investments by banks and insurance companies (which will form part of a wider reflection on long-term investment, on the basis of technical work to be jointly done by the European Banking Authority and the European Insurance and Occupational Pensions Authority;
- the proposal for an SME growth market label to be given to those multilateral trading facilities (MTFs) that respond to a common set of characteristics (as part of legislative proposals to amend the Markets in Financial Instruments Directive (*2004/39/EC*) ("MiFID II") (which the Commission invites the Parliament and the Council to adopt as a legislative proposal as swiftly as possible);
- a new European Social Entrepreneurship Funds regime (see below) to enable EU funds to specialise in this field and to be marketed across the EU under a specific and distinctive label (which the Commission invites the Parliament and Council to adopt before the end of 2012);
- a report by the European Banking Authority on the current risk weighting for SMEs in the context of the CRD IV package of reforms,

following which the Commission will consider appropriate measures as part of those reforms; and

- a 2012 review by the Commission of current lending practices, including transparency mechanisms, following which the Commission may consider taking regulatory action to encourage responsible and transparent lending to SMEs.

The European Commission's Social Entrepreneurship Funds Legislative Proposal

On 7 December 2011, the European Commission published its legislative proposal for a regulation on European social entrepreneurship funds ("EuSEFs").

The proposed regulation aims to create a recognised brand for social entrepreneurship funds. This type of fund must invest at least 70 per cent of capital committed in social businesses, defined as undertakings whose primary objective is to achieve social impacts, rather than generate profits for shareholders or other stakeholders. A manager of a qualifying fund will benefit from a European marketing passport, which will allow access to eligible investors across the EU.

This proposed regulation will now pass to the European Parliament and the Council of the EU for negotiation and adoption.

Comments: These developments now pave the way for four separate, and in some cases overlapping, regulatory regimes for investment funds in the EU, i.e., UCITS; alternative investment funds; venture capital funds; and social funds (EuSEFs).

EBA Announcement on Additional Capital

EU banks need to raise €114.7bn (£97.9bn) to shore up their financial stability, the European Banking Authority (the "EBA") has said on 8 December 2011, revising upwards its estimate of German banks' shortfall by €11bn, according to recent media reports.

The total in new capital required for EU banks has been revised by the EBA upwards from its €106bn estimate in October, but nearly all of the increase was due to a deterioration in Germany's banks. Some other member states' totals have decreased. The data used was updated from June to September 2011.

Banks now have until June 2012 to reach a core Tier 1 capital ratio of 9 per cent after writing down the value of their sovereign debt holdings to market levels.

The figures for the EU Member States concerned total a shortfall of £114.7bn, none of which is attributable to the UK's banks, are:

Member State	Capital Shortfall
Austria	€3.9bn
Belgium	€6.3bn
Cyprus	€3.5bn
France	€7.3bn
Germany	€13.1bn
Greece	€30bn
Italy	€15.4bn
Netherlands	€159m
Norway	€1.5bn
Portugal	€7bn
Slovenia	€320m
Spain	€26.2bn
UK	€0

UK Regulatory Developments

FSA Consultation Papers on Distribution of Retail Investments

On 10 November 2011, the FSA published a consultation on the distribution of retail investments (CP11/25) focusing on proposals to clarify issues that have been raised by the industry concerning:

- facilitation of the payment of adviser and consultancy charges by product providers under the retail distribution review ("RDR") rules; and
- whether product providers, when reporting data under the FSA's data requirements (such as in respect of product sales), should report

investment amounts on a basis that is net or gross of any adviser charges.

These proposals arise from queries the FSA received on its RDR rules, published in March 2010 and which will come into force on 31 December 2012. Comments can be made on the proposals in CP11/25 until 10 January 2012. (The FSA plans to publish a policy statement giving feedback in Q1 of 2012.)

On 16 November 2011, the FSA also published a further consultation paper on the distribution of retail investments under the RDR (CP11/26).

In CP11/26, the FSA is consulting on guidance to help firms understand how legacy assets should be treated under the RDR rules applying to advice given on or after 31 December 2012. (Legacy assets for this purpose are retail investment products purchased by a retail client before the RDR rules come into effect, and which the client is still holding when the rules are in force.)

The FSA had also received queries from firms on the adviser charging rules contained in new sections 6.1A and 6.1B of the Conduct of Business Sourcebook ("COBS") and how the ban on new commission will affect trail commission and legacy commission for advised sales. These queries follow guidance in the FSA's March 2010 policy statement on the RDR (PS10/6) and its October 2010 quarterly consultation (CP10/22). The FSA is of the view that the ban on new commission for advised sales of retail investment products has not been properly understood by some firms.

CP11/26 summarises the comments that were made to the FSA following discussions with certain trade bodies on the issue, and sets out the FSA's views, including:

- allowing legacy commission to continue could perpetuate bias, with advisers having a vested interest in recommending that customers continue to hold legacy products or to increase payments into them; and
- it would be helpful to have guidance to clarify how the commission ban should operate in practice.

This guidance has now been set out as an appendix to CP11/26.

CP11/26 closes for comments on 16 January 2012. (The FSA will publish a feedback statement in Q1 of 2012.)

FSA Consultation Paper on Accredited Bodies Under the RDR

On 10 November 2011, the FSA published a consultation on FSA accredited bodies under the RDR (CP11/24).

In its January 2011 policy statement (PS11/1) the FSA confirmed its intention to supervise and enforce professional standards for individual advisers under the RDR. It also set out that there would be an enhanced role for FSA accredited bodies and how bodies could apply to the FSA for accredited status. Essentially, firms must satisfy requirements in four broad areas. The FSA also indicated that interested candidates could submit applications to the FSA so it could consider them for accredited body status.

The FSA subsequently received applications from a number of bodies for accredited status and, in its September 2011 quarterly consultation paper (No 30) (CP11/18), the FSA explained it would consult in separate consultation papers on applications to be recognised as an accredited body.

In CP11/24, the FSA now sets out its intention to confer accredited body status on the following two applicants:

- the Institute of Chartered Accountants in England and Wales; and
- the Pensions Management Institute.

In CP11/24, the FSA also explains that the criteria which is expects all accredited bodies to demonstrate from 31 December 2012 (the date by which firms must be compliant with the RDR rules).

The FSA also expects to receive further applications from potential accredited bodies in the future. It will consult on any decision to accredit them. For advisers, FSA confirmation of accredited body status will enable them to decide which body they wish to approach to validate their qualification gap (if required) and to issue their statement of professional standing.

HMRC ISA Bulletin 39: Bulk Transfers/ISA Guidance Notes

HMRC issued ISA Bulletin No 39 on 9 November 2011.

The ISA regulations are to be amended to remove the obligation for ISA managers to obtain a fresh application when an account is transferred as part of manager-instigated bulk transfer arrangements.

The new manager will need to obtain fresh applications only where investors seek to subscribe to their accounts after the transfer and the 'new' manager does not already hold a valid application form.

In addition, the latest version of the ISA Guidance Notes is now available on the HMRC website at http://www.hmrc.gov.uk/isa/isa-guidance-notes.pdf.

The New UK Investment Trust Company Tax Regime: Final Regulations

The Investment Trust (Approved Company) (Tax) Regulations 2011 ("the 2011 Regulations") have now been published. These complete the process of modernisation of the investment trust company ("ITC") tax regime. Corresponding changes are to be made to the Companies Act 2006 provisions relating to investment companies. The 2011 Regulations confirm that the new regime will take effect for accounting periods beginning on or after 1 January 2012.

It is well known, ITCs are exempt from UK corporation tax on their chargeable gains, but generally pay tax on income.

Conditions for approval as an ITC under the new tax regime from 1 January 2012 are that:

- the business of the company must consist of investing its funds in shares, land or other assets with the aim of spreading investment risk and giving members of the company the benefit of the results of the management of its funds;
- the shares making up the company's ordinary share capital must be admitted to trading on a regulated market;
- the company must not be a venture capital trust or a REIT;
- the company must not be a close company at any time during any accounting period; and
- the company must not retain more than 15 per cent of its income (regardless of source) for any accounting period (in other words, it must distribute at least 85 per cent of its income for the period).

Comments: The new regime should make ITCs significantly more attractive for certain investment strategies and UK taxpayers will welcome the regulations as they remove certain unattractive features of the current rules, such as an ITC's need to seek annual approval. They also add attractive new features such as the "white list" of non-trading transactions.

In terms of the amendments made in the 2011 Regulations to the previous draft regulations, there are also many welcome changes. There are new provisions on reporting funds, which are intended to avoid undesirable tax charges and, in relation to index-linked investments, at least, put ITCs on an equal footing with other investment vehicles. The extension of the deeming provisions for companies being wound up is also to be welcomed. However, the rules have been tightened up in some respects. In particular, the provisions on breaches are now wider and more rigid, and there is now an express time limit for distributions following amendments to tax returns.

Parliamentary Bill to Implement the ICB's Recommendations

The Chancellor of the Exchequer, when appearing before the Draft Financial Services Bill Committee on 15 November 2011, announced that the Government intends to publish by Christmas more detailed plans concerning the implementation of the recommendations of the Independent Commission on Banking (the "ICB"), which called for structural reform (including a retail ring-fence) and enhanced loss-absorbing capacity for UK banks. (The ICB published its final report and recommendations in September 2011.)

The Government had considered introducing the ICB reforms as part of the Financial Services Bill but the Chancellor has now confirmed that he intends to introduce these reforms in a separate Parliamentary Bill during the 2012-13 parliamentary session.

FSA Consultation on Permitted Links

The FSA has issued a consultation paper on 14 November 2011 (CP 11/23) on proposed changes to permitted link rules so that they will be consistent with the requirements of the Solvency II EU Directive. The proposed new rules will largely continue existing FSA requirements, but will expand the range of indices to which index-linked policies may be linked. Disappointingly, there is no proposal to allow natural persons access to permitted-link only QISs, (for which the industry has been lobbying).

The FSA's consultation paper broadly proposes:

- for policyholders who are not natural persons, there will no longer be a restricted list of assets for unit-linked policies. Instead insurers will be subject to Article 132 of Solvency II, the prudent person principle (and all other relevant requirements of Solvency II); and
- for policyholders who are natural persons, the requirements will largely remain unchanged, except in relation to the range of indices to which benefits may be linked: the proposal is to extend the definition of "approved index" to include indices which meet the requirements for UCITS, (i.e. under COLL 5.2.33).

FMLC Final Response to HM Treasury June 2011 Consultation on New UK Regulatory Structure

On 22 November 2011, the Financial Markets Law Committee ("the FMLC") established by the Bank of England published its final response to HM Treasury's June 2011 consultation on the new UK financial services regulatory structure. (In September 2011, the FMLC had published an initial response to the consultation).

The final response expands on the areas of concern identified in the initial response and is divided into the following sections:

- co-ordination between the regulatory authorities;
- enforcement;
- regulatory processes, permission and regulated activities;
- passporting;
- listing and extra-territoriality;
- rules and guidance;
- administrative discretion and other powers;
- systemically important infrastructure.

Definition of CIS: The FMLC also published a letter to HM Treasury (dated 15 November 2011) calling on the Government to take advantage of the amendments to the Financial Services and Markets Act 2000 ("FSMA") to address issues raised in a July 2008 FMLC paper, *"Operating" a collective investment scheme*. This paper drew attention to issues of legal uncertainty arising from the definition of "collective investment scheme" set out in section 235 of FSMA.

Legislation for a Protected Cell Regime for OEICs

On 23 November 2011, draft legislation introducing a protected cell regime for UK open-ended investment companies ("OEICs"), the *Open-Ended Investment Companies (Amendment) Regulations 2011*, was published together with a draft explanatory memorandum and an impact assessment.

(In July 2009, HM Treasury and the FSA published a joint consultation paper on a protected cell regime for UK OEICs.)

The impact assessment now released stated that, following responses to the consultation, changes have been made to the transitional arrangements for the new regime, with the compliance period extended from one year to two years, and OEICs permitted to apply to the FSA for a one-year extension of the compliance period.

Draft Finance Bill 2012 Clauses

The Government published on 6 December 2011 draft legislation to be included in Finance Bill 2012, open for consultation until 10 February 2012.

The draft Finance Bill 2012 clauses relevant to the investment management industry include the following:

- the reform of the Controlled Foreign Company regime; and
- making the necessary powers to provide appropriate tax treatment for investors in tax-transparent funds.

The Government also announced on 6 December 2011:

- proposals to simplify and rewrite the mergers and reconstruction rules for collective investment schemes;
- its intention to make the necessary legislative changes in order to facilitate the creation of Property Authorised Investment Funds (PAIFs) for the retail market.

The Financial Services and Markets Act 2000 (Market Abuse) Regulations 2011

On 8 December 2011, the above Regulations were published together with an accompanying explanatory memorandum and impact assessment.

When the UK Government implemented the Market Abuse Directive (*2003/6/ED*) ("MAD") it retained the scope of the UK's existing market abuse prohibitions in sections 118(4) and 118(8) of the Financial Services and Markets Act 2000 ("FSMA"), which go beyond the narrower prohibitions in MAD. However, those sections were made subject to a sunset clause, pending the outcome of a review by HM Treasury to assess whether they remained justified. The sunset provisions were extended in 2008, and again in December 2009, to allow any changes to align with the outcome of the ongoing, but delayed, EU review of MAD.

The sunset provisions were due to expire on 31 December 2011. After an informal consultation in September 2011, HM Treasury has decided to extend those provisions once more until 31 December 2014, to reflect the existing policy of aligning with the outcome of the MAD review, which is expected to take approximately three years to come into effect across EU member states. The above Regulations give effect to this decision and come into force on 31 December 2011.

FSA Consultation on Updated Guidance on Distributor-Influenced Funds

On 5 December 2011, the FSA published a guidance consultation on distributor-influenced funds (GC11/29).

In December 2008, the FSA published two factsheets for firms active in the distributor-influenced funds market. The FSA is now consulting on revisions to those factsheets to reflect changes to its rules reflecting the RDR. The guidance consultation sets out the changes to the December 2008 versions of the factsheets.

The FSA believes that the RDR will have a significant impact on distributor-influenced funds. In an accompanying press release, it comments that:

- firms advising on distributor-influenced funds should no longer receive a share of the annual management charge for their role on a distributor-influenced fund governance committee;
- adviser charges for recommending a distributor-influenced fund should not vary inappropriately compared with substitutable or competing retail investment products; and
- in the FSA's view, it will be extremely difficult for firms to recommend distributor-influenced funds and meet the RDR standard for independent advice.

Comments on the guidance consultation may be made to the FSA until 30 January 2012.

The Non-Investment Products Code

On 14 November 2011 the Bank of England ("BoE") published a revised version of the above Code, which applies to trading in wholesale market dealings in non-investment products ("NIPs"), specifically:

- sterling wholesale deposits;
- foreign currency wholesale deposits;
- gold and silver bullion wholesale deposits;
- spot and forward foreign exchange; and
- spot and forward gold and silver bullion.

The BoE and the FSA have been involved in the Code's development and it has been endorsed by a number of trade associations. The Code is not underpinned by statute, except where reference is made to existing legal requirements. However, non-compliance with the Code may raise issues about the integrity or competence of a firm and the FSA expects firms to take due account of it when conducting business in NIPs. Its provisions are intended to act as guidance for management and individuals at broking firms and principals on what is currently considered to constitute good practice in the wholesale markets.

The Code was last revised in April 2009 and the latest set of revisions include:

- new provisions on electronic trading, responsibilities of the firm and the use of central counterparties;
- amended provisions on entertainment and gifts;
- amended and additional provisions on automated methodology and guidelines for exchanging standard settlement instructions; and
- the deletion of provisions on gambling.

Autumn Statement 2011: Financial Services Implications

On 29 November 2011, the Chancellor of the Exchequer, made his Autumn Statement, which included announcements in the following areas, of particular interest in the financial services industry:

- **Bank levy:** the Government will increase the rate of the bank levy from 0.078 per cent to 0.088 per cent from 1 January 2012. (The bank levy was introduced to ensure that banks continue to make a fair contribution reflecting the risks they pose to the financial system and wider economy. This increase is intended to offset the shortfall in receipts for 2011 and future years).

- **Covered bonds:** the Government will amend the regulations for UK covered bonds to provide greater transparency for investors, and help banks use covered bonds to raise funding. (The FSA and HM Treasury published a joint consultation on covered bond regulation alongside the April 2011 Budget.)

- **The controlled foreign company ("CFC") regime:** the Government is publishing further details of its reform of the CFC rules (on which it consulted in July 2011). The proposals included specific exemptions from the CFC rules for CFCs carrying on banking or insurance business.

KIID: Supplementary Information

Readers will be aware of the contents of the Key Investor Information Document ("KIID") required by the EU's UCITS IV Directive. In the UK, the FSA will also require an additional document containing supplementary information to be supplied with the KIID — the "Supplementary Information Document" (or "SID").

Following the introduction of the KIID, the FSA has introduced an additional requirement for firms to disclose (in the SID) information regarding complaint handling procedures, compensation arrangements and cancellation rights to consumers, alongside the KIID. However, the FSA has not been specific regarding the format of the SID and has left it to the funds industry to devise ways of communicating this information, although the FSA has advised that the document should be presented in a sufficiently clear format to catch the attention of potential investors. Unlike the KIID, the SID is not required for non-retail investors, however.

The Investment Management Association, on 28 November 2011, produced a template for the SID for its members and welcomes comments on it.

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Certain of the summaries of developments that it contains have been based on those contained in the Financial Services daily and weekly know-how services of [Practical Law Company Limited].

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