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A legal update from Dechert's Financial Services Group

Dechert LLP

Financial Services Europe and International Update

Regulatory Developments

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

EU Regulatory Developments

ESMA 2012 Work Programme

On 4 January 2012 ESMA published its 2012 work programme.

ESMA has the following seven areas as its key priorities for 2012:

- the proposed Regulation on over-the-counter derivative transactions, central counterparties and trade repositories (EMIR);
- financial consumer protection;
- harmonisation of supervisory practices;
- credit rating agency regulation and supervision;
- the proposals to revise MiFID;
- the Alternative Investment Funds Management Directive (*2011/61/EU*); and
- the proposed Regulation on short selling and certain aspects of credit default swaps.

The Danish Presidency's Work Programme to 30 June 2012

On 6 January 2012, the Danish Presidency of the Council of the EU published its work programme for the six-month period to 30 June 2012. This will focus on:

- achieving consensus in the Council on the European Commission's proposed revision of capital and liquidity requirements for credit institutions (CRD IV);
- working towards a common European framework for crisis management in the financial sector, (such as early intervention and prevention relating to ailing banks) the Commission is expected to publish legislative proposals shortly, following its January 2011 consultation on a possible EU framework for bank recovery and resolution;
- achieving consensus in the Council on the proposed CRA III Regulation;
- prioritising negotiations with the European Parliament on the proposed Regulation on OTC derivative transactions, central counterparties and trade repositories (EMIR);
- progressing work on legislative proposals to amend the Markets in Financial Instruments Directive (*2004/39/EC*) ("MiFID") and the Market Abuse Directive (*2003/6/EC*); and
- improving the protection of European consumers in the financial sector.

Guidelines on Systems and Controls for Highly Automated Trading

On 22 December 2011, the European Securities and Markets Authority ("ESMA") published its final report on guidelines on systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities (the "guidelines"). The report contained feedback to the July 2011, consultation by ESMA.

The guidelines cover:

- the operation of an electronic trading system by a regulated market or a multilateral trading firm ("MTF");
- the use of an electronic trading systems, including trading algorithms, by investment firms for own account dealing or for the execution of orders on behalf of clients; and
- the provision of direct market access or sponsored access by an investment firm as part of the service of the execution of orders on behalf of clients.

The guidelines will also have implications for firms not authorised as market operators or investment firms under the Markets in Financial Instruments Directive (2004/39/EC) ("MiFID"). These include firms which sell electronic trading systems to market operators or investment firms, or act as the outsourced providers of such systems, or provide connectivity services to investment firms when accessing trading platforms. The guidelines will also affect firms exempt from MiFID which trade on own account and access trading platforms directly as members, participants or users, or through direct market access or sponsored access.

The guidelines will become effective one month after they have been published by national regulators on local websites. Market participants will need to comply with the guidelines by 1 May 2012.

ESMA Consultation on MiFID Compliance Function Requirements

MiFID requires investment firms to implement a series of systems and controls aimed at securing a robust governance framework, with a clear organisational structure and lines of responsibility, and effective risk management and compliance processes. This includes policies and procedures to ensure regulatory compliance and the establishment of a compliance function. On 22 December, ESMA published a consultation on certain aspects of MiFID compliance functions. ESMA is concerned that compliance risk can take second place to other risk areas within an investment firm and this can lead to the deficient implementation of appropriate compliance processes. Accordingly, the compliance function should have a more prominent role within investment firms.

In accordance with Regulation 1095/2010 establishing ESMA, the consultation sets out draft guidelines on the compliance function provision in Article 13 of MiFID and Article 6 of the MiFID Implementing Directive (2006/73/EC.) Specifically the guidelines focus on:

- the responsibilities of the compliance function for monitoring, reporting and advising; and
- the organisational requirements of the compliance function for the standards of effectiveness, permanence and independence.

The consultation closes on 24 February 2012. (ESMA will consider the responses it receives to the consultation in Q1 of 2012 and expects to publish a final report and guidelines in Q2 of 2012).

ESMA Consultation on MiFID Suitability Requirements

Also on 22 December 2011, ESMA published a consultation on guidelines on certain aspects of MiFID's suitability requirements.

Article 19(4) of MiFID requires that when providing investment advice or portfolio management services, investment firms must ensure that the specific transaction to be recommended or entered into is suitable for the client in question. ESMA is concerned that recent evidence and supervisory experience indicates that full and effective compliance with the MiFID suitability requirement is not as consistent or as widespread across EEA member states as it could or should be. (This compromises both MiFID's and ESMA's investor protection aims).

ESMA's consultation sets out draft guidelines for investment firms (including credit institutions and UCITS management companies when providing investment services) and competent authorities. They apply when providing investment advice and portfolio management services and cover:

- information to clients about the suitability assessment;
- arrangements necessary to understand clients and investments;

- qualifications of investment firm staff;
- extent of information to be collected from clients'
- reliability of client information;
- updating client information;
- client information for legal entities or groups;
- arrangements necessary to ensure the suitability of an investment; and
- record keeping

The consultation closes 24 February 2012. (ESMA will consider the responses it receives to the consultation in Q1 of 2012 and expects to publish a final report and guidelines in Q2 of 2012).

EMIR Negotiations Likely to Continue into 2012

At the end of December 2012, media reports appeared stating that delays are likely to occur in the negotiations on the proposed European Market Infrastructure Regulation ("EMIR").

According to media reports, a trialogue meeting took place on 19 December 2011, but the meeting ended inconclusively after failing to reach agreement on whether to give the ESMA the power to authorise clearing houses. There is also disagreement about whether market participants from non-EU countries should be given access to EU markets in the clearing business.

It now seems likely that a final version of the EMIR may not be agreed until February 2012.

UK Regulatory Developments

Discussion Paper on Instruments of Macro-prudential Policy

In late December 2011, the Bank of England (the "Bank") published a discussion paper on instruments of macro-prudential policy. This provides a detailed analysis of the proposed macro-prudential tools of the Financial Policy Committee (the "FPC"). It has been prepared by the Bank and the Financial Services Authority (the "FSA").

One of the powers of the FPC will be to direct the Prudential Regulation Authority (the "PRA") and the Financial Conduct Authority (the "FCA") to adjust specific macro-prudential tools that HM Treasury will set out in secondary legislation.

The discussion paper sets out a range of potential instruments for tackling systemic risk, alongside a preliminary analysis of their usefulness and some key characteristics that might be helpful in choosing between them.

The discussion paper rather surprisingly does not reach any conclusions on the macro-prudential toolkit. However, it does ask for the following feedback:

- are there any additional tools that the FPC should be considering?
- has the FPC focused on the right instruments in its preliminary discussions as its September 2011 meeting?
- are the criteria that are set out to assess the merits of different tools sensible and sufficient?

Comments should be sent to the Bank of England by 10 February 2012.

Court of Appeal Decision in Lehman Brothers Application Published

The Court of Appeal's judgment in *Pearson and others v Lehman Brothers Finance SA [2011] EWCA Civ 1544* was published in late December 2011.

The appeal, brought by Lehman Brothers Finance SA ("LBF"), was against a November 2010 High Court decision in which the High Court held that Lehman Brothers International Europe ("LBIE") was beneficially entitled to certain securities held in its house depot account that it had originally purchased for the account of other Lehman companies, with the exception of a small number of securities held on trust for Lehman Brothers Inc.

The Court of Appeal dismissed LBF's appeal (and a cross-appeal, by way of a respondent's notice, on the part of LBIE's administrators), subject to keeping open the following possibilities, so as to be capable of resolution by the judge if the parties cannot agree the position:

- if there were any securities subject to the manual "Rascals" process (i.e., the manual version of the settlement process which was used by the Lehman group until its collapse) on 15 September 2008 (which was the day before LBF sent a letter to LBIE terminating all inter-company agreements and arrangements to act on behalf of, or as agent for, LBF), having been made the subject of a stock loan after 31 July 2008, then LBIE did not have the beneficial title to those securities, which therefore belonged beneficially to LBF at the point on which the Lehmans group collapsed; and

- the above is subject, however, to the possibility that LBIE can show it paid the collateral under the stock loan in some other manner, or that the securities were first acquired from third parties after 31 July 2008.

The Court unanimously agreed that nothing in the reasoning used to reach the judgment depends on whether LBIE was entitled to a lien or any equivalent right over the relevant securities. Accordingly, it is therefore not necessary to refer or remit any question on that to the judge before the issues on the appeal can be determined.

The reason for keeping open these specific possibilities is that issues concerning whether LBIE or any other person had a lien over the relevant securities were excluded from the case brought before the High Court on the basis they would be deferred to other proceedings in which they would be raised. The High Court's judgment therefore did not consider any issue of lien, meaning no such issue could be decided by the Court of Appeal on the appeal either.

Draft Financial Services Bill

In late December 2011, the Joint Committee on the draft Financial Services Bill 2011-12 ("FS Bill") published its report on the FS Bill. (The FS Bill is the primary legislation introducing the government's reforms to the UK financial services regulatory structure.)

The Committee's recommendations include the following:

- the Court of Directors of the Bank of England (the "Bank") should be replaced by a supervisory board, which should include some expert members with experience in prudential policy;
- when the Bank has given a formal warning of a material risk to public funds, the Chancellor of the Exchequer should automatically have the power to direct the Bank and take responsibility for handling the crisis;
- the regulatory perimeter of the Prudential Regulation Authority (the "PRA") should be widened to include a broader range of investment firms including firms engaging in the rehypothecation of client money and assets;
- the PRA, rather than the Financial Conduct Authority (the "FCA") should be responsible for the regulation of market infrastructure;
- the FCA should not be required to consult with the recipient of a warning notice before exercising its proposed new power to announce the issuing of warning notices;
- the FCA's role in promoting competition should be clarified and the FCA should be given greater competition powers to achieve its competition objective;
- the Government should consider introducing into the FS Bill measures relating to the remuneration arrangements for executives and non-executives, and introducing a concept of strict liability for executives and board members; and
- the legislation enacting the recommendations of the Independent Commission on Banking (the "ICB") should be introduced during the 2012-13 parliamentary session.

On the same day, in relation to the last bullet point above, HM Treasury and the Department for Business, Innovation and Skills published the Government's response to the final report and recommendations of the ICB which set out the Government's initial views on the ICB's principal recommendations and raised a number of outstanding policy questions on which the Government is now consulting until 12 March 2012.

The Government intends to implement the ICB's recommendations in stages, with the final, non-structural changes relating to loss-absorbency fully completed by the start of 2019.

This means that primary and secondary legislation relating to the ring-fence will be put in place by the end of the current Parliament in May 2015. Banks will be expected to comply with the new requirements as soon as practicable after that date. The Government will work with banks to develop what it describes as a reasonable transition timetable.

The Government will publish a White Paper in Spring 2012 that will provide further detail on how the ICB's recommendations will be implemented.

Protected Cell Company Regime – FSA Rule Changes

The FSA is now publishing the Handbook Instrument containing rules relating to the introduction of the protected cell regime.

The January FSA Handbook Notice will also contain feedback commentary on its rules.

The FSA has also sent an information note to Authorised Corporate Directors. The note summarises action that firms need to take as a result of the Statutory Instrument relating to UK protected cell companies and the FSA rules.

ISAs: HMRC's ISA Bulletin No. 41

HMRC have recently issued ISA Bulletin No.41. This Bulletin includes articles on annual returns of information and statistics; applications for approval as an ISA manager; opening an ISA; members of the armed forces on active service in war zones; switching ISA investments, ISAs going into cash deficit, and Junior ISAs.

Provision of the KIID – FSA Letter to IMA

A number of KIID implementation issues were debated at a meeting with the FSA held by the Investment Management Association (the "IMA") in September 2011. These issues principally concerned the provision of the KIID to those investors undertaking direct paper or telephone dealing but also touched on other matters.

The FSA has now responded to the issues and has offered guidance on how it might alleviate the various problems. The IMA is circulating the response to its members so that the members can be aware of the FSAs current thinking. (There are other matters referred to in the FSA's response where the guidance offered is not as helpful and the IMA will maintain its dialogue with the FSA on these issues).

EU Member State National Developments

France: Finalisation of the Implementation Process of UCITS IV Under French Law

Further to the implementation of the UCITS IV Directive in France in August 2011 and further to the update of the French Monetary and Financial Code as well as of the general regulations of the AMF, the French regulator has now issued the following instructions and guidelines in order to complete the general update of the French legal framework in accordance with the UCITS IV Directive:

- Instruction n°2011-19 related to authorisation and periodic reporting requirements for French UCITS (i.e., *OPCVM coordonnés*) and foreign UCITS marketed in France;
- Instruction n°2011-20 related to authorisation and periodic reporting requirements for French non coordinated UCIs which do not benefit from the EU passport (i.e., *OPCVM non coordonnés*);
- Instruction n°2011-21 related to authorisation and periodic reporting requirements for French UCIs for employee saving schemes;
- Instruction n°2011-22 related to authorisation and periodic reporting requirements for French *FCPR*, *FCPI*, *FIP* (i.e., French structures of private equity funds); and
- Instruction n°2011-23 related to authorisation and periodic reporting requirements for French *OPCI* (i.e., a type of real estate fund);

It is also relevant to mention that the AMF published on 23 December 2011 revised guidelines for the drafting of commercial documents and the marketing of UCIs pursuant to its recommendation n° 2011-24.

As part of the transposition of the UCITS IV Directive it should be noted that the French regulator decided to extend the use of the KIID to non-UCITS funds which can receive subscriptions from retail investors. The funds concerned are *OPCVM non coordonnés à vocation générale* (non coordinated general purpose funds), *FCPR agréés* (including *FIP* and *FCPI*), *FCPE*, *SICAVAS*, *OPCI*, unleveraged *OPCI* with lightened investment rules and *OPCVM ARIA 3*. This unusual approach, compared to others EU jurisdictions, is intended to facilitate the comparison between the various products with improved information available to the investors.

France: Tax Reforms – Some Recent Changes

French tax legislation has recently undergone many changes which have a wide-ranging impact for both individuals and trustees, whether French resident or not. The changes are particularly complex. Specific advice should be taken in respect of individual circumstances.

Wealth Tax

For some, the reform has simplified and reduced French wealth tax exposure. The threshold has been increased from €800,000 to €1,300,000 from 1 January 2011. Furthermore, with effect from 2012, the total net value of assets exceeding the threshold will be taxed at one of two tax rates:

- €1,300,000 to €2,999,999 – 0.25 per cent
- €3,000,000 and more – 0.5 per cent

These are flat rates, i.e., the band in which the net asset value falls determines the rate of Wealth Tax on the total asset value.

Tax administration has also been simplified with individuals with net wealth of less than €3 million being able to declare their wealth tax liability on their income tax return. Anti-avoidance rules have been introduced which affect Société Civile Immobilière (a vehicle used by non-French residents to own French property). Under the new legislation, only commercial loans will be deductible for French wealth tax purposes.

Removal of Tax Shields

In the past an individual's aggregate income, social, net wealth and local taxes could not exceed 50 per cent of their worldwide income for the prior year and refunds were available if the limits were breached. This will be abolished from 2013. Certain French residents also benefited from a cap on their wealth tax such that, when combined with the income tax payable in the same year, it could not exceed 85 per cent of their previous year's income. This has also been removed, from 1 January 2012.

Life Assurance Bonds

The reform also affects individuals with life assurance bonds taken out prior to moving to France. Previously, payment of a death benefit from such a policy to a French resident beneficiary would have been exempt from tax in some cases. This exemption has now been largely removed.

Taxation of Trusts

The new anti-avoidance legislation introduces a concept of trusts and sets out the framework for taxing trusts that have French resident settlors or beneficiaries (including discretionary beneficiaries) or own French assets. The rules are extremely complex and beneficiaries, settlors and trustees should seek specific advice in relation to their own position prior to 1 January 2012 when the rules and charges come into effect.

The main points are:

- Distributions (or entitlements) of income are subject to tax at the highest rate of 54.5 per cent (including social security contributions) irrespective of the underlying source of the income and the nature of the entitlement of income by the individual. (This is a clarification of existing understanding.)
- Trusts are 'looked-through' for gift and inheritance taxes. These taxes could apply to property transferred via a trust, capital distributions and on the death of the settlor or a beneficiary. The rate can be up to 60 per cent depending on the relationship between the 'donor' and 'donee', where the trustees are resident and, for trusts set up after 11 May 2011, if the settlor is French resident.
- New disclosure requirements have been introduced whereby trustees of trusts where there is a French resident beneficiary/settlor or French situs assets have to disclose trust interests (including discretionary interests) and values. A new 5 per cent penalty for non-disclosure on the value of the trust has also been introduced.
- In addition, the trustees would be liable to a 0.5 per cent annual levy on the value of the trust assets, potentially applying on all of the trust assets where the beneficiary/settlor is French resident, or otherwise on the value of the French assets (with certain financial assets not caught). There may be an exemption to the 0.5 per cent levy on the trustees, where they have complied with their disclosure responsibilities and the beneficiary is fully compliant with their wealth tax affairs.

Leaving France

An exit tax will apply if an individual has been resident for six out of the previous ten years. The new charge taxes unrealised gains and applies to holdings of more than 1 per cent of the capital of a company or holdings of more than €1.3 million. Liability can be deferred in the short term, or indefinitely in certain cases.

Modification of the Capital Gains on Real Estate Assets Fiscal Regime

Section 1 of the second Amended Finance Bill for 2011 approved on 19 September 2011 has modified the fiscal regime of the capital gain on real estate assets triggered by the sale of a property which is not a primary residence.

Capital gain realised as from 1 February 2012 will be subject to income tax after application of the following allowance/deduction:

- 2 per cent per year of holding after the 5th year;
- 4 per cent per year of holding after the 17th year;
- 8 per cent per year of holding after the 24th year

Then, no allowance/deduction will be applicable during the first five years of holding and a complete exemption will be possible only after 30 years of holding, as against 15 years currently.

The 1,000 Euro deduction will be applicable during the first five years of holding period.

In addition, in order to limit tax optimisation, this provision is applicable to the real estate contribution or ownership rights which benefit familial real estate partnership realised since 25 August 2011.

Note: In part this summary is based on information contained in a recent newsletter issued by Deloitte PCS Limited: http://www.deloitte.co.uk/privateclientservices.

Italy: New Tax Reporting Requirements for Funds Investing in Eligible Italian Bonds

The Italian tax authorities have recently issued regulations (Decree of 13 December 2011 – No. 11A16232) regarding the new Italian tax reporting requirements for funds investing in eligible Italian bonds. The reporting regime is effective from 1 January 2012.

The regulations contain details of the methodology to determine the portion of income received by Italian investors from investment funds that relates to indirect investment in eligible bonds and therefore is subject to the lower rate of 12.5 per cent instead of 20 per cent. It will be based on the average of the ratio of a fund's investment in eligible bonds to total assets (net of any "tax assets") as per the last two available financial statements (semi-annual or annual).

For example:

- An investment fund distributes 100 of income in respect of the period commencing 1 January 2012.
- Percentage investment in eligible bonds at 31 December 2010 – 23 per cent
- Percentage investment in eligible bonds at 30 June 2011 – 31 per cent
- Average is 27 per cent [(23% + 31%)/2]

Income relating to indirect investment in eligible bonds is therefore 27 [100 x 27%] and this will be taxed at the lower rate of 12.5 per cent.

Income relating to other investment is 73 [100 -27] and this will be taxed at a new rate of 20 per cent.

For new funds, for which no financial statement have yet been published, the new 20 per cent rate will apply to the entire distribution. Once the first set of financial statements is published, the applicable percentage will be based on the figures in that single set of accounts.

USA: Draft FATCA Regulations to be Published in January 2012

The Internal Revenue Service of the United States has recently announced that the expected draft FATCA regulations will not now be issued until shortly after the New Year. The period for providing written comments on the draft regulations will necessarily be shorter than usual as the IRS remains committed to finalising the regulations during the summer of 2012.

(The text of IRS Commissioner of Internal Revenue Douglas Shulman's speech can be found at http:/www.irs.gov/newsroom/article/0,,id=251240,00.html)

USA: The Dodd-Frank Act – The Volker Rule

The deadline for responses has now been delayed until 13 February 2012.

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

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