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A legal update from Dechert's Financial Services Group

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Financial Services Europe and International Update

Regulatory Developments

This update summarises current regulatory developments in the European Union and supranationally, and in the UK and certain other jurisdictions focusing on the investment funds and asset management sectors, during the past month.

EU and Supranational Regulatory Developments

European Council Meetings

European Council met on 1 and 2 March 2012. During the meeting of the Member States adopted the Fiscal Compact which will now go forward for ratification. On financial services reform, the Council called for, amongst other things:

- EMIR and the CRA2 to be adopted as rapidly as possible;
- CRD4 to be agreed by June 2012;
- MiFID2 and MiFIR to be agreed by December 2012;

The Commission will also be considering the possible strengthening of the current legal framework relative to executive pay and work on the FTT is to be carried forward.

The European Commission's draft Regulation on improving securities settlement in the EU and on central securities depositories

The Commission, it will be recalled, is seeking to complete the EU regulatory framework for securities, as part of its efforts to create a sounder financial system. Two of the three main steps are already in progress, with trading being delivered through MiFID and clearing through EMIR. The final stage in the process to be addressed is settlement, where concerns have been raised at the absence of an efficient single internal market. Remaining barriers have resulted in a fragmented market which is viewed by the Commission not only as inefficient but which also increases the risks associated with cross border transactions.

The above proposed Regulation was published by the Commission on 7 March 2012 and aims to set up a common regulatory framework for central securities depositories ("CSDs"). This will include bringing more safety and security to securities settlement, shortening the settlement time process, together with minimising settlement failures.

Included in the proposal are the following key elements:

- the settlement period will be harmonised and set at a maximum of two days after the trading day for securities traded on stock exchanges or other regulated markets;
- penalties will be applied to market participants who fail to deliver their securities on the agreed date and participants will be required to buy in those securities in the market and deliver them to their counterparties;
- issuers and investors will be required to keep a record for virtually all securities, and to record them in CSDs if they are traded on stock exchanges or other regulated markets;

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- CSDs will have to comply with strict organisational, conduct of business and prudential requirements to ensure their viability and the protection of their users and will also have to be authorised and supervised by their national competent authorities;
- CSDs which are authorised will be granted a passport to provide their services in other Member States;
- users will be able to choose between all thirty CSDs in the EU; and
- CSDs in the EU will have access to any other CSDs or other market infrastructures such as trading venues or central counterparties, in whichever country they are based.

This proposal is now with the Council and European Parliament for negotiation and adoption.

EMIR – Joint Discussion Paper from the ESAs

It will be recalled that agreement was reached in trialogue in-mid February 2012 on the proposal for a Regulation on OTC derivatives, central counterparties and trade repositories ("EMIR"). Following concern expressed at the tight timescale for production of the technical standards, ESMA has now secured a three month extension with a new deadline of 30 September 2012.

A joint discussion paper on regulatory technical standards in this area was published on 6 March 2012 by the three European Supervisory Authorities (ESMA, EBA and the EIOPA). This focuses on risk mitigation techniques for OTC derivatives that are not cleared by a central counterparty. (Under EMIR, powers were delegated to the Commission to adopt Regulatory Technical Standards ("RTSs") on the level of capital and collateral that counterparties to derivatives transactions need to maintain, the type of collateral and segregation arrangements and on the procedures to apply an intragroup exemption.)

Separately the EBA has also published a discussion paper on draft RTSs on capital requirements for CCPs on 6 March 2012, under the EMIR. The EBA is seeking stakeholders' views on this issue with the understanding that the European Commission, the European Parliament and the Council of the European Union reached a political agreement on EMIR in their trialogue meeting on 9 February 2012.

In developing its proposal, the EBA has considered the draft principles for financial markets infrastructure consulted on by the Committee on Payment and Settlement Systems ("CPSS") and IOSCO in March 2011. Its considerations are also based on the Capital Requirements Directive (*2006/48/EC* and *2006/49/EC*) (the "CRD"). The EBA's approach will result in capital requirements that are at least equal to those resulting from the CPSS-IOSCO principles.

The EBA's preliminary view is that a CCP's capital, including retained earnings and reserves, should be at all times at least equal to the higher of the following two amounts:

- the CCP's operational expenses during an appropriate time span for winding-down or restructuring its activities; and
- the capital requirements for those risks that, according to EMIR, must be covered by appropriate capital.

The EBA believes that risk exposures and capital requirements should be calculated using approaches applicable to banks under the CRD. Capital held under international risk-based capital standards should be included as appropriate to avoid double regulation.

The EBA's paper closes for comments on 2 April 2012. The EBA will then conduct a public consultation before submitting the draft RTSs to the Commission.

BIS working paper on collateral requirements for centrally cleared OTC derivatives

On 6 March 2012, the Bank for International Settlements ("BIS") published a working paper on collateral requirements for mandatory clearing of over-the-counter (OTC) derivatives. (As a result of the G20 commitment that all standardised OTC derivatives should be cleared with central counterparties ("CCPs") by the end of 2012, the volume of central clearing of bilateral derivatives contracts is set to rise.)

The authors of the BIS paper estimate the amount of collateral that prudent CCPs should require to clear safely all interest rate swap and credit default swap ("CDS") positions of the major derivatives dealers. Their findings include:

- major dealers already have sufficient unencumbered assets to meet initial margin requirements, although some may need to increase their cash holdings to meet variation margin calls;
- a default fund worth only a small fraction of dealers' equity appears to be sufficient to

protect CCPs against almost all potential losses that could arise on default of one or more dealers; and

- concentrating clearing of OTC derivatives in a single CCP could economise on collateral requirements without detriment to the robustness of central clearing.

(The requirement for mandatory clearing of OTC derivatives will be imposed in the EU by the EMIR on which in February 2012, the European Parliament, the Council of the European Union and the European Commission appear to have reached agreement.)

The deadline for responses to the BIS consultation is also early in April 2012. Draft technical standards will subsequently be included in a consultation paper which is expected to be published in the summer of 2012.

The proposed FTT: ECOFIN review of progress and update

It will be recalled that in September 2011, the Commission published a proposal for a EU Financial Transaction Tax (the "FTT"). The proposed FTT would be levied on transactions of shares and bonds at 0.1% and derivatives at 0.01% which were carried out by financial institutions where at least one of the parties to the transaction was established in the European Union.

EU Finance Ministers met on 13 March 2012 to discuss the progress made on the FTT. The Danish Presidency noted that they had speeded up discussion of the file and the working group had now completed a first technical reading of the proposal but that further technical discussion would be needed to address issues raised, including the tax base, the structure of tax rates and the person liable to the tax, the impact on the economy, the risk of relocation, and enforcement of the tax vis-à-vis non-EU financial institutions. Commissioner Semeta confirmed that the Commission would provide further analysis on these issues.

Several Member States (Luxembourg, Malta, Sweden, Italy, the Czech Republic, and the Netherlands) restated their concerns regarding the impact of the FTT on competitiveness and growth and agreed that further analysis was required to respond to the concerns raised so far.

There was a consensus that agreement among all 27 member states would be preferable and therefore it would be expedient to begin looking at alternatives that are acceptable to all member states. Finland proposed that the Presidency and the Commission to look at alternatives and present a compromise proposal at the June ECOFIN meeting. France supported this and suggested that the tax that is currently being Introduced in France could serve as a model. Sweden agreed that alternatives should be looked at but warned that there is strong opposition in Sweden to European taxes with any revenues therefrom going towards the European budget.

In conclusions, the Presidency called on the Commission to provide further analysis of:

- the impacts of the proposal on the economy and competitiveness;
- the amount of tax the financial services industry already contributes;
- the cost of new and proposed regulations on the financial services industry (EMIR, CRD4, etc); and
- alternative proposals

(The Finance Ministers will discuss alternatives to the FTT at the informal ECOFIN at the end of March 2012 with the next substantive discussion expected to take place at ECOFIN in June 2012.)

In an exchange of views with the European Parliament's Economic & Monetary Affairs Committee on 20 March 2012, Commissioner Semeta reported general support for the proposal's objectives and agreement that technical work on it must continue and called for rapid progress, under the Danish Presidency. A report supplementary to the Commission's impact assessment of September 2011 will be published before the Council working group's next meeting on 23 April 2012. That report will not contain fundamental changes but will take account of discussions among Member States on clarifying some elements and quantifying certain assumptions used and revise the assessment to show a beneficial effect on growth.

In a letter to the Dutch Ministry of Finance in January 2012, that has now been published, the Netherlands' regulator, the Authority for the Financial Markets (the "AFM"), has argued that a European FTT is undesirable and will adversely affect the transparent and efficient functioning of financial markets, financial stability and, ultimately, the real economy and the certainty of pensions for the Dutch. The AFM has also pointed to concerns as to undesirable likely behavioural effects; the AFM believes that the objectives could be achieved more easily by directed incentives in specific regulations, rather than by a FTT.

Packaged Retail Investment Products (''PRIPs''): European Commission commences internal consultation

It will be recalled that the Commission was given a mandate by ECOFIN in May 2007 to examine Community law applicable to retail investment products with a view to assessing whether current investor protection standards are sufficient. The Commission organised a technical workshop and hearing with industry in 2008 following on from a consultation conducted in late 2007.

In November 2011, the Commission launched a consultation on its PRIPs initiative, which outlined possible measures for improving the transparency and comparability of investment products and ensuring effective rules always govern the sales of the products. It also addressed inconsistencies in the standards that apply to different products and industry sectors.

We understand that a regulation on key information documents ("KIIDs") for retail investment products has just entered the Commission's internal consultation process and that the regulation is expected to apply to all products that are designed to provide investment opportunities to retail customers, such as investment funds, investments packaged as life insurance policies or retail structured products.

The regulation is also expected to lay down common standards on the length, presentation and style of the KIID, which is intended to provide retail investors with critical information about the product in clear language. It is believed that the products covered by the regulation will be identified and monitored by the European Supervisory Authorities.

(The Commission is expected to publish a PRIPs regulation within the next few months.)

European Council compromise proposals on CRD IV

On 4 March 2012, the Danish Presidency of the Council of the EU published:

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

Both compromise proposals were prepared following discussions at Council working party meetings in January and February 2012.

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

On 7 March 2012, ECON published its second report on the proposals. This second draft report sets out additional proposed amendments to the Directive, but does not contain an explanatory statement relating to the proposed amendments.

CLLS response to ESMA consultation on certain aspects of the MiFID compliance function requirements

The respected Regulatory Law Committee of the City of London Law Society (the "CLLS") has published a Response dated 13 March 2012 to the European Securities and Markets Authority's ("ESMA") consultation on guidelines on certain aspects of the MiFID (*2004/39/EC*) compliance function requirements.

The CLLS comments on certain aspects of the guidelines that cause concern or could be improved significantly. Their comments include:

- concern at the limited role the guidelines acknowledge for senior management, and their narrow focus in general;
- ESMA should anticipate equivalent guidelines contained in other legislation (for example, relating to market abuse or the Alternative Investment Fund Managers Directive);
- insufficient attention is given to the need for a risk-based approach (and although this is mentioned, ESMA seems to give the impression that the guidelines support a comprehensive (non-risk based) approach);
- too many of the guidelines are over-prescriptive, and there is inadequate flexibility, for example, to cater for different types of organisations;
- the guidelines' objectives need clarification, particularly when trying to assess the adequacy of alternative approaches; and
- the compliance function responsibilities are described too broadly: all parts of the organisation are responsible for contributing

to the firm's compliance in performing their functions.

(The ESMA consultation closed on 24 February 2012 and ESMA expects to publish a final report and guidelines in Q2 of 2012.)

ESMA speech on the AIFM Directive work programme

The European Securities and Markets Authority ("ESMA") has published a speech made by Professor Steven Maijoor, Chairman of ESMA, on 15 March 2012 providing details of ESMA's current work programme relating to the Alternative Investment Fund Managers Directive (*2011/61/EU*) (the "AIFM Directive"). The speech supplements and expands on announcements made in ESMA's work programme for 2012.

In the speech, Mr Maijoor announced details about ESMA initiatives including:

Third country co-operation arrangements: ESMA is working towards the establishment of co-operation arrangements with non-EU authorities. Although the relevant agreements will be between non-EU and EU authorities, ESMA intends to centralise the process and negotiate on behalf of the EU competent authorities. ESMA is currently developing guidelines on the content of the co-operation arrangements. These guidelines will in effect be a model memorandum of understanding (MoU) that will serve as the basis for negotiations with non-EU authorities.

Remuneration guidelines: ESMA is working on guidelines on remuneration under Article 13 of the AIFM Directive and intends to publish a consultation paper in the second quarter of 2012.

Key concepts discussion paper: Professor Maijoor suggested that some of the issues considered in ESMA's February 2012 discussion paper on key concepts of the AIFM Directive would probably be addressed in the form of ESMA guidelines or a Q&A, rather than in regulatory technical standards

Comment: Press reports have subsequently appeared suggesting that the European Commission is likely to reject substantial parts of ESMA's technical advice on the Level 2 measures from the AIFMD, including the third countries section and the way with which leverage was dealt by ESMA.

Responses to ESMA's discussion paper on the AIFM Directive's key concepts

On 27 March 2012, the European Securities and Markets Authority ("ESMA") published the responses it has received to its February 2012 discussion paper on key concepts under the Alternative Investment Fund Managers Directive (*2011/61/EU*).

One of the respondents was the respected Regulatory Law Committee of the City of London Law Society (the "CLLS"), whose response dated 23 March 2012 focused on issues including:

- the definition of an alternative investment fund ("AIF") and capital raising;
- concerns about providing precise definitions for family office vehicles, insurance contracts, joint ventures and holding companies; and
- the treatment of MiFID firms and credit institutions.

In particular, the CLLS was concerned that many firms that currently manage some investment funds and advise on, receive and transmit, and execute orders for other investment funds or clients, will not be able to continue both activities in one legal entity. It also appears that an entity that is permitted to carry on certain limited MiFID activities, in addition to being an alternative investment fund manager, will be subject to the full Capital Adequacy Directive (*2006/49/EC*) (CAD) regime as if it were a MiFID firm.

European Commission consultation on Shadow Banking

It will be recalled that "shadow banking" was identified as an area of potential instability due to its size and interconnectedness with the traditional banking sector by the G20 in 2011. The FSB was asked to examine shadow banking to develop recommendations on the oversight and regulation of the entities and activities concerned. A FSB task force on shadow banking set up five workstreams to examine the issue which are due to report in the second half of 2012.

On 19 March 2012, the Commission published a Green Paper consultation on shadow banking with the aim of contributing to the global debate on how to improve the regulation and oversight of the shadow banking sector.

The Green Paper explores the following areas:

- the definition of shadow banking and the entities and activities which should be covered;
- the potential risks associated with shadow banking;
- the need for monitoring and supervising of the shadow banking sector;
- measures to limit opportunity for global regulatory arbitrage;
- current measures to regulate the shadow banking sector such as AIFMD, UCITs and Solvency II; and
- outstanding issues where additional regulatory reform may be needed. These are broken down in to five areas (reflecting the five FSB workstreams): banking regulation, asset management regulation, securities lending and repos, securitisation and other shadow banking entities.

Responses to the Commission's consultation are required by 1 June 2012 and the Commission will hold a stakeholders' conference on this subject on 27 April 2012.

IOSCO recommendations on mandatory clearing of OTC derivatives

On 29 February 2012, the International Organization of Securities Commissions ("IOSCO") published a final report on requirements for mandatory clearing.

The Report is addressed to national authorities that are developing and implementing mandatory clearing requirements pursuant to the G20 commitments to improve transparency, mitigate systemic risk and protect against market abuse in the over-the-counter ("OTC") derivatives markets. The Report outlines recommendations that authorities should follow when establishing mandatory clearing requirements for standardised OTC derivatives.

IOSCO has produced the Report in response to a request by the Financial Stability Board (the "FSB") in its report on implementing OTC derivatives market reforms. (The FSB had asked IOSCO to co-ordinate the application of central clearing requirements on a product and participant level, and any applicable exemptions in order to minimise the potential for regulatory arbitrage.)

IOSCO has made seventeen recommendations in its Report including in the following areas:

- determination of whether mandatory clearing obligations should apply to a product or set of products: authorities should consider using both a bottom-up and top-down approach and should also decide whether certain contracts should be "frontloaded" (although they need to consider the legal and practical implications of doing this);
- consideration of potential exemptions to the mandatory clearing obligations;
- establishing appropriate communication amongst authorities and with the public;
- consideration of relevant cross-border issues in the application of mandatory clearing obligations: authorities should closely co-operate with each other to identify overlaps, conflicts and gaps between their regimes, and should co-ordinate their approaches via multilateral or bilateral channels to reduce these issues and the risk of regulatory arbitrage; and
- the monitoring and reviewing the overall process and the application of the mandatory clearing obligations.

The report also summarises the details and status of a number of key jurisdictions' mandatory clearing regimes, and the current and proposed exemptions to those mandatory obligations.

IOSCO updates systemic risk data requirements for hedge funds

On 22 March 2012, IOSCO published an updated list of categories of data for the collection of hedge fund information. (IOSCO first published a template for collecting hedge fund data in February 2010).

IOSCO is of the view that regular monitoring of hedge funds by regulators for systemic risk indicators and measures will provide important data that will help to monitor trends in hedge funds and potential systemic risks. IOSCO's task force on unregulated financial entities will conduct a hedge fund survey in September 2012 seeking categories of information including:

- performance and investor information;
- trading and clearing;
- leverage risk; and

- counterparty risk.

The Volcker Rule: opportunities for hedge fund managers

The Volcker rule, which is due to come into effect in the USA in July 2012, prohibits banks from trading with their own funds for profit and is encouraging so-called proprietary traders to set up on their own. As a consequence of the rule, Reuters reports that one leading global bank's alternative asset management arm is now scouring the market for promising new hedge fund managers. (The rule could prove a boon for its recently launched emerging manager programme as it is providing hedge fund managers across strategies such as long-short equity, distressed debt and trading funds).

It is thought unlikely that the rule will be finalised by the July 2012 deadline, however, but many Fund managers are still exiting banks ahead of when the ban is due to come into force.

The Volcker Rule is contained within Section 619 of the Dodd-Frank Act. As is indicated above the Rule seeks generally to prohibit banking entities from conducting 'proprietary trading' and from sponsoring or acquiring any equity, partnership or other ownership interest in a private equity or hedge fund. The Rule was introduced in response to the financial crisis and becomes effective on 21 July 2012, subject to a two year 'Conformance Period' for the industry. The Rule does not apply with respect to:

- the trading of securities and other instruments in connection with underwriting or market making related activities;
- risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings;
- trading activities conducted solely outside the US by companies that are not directly or indirectly controlled by a company organised under US law;
- trading on behalf of customers;
- trading of certain government obligations; and
- certain trading activities by regulated insurance companies

Comment: The proposed rules are complex and unclear in several areas. The Volcker Rule could have a substantial negative effect on liquidity which would impact all market participants. The extraterritorial scope of the proposed rule is much too broad and is likely to catch activity that is extremely remote to US interests and with minimal stability gains. For example, a non-US bank investing in a non-US hedge fund could be caught by the rule if that fund has only one US investor. The proposed rules may also conflict with mandatory rules in other jurisdictions, such as the rules for depositaries in the AIFM Directive.

Entering into sovereign CDS under the new EU Short Selling Regulation

The European Parliament formally adopted the text of the Regulation on short selling and certain aspects of credit default swaps ("the Regulation") at its plenary session on 14 March 2012 and it was published in the Official Journal shortly afterwards and one day after its publication, the Regulation formally entered into force. It is important to note, however, that with the exception of certain transitional measures in Article 46, the provisions of the Regulation will not apply until 1 November 2012.

The transitional measures referred to above are, however, highly significant since Article 46 (2) states that:

"CDS transactions resulting in an uncovered position in a sovereign credit default swap that have been concluded before [the date of entry into force of the Regulation] ... may be held until the maturity date of the CDS contract"

The issue of when a sovereign CDS can be regarded as covered will be dealt with in the European Commission's delegated acts (i.e. Level 2 measures). These are currently under consultation by ESMA and the Commission is expected to publish its final text this summer.

Thus for firms entering into sovereign CDSs, three different periods will apply:

1. **Until entry into force (tbc but mid- to late March 2012):**
   - ❑ entry into sovereign CDS transactions is permitted; and
   - ❑ CDSs may be held until maturity, even if they would result in an uncovered position under the Level 2 measures when published.

2. **Between entry into force and 1 November 2012:**

   - entry into new sovereign CDS transactions will be permitted;
   - until publication of the Level 2 measures, firms will have no certainty as to whether the position will be capable of being regarded as covered; and
   - any uncovered positions will have to be unwound or covered by 1 November 2012.

3. **After 1 November 2012:**

   - new transactions resulting in uncovered positions in sovereign CDS will not be permitted, unless the competent authority of a particular Member State temporarily waives the restriction on its own sovereign debt instruments.

Readers should note that the above is only **indicative guidance** but represents the current views of both the FSA and the Alternative Investment Managers Association Professional advice should be sought as appropriate in respect of specific queries.

CFTC approves new rules on Commodity Pool Operators

On 9 February 2012, the Commodity Futures Trading Commission of the United States (the "CFTC") voted to approve final rules on the registration and compliance of commodity pool operators ("CPOs") and Commodity Trading Advisors ("CTAs"). The CFTC rescinded the exemption in Regulation 4.13(a)(4) on which many fund managers currently rely. The exemption applied if interests in the pool were exempt from registration under the Securities Act of 1933, and such interests were offered and sold without marketing to the public in the United States; the CPO reasonably believed that each participant was a "Qualified Eligible Person" ("QEP") or an "accredited investor". There is a transitional period for CPOs currently relying on the exemption, until 31 December 2012, for firms to register as CPOs.

The CFTC did not rescind the de minimis exemption in Regulation 4.13(a)(3) as previously suggested, however, it did revise the thresholds to explicitly include swaps in their calculation. The CFTC's final rules also include amended reporting requirements for CPOs and CTAs and a requirement to include a warning text in the Risk Disclosure Statement if the pool or CTA may engage in swap transactions.

IOSCO consultation on principles for the regulation of ETFs

On 14 March 2012, IOSCO published a consultation report on the regulation of exchange traded funds ("ETFs"). This examines the key regulatory issues about ETFs and proposes fifteen separate investor protection principles to provide practical guidance for both the industry and regulators. It also considers certain market structure and financial stability issues.

The proposed principles address ETFs that are organised as collective investment schemes ("CISs"), and are not intended to cover other exchange traded products ("ETPs") that are not organised as CISs. Fourteen of the proposed principles are categorised under the following three headings:

- principles related to ETF classification and disclosure;
- principles related to the marketing and sale of ETF shares; and
- principles related to the structuring of ETFs

(The 15th proposed principle relates to the broader risk of liquidity shocks and transmission across correlated markets.)

The report states that implementation of the principles may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances. Some of the principles may be better suited to industry best practice than regulatory requirements.

Comments in response to this consultation are requested by IOSCO by 27 June 2012.

UK Regulatory Developments

FSA guidance consultation on the RDR and independent and restricted advice

On 27 February 2012, the FSA published a guidance consultation on the retail distribution review (the "RDR") and independent and restricted advice (GC12/3).

The proposed guidance is likely to be of most relevance to firms that provide personal recommendations to retail clients on retail investment products, it relates to section 6.2A of the FSA's Conduct of Business Sourcebook ("COBS").

RDR implementing rules will mean that from the end of 2012 firms providing investment advice to retail clients will need to describe these services as either "independent" or "restricted." The FSA has received a number of queries about the standard for independent advice and has therefore focused on the following issues in GC12/3:

- the key components of the standard for independent advice;
- the requirements for how firms hold themselves out;
- advice tools and investment strategies, and how their use may influence the ability of firms to meet the independent advice rules; and
- professional standards and how differences between the qualifications and skills of advisers may affect the ability of this advice to meet the independent advice rules.

Responses to GC12/3 are requested by the FSA by 9 April 2012.

FSA policy statement on treatment of legacy assets under the RDR adviser charging rules

On 27 February 2012, the FSA also published a policy statement on the treatment of legacy assets under the RDR adviser charging rules (PS12/3), following its November 2011 consultation, CP11/26.

PS12/3 provides feedback on the responses to CP11/26, many of which requested additional guidance on how the adviser charging rules interact with the rules made by the FSA in September 2011 confirming that trail commission can continue on pre-RDR assets. It also explains the approach the FSA has adopted in final guidance on the treatment of legacy assets, including:

- information about the position on non-advised changes, offsetting trail commission against adviser charges, and the rules on re-registration of commission;
- guidance in section 6.1A of COBS for cases where trail commission can be paid, top-ups, and increases in regular payments;
- changes to the Perimeter Guidance Manual ("PERG"), setting out whether recommendations will be advising on investments for the purposes of article 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544); and
- waivers from guidance to allow allocations of over 100 per cent (so called "negative charges").

As part of the FSA's supervisory work, it will review the implementation of the adviser charging rules, and also monitor changes in the market leading up to the implementation of the RDR at the end of 2012 (such as significant increases in the sale of particular products that could indicate non-compliance with the rules on suitability and serving the client's best interests). Once the RDR rules have come into force, the FSA will then take action if it sees firms acting in a way that could lead to consumer detriment, for example, recommending retention of higher charging products so that trail commissions can continue to be received. The FSA will also monitor the overall level of trail commissions in the market and check whether it is reducing or remaining at the current levels.

The FSA's finalised guidance on distributor-influenced funds

On 27 February 2012, the FSA also published finalised guidance ("FG12/4") on distributor-influenced funds.

The guidance takes the form of two factsheets:

- Distributor-influenced funds: points for distributors to consider.
- Distributor-influenced funds: points for authorised corporate directors, fund managers and platform providers to consider.

The factsheets are revised versions of factsheets on distributor-influenced funds which were published in December 2008. They have been updated to reflect changes to FSA rules resulting from the RDR. (The FSA consulted on these amendments to the December 2008 factsheets in a guidance consultation (GC11/29), published in December 2011).

In responding to the feedback received, the FSA has stated that the content of the revised factsheets reflects the text on which it consulted, although some small changes have been made in the interests of clarity. It notes that many respondents requested more detailed guidance on a range of issues which were not covered by the guidance consultation. Although the FSA will give further consideration to this, and may, in due course, consult again on further guidance, it does not intend to write any more detailed set of rules for firms to follow in this market.

The FSA reminds firms that the purpose of the revised factsheets is to give a high-level steer, rather than to provide detailed instructions. It remains the responsibility of firms to interpret relevant FSA rules as they apply to their business.

FSA report on assessing sources of systemic risk from hedge funds

On 29 February 2012, the FSA published a report assessing the possible sources of systemic risk from hedge funds, setting out the findings of the September 2011 hedge fund survey (the "HFS") and the October 2011 hedge fund counterparty survey (the "HFACS"). (These surveys, which are conducted every six months, help the FSA to assess potential systemic risks to financial stability from hedge funds, including the nature of bank and prime broker interactions). The main recent findings include:

- most surveyed hedge funds reported negative returns for the survey period;
- the footprint (i.e., the presence in financial markets) of funds is generally small when measured by the value of their exposures and by turnover: potential exceptions however are the convertible bond, interest rate derivative and commodity derivative markets;
- leverage has not changed significantly in the aggregate relative to previous surveys: leverage varies by strategy and fund, but borrowings relative to net asset value remains highest for fixed-income strategies;
- hedge funds report that they are able to liquidate their assets ahead of liabilities falling due and nearly all surveyed funds report the ability to suspend investor redemptions or create side pockets;
- counterparty exposures of funds remain fairly concentrated amongst five banks; and
- approximately 43 per cent of funds reported zero rehypothecated assets, (Rehypothecation allows collateral posted by a fund to be transferred to its broker, to be used again by that broker for its own funding purposes).

The FSA intends to repeat the HFS in March 2012 and the HFACS in April 2012.

FSA Quarterly Consultation

On 6 March 2012, the FSA published quarterly consultation CP12/5. Comments are invited on the following proposed amendments by 6 May 2012 (or 6 April 2012 for the RDR proposal):

- **The Retail distribution review (the ''RDR''):** the FSA is proposing amendments to the Training and Competence Sourcebook ("TC") to add a qualification to the appropriate qualification list.
- **BIPRU liquidity regime:** the FSA intends to make minor changes to the liquidity regime in the Prudential sourcebook for Banks, Building Societies and Investment Firms ("BIPRU") and the liquidity reporting rules in the Supervision Manual ("SUP").
- **Listing rules and UKLA:** the FSA proposes to amend the Listing Rules (the "LR") concerning the definition of "substantial shareholder" and chapter 9 of SUP to end the provision of providing individual guidance on a "no names" basis by the UKLA.
- **Authorised contractual schemes (''ACSs''):** the FSA proposes to amend the Collective Investment Schemes sourcebook (COLL) and other areas of the Handbook to introduce regulatory requirements for ACSs.

The LIBOR review

It has been reported that the British Bankers' Association (the "BBA") is to review the rate setting process for LIBOR ("London Interbank Offered Rate") and has met with HM Treasury, the Bank of England and the FSA to consider the impact of future market and regulatory developments on LIBOR. Technical discussions with interested groups, including users of the rate, are expected to begin shortly.

The review comes amid press reports that some overseas regulators are conducting investigations into the alleged manipulation of LIBOR in price setting for certain financial products.

LIBOR rate setting is not currently a regulated activity under the Financial Services and Markets Act 2000.

(LIBOR is fixed daily by a select group of banks who contribute rates that are used to calculate it. Only those banks on the BBA LIBOR panel are eligible to contribute. LIBOR is the benchmark commonly used as part of the interest calculation in a floating rate lending transaction.)

Comment: On 6 March 2012 the Financial Secretary to the Treasury confirmed that the FSA and other UK authorities and the EU competition authorities are currently examining LIBOR.

The OFT's cash ISAs review

On 14 March 2012, the Office of Fair Trading (the "OFT") published a review of industry progress on implementing reform initiatives for improving the cash ISA market for customers.

The initiatives were agreed with, or recommended, by the OFT in June 2010 following its investigation into a complaint about various practices of cash ISA providers. One of the outcomes of the investigation, was agreement by the cash ISA industry to revise industry guidelines in three key areas:

- **The time taken to transfer cash ISAs:** there has been significant improvement in the time taken to complete cash ISA transfers since the OFTs 2010 investigation. 93 per cent of cash ISA transfers during 2011 were completed within the fifteen working day timescale required by the new industry transfer guidelines.

- **Backdating of interest:** all providers of cash ISAs reviewed by the OFT are following new guidelines requiring that, if transfer delays occur, the acquiring provider must back date the interest to the earlier of day 16 of the transfer process or the date on the cheque.

- **Publication of the interest rate on the face of cash ISA statements:** at the time of the OFTs 2010 investigation, only a limited number of the major cash ISA providers provided interest rate information on statements. After its investigation, the OFT worked closely with the industry to extend the provision of interest rates on statements. This led to the British Bankers' Association and the Building Societies Association agreeing that their members would, on a voluntary basis, provide interest rates on cash ISA statements delivered in paper and/or electronic format. National Savings & Investments also agreed to do this.

In its review, the OFT found that all cash ISA providers surveyed did currently publish interest rates on cash ISA statements (although one was publishing this information at the end of statements rather than on their face, and this will be rectified).

UK policy options for implementing the AIFMD

On 14 March 2012, HM Treasury published an informal discussion paper "Policy options for implementing the Alternative Investment Fund Managers Directive (AIFMD)" which seeks comments on a number of high-level policy decisions that will need to be taken as part of the transposition of the AIFMD, due to take place by 22 July 2013. The areas covered by the paper are:

- the regime that will apply to alternative investment fund managers ("AIFMS") which fall below the AIFMD threshold for full authorisation: HM Treasury suggests two options: applying the AIFM Directive requirements fully to all smaller AIFMs; or applying a lighter regime selectively;

- interaction of the AIFMD with the proposed regulations on European venture capital funds and European social entrepreneurship funds;

- application of the FSA's approved persons regime to AIFMs: HM Treasury sets out the pros and cons of applying the UK approved persons regime to AIFMs and seek comments on the cost and benefits of applying the approved persons regime to different types of AIFM;

- the marketing of alternative investment funds to retail investors: HM Treasury does not suggest any extension of the types of fund that may be marketed to retail investors; and

- amending the national private placement regime: HM Treasury does not suggest imposing additional requirements for third-country managers of third-country funds above the AIFMD minimum.

The deadline for submitting comments is 4 May 2012 and will help inform a policy position for a formal HM Treasury consultation in summer 2012.

Lehman Client Money: broad view of client money pool and client claims upheld in the Supreme Court

The Supreme Court on 29 February 2012 upheld the decision of the Court of Appeal on each of three appealed questions relating to the scope of the statutory trust over client money under the FSA's Clients' Assets sourcebook ("CASS"). The Court (in judgment *[2012] UKSC 6)* held:

- a statutory trust over client monies arose at the time Lehman Brothers (International) Europe ("LBIE") received those monies, not when those monies were segregated from LBIE's own assets: the Court rejecting the argument that the trust only arises once the firm has segregated client money. This part of the judgment was unanimous. The Court's solution was regarded as achieving the objectives of both the Markets in Financial Instruments Directive ("MiFID") and the FSA's client money rules contained in CASS of the FSA Rulebook. CASS 7 contains the rules for firms handling client money. A key obligation is for MiFID firms to segregate money that they receive in the course of MiFID business from the firm's own money. Most significant firms will be MiFID firms conducting MiFID business. The ruling that the statutory trust applies to client monies on receipt, regardless of whether they have been segregated, is significant as the scope of assets potentially within the client money pool and available to protected customers is broader than it would be if only segregated assets were included.

- the client money pool includes client money in LBIE's house accounts, as well as in its segregated client accounts: Lords Hope and Walker dissented in part on this issue. However, the majority held that CASS 7.9.6 is to be read as requiring all identifiable client money to be treated as pooled whether or not such money was held in a segregated client bank account or a house account. If only segregated client money was to be pooled, clients would have to rely on the firm to comply with its regulatory obligation to segregate client money in order to be afforded the full extent of the protection envisaged by MiFID. This outcome is unfavourable to clients dealing with firms that have inadequate systems or otherwise have failed in their duties to segregate client monies. However, clients whose assets were actually segregated argue that having carried out diligence to ensure that their assets were segregated, they merit greater protection than those who failed to carry out the same checks. As a result of this judgment, the client money pool will be shared between all claimants, whether purportedly diligent or not, resulting in reduced claims for the segregated clients.

- any client with a contractual claim to client money has a right to share in the client money pool: there is no requirement that client money should have actually been segregated on the client's behalf. Lords Hope and Walker dissented on this issue, although the majority upheld the "claims basis" for participation in the client money pool. Thus those clients of the investment firm with an entitlement (contractual or otherwise) to have client money segregated for them will have a beneficial interest in the pool. The Court rejected the argument that only those clients for whom the firm had actually segregated client money in client bank accounts were entitled to participate in the pool. The client money rules are intended to protect all client money received prior to a primary pooling event (in this context when LBIE entered into administration). This was deemed to be consistent with the clear purpose of CASS 7, which is to grant a high degree of protection to client monies.

Comment: The LBIE client money litigation deals with fundamental issues concerning the protections given by financial institutions to their clients and the decisions of the High Court and the Court of Appeals in LBIE were keenly followed by the market. Although only certain key points from the case were considered on appeal to the Supreme Court, the case is of great interest not only for the Lehman creditors but also for those with interests in the MF Global administration, and more generally for customers who are concerned about their assets that they place with financial institutions.

What then are the implications of the Supreme Court's ruling?

Lord Dyson, giving the leading judgment for the majority, accepted that the decision provides for a "cataclysmic shift of beneficial ownership" in the context of LBIE's administration. It seems certain that the immediately identifiable client money pool is subject to a significant shortfall. Briggs J had noted in his judgment in the High Court that "LBIE failed to identify as client money, and therefore also failed to segregate, vast sums received from or on behalf of a significant number of its clients". In this respect, the most significant group of clients whose money LBIE failed to segregate were its own affiliates.

The Supreme Court's ruling clearly takes a broad approach both as to the scope of client money and to the number of persons interested in the pool, with the outcome that unsecured creditors will claim against a diminished estate. Interestingly, the Court applied a purposive approach to the interpretation of CASS, not least because of the ambiguities and lack of clarity in the relevant CASS provisions, (perhaps not untypical of FSA legal drafting). The result is that clients with claims for segregated client money and clients with claims for non-segregated client money are in principle to be treated equally. If a firm fails to segregate the client money it receives, this will not result in any differential treatment in terms of proprietary rights for clients with client money claims. The difficulty, however, is that, for accounts other than the firm's client bank accounts and the house account used to take in client money, clients need to rely on complex tracing procedures to identify assets or monies that may be brought within the client money pool. This is the particular challenge in the tracing application made by the Joint Administrators of LBIE which was adjourned by the High Court on 11 May 2011 pending the Supreme Court's ruling on the above client money issues. LBIE's administrators will most likely require detailed guidance from the High Court in relation to the appropriate tracing procedures. They have issued an update on the judgment, stating: "[i]f further assistance from the Court is required, the Supreme Court has held that such further guidance must be sought from Mr. Justice Briggs, as the judge overseeing LBIE's administration" There is now likely to be further litigation on the extent to which monies held in a house account can be traced and included in the client money pool.

As to the timing of any distributions of client monies, Lord Walker comments: "[a]s to the need for the administrators to have a workable scheme which provides for a timely distribution, that is an aspiration which has already, sadly, perished. A straightforward, timely distribution is impossible because of LBIE's massive non-compliance with CASS."

Tony Lomas, joint administrator of LBIE, has now confirmed that any distributions will be delayed. Similar issues may arise in connection with the more recent MF Global UK Limited administration. Going forward, it is likely that clients will still want to ensure proper segregation of their monies to avoid having to rely on tracing procedures as a basis for a proprietary claim. More generally, the FSA is likely to introduce significant revisions to its rather ambiguous and unclear CASS rules in light of this judgment.

Private equity: updated guidelines for good practice reporting by portfolio companies

On 14 March 2012, the Guidelines Monitoring Group (the "GMG") published an update of its guidelines on good practice reporting by private equity portfolio companies under the Walker Guidelines. Although the specific extracts from company reports, showing examples of reporting that the GMG considers to represent good practice, have been updated, the format and content of the updated guidelines remains largely unchanged from the version issued in June 2011. The updated guidelines now include the following additional points of good practice, supplementing those in the 2011 version:

- **Financial review – financial risks:** a portfolio company's financial review should include disclosure of the likelihood and impact of the key financial risks identified, and clear linkage of how they are managed and monitored.

- **Employees:** the section of a company's business review relating to its employees should include an explanation of its policies on recruitment, training and development.

- **Social and community issues:** the business review should include information on supply chain monitoring to ensure social policies are consistent throughout, such as the use of labour and the wider impact on society in overseas locations.

- **Essential contractual or other arrangements:** the updated guidelines note that basic compliance with the Companies Act 2006 obligation to disclose information on persons with whom the business has key contracts or other essential arrangements ought to extend not only to key customer and supplier contracts, but also to property and debt management contracts, if they are key to the business. Also, key relationships may exist where no formal contract exists. As regards good practice, the GMG considers that, overall, portfolio companies are poor at explicit disclosures around essential contracts. As such, the guidelines recommend that disclosure ought also to cover key relationships, as well as contracts; the nature of the relevant arrangements and their importance to the business, as an alternative to simple disclosure of party names; disclosure of the business benefits of the arrangements disclosed and how the company manages the risks associated with them.

(The GMG notes that the standard of reporting over the last year by a number of companies being assessed under the Walker Guidelines for the first time was not as high as reporting by other portfolio companies. Overall, however, it concludes that many companies do report to a standard that is consistent with reporting by FTSE 350 companies, the benchmark against which the GMG considers it appropriate to measure compliance.)

UK Budget 2012 – Overview of Charges of Interest to the Financial Services Industry

As our readers will know, the Chancellor of the Exchequer announced the 2012 Budget on the afternoon of 21 March 2012. This summary provides a brief overview of some of the measures which may be relevant to our readers.

General Anti-Avoidance Rule

The Government has accepted the recommendation of Graham Aaronson QC that a general anti-avoidance rule ("GAAR") targeted at artificial and abusive tax avoidance schemes would benefit the tax system. A consultation will commence with a view to legislation being introduced in Finance Bill 2013.

It will be recalled that Government fist announce that it would consider introducing a legislative general anti-avoidance rule in the June 2010 Budget. A study group led by Graham Aaronson QC was duly established, and the group published its final report in November 2011. It recommended the introduction of a targeted GAAR and included illustrative draft legislation and guidance.

It should be noted that "GAAR" was initially an acronym for "general anti-avoidance rule". It is now apparently an acronym for "general anti-abusive rule". Presumably this is intended to demonstrate an intention that the rule should only catch abusive transactions, rather than legitimate tax planning.

Corporation Tax Rates

The main rate of corporation tax will fall from 26 per cent to 24 per cent from 1 April 2012 (rather than 25 per cent as previously announced) and will fall by a further 1 per cent in each of the next two years, to reach 22 per cent from 1 April 2014.

Controlled Foreign Companies ("CFC") Reform

Legislation will be introduced in the Finance Bill to replace the existing CFC regime. This follows a lengthy consultation and aims to strike a better balance between creating a more competitive corporate tax system and protecting the UK corporate tax base. These changes are proposed to come into effect in 2013.

Bank Levy

From 1 January 2013 the bank levy rate will be increased to 0.105 per cent for short-term liabilities, and a rate of 0.0525 per cent will apply for long-term equity liabilities.

These increases will be legislated in the Finance Bill 2012, along with the previously announced rates for 2012. (The stated reason for the increases is to ensure that the bank levy generates its target revenue of £2.5 billion a year).

Tax Transparent Funds ("TTFs")

Following a consultation, legislation will be introduced to permit the authorisation of TTFs from summer 2012. As announced in Budget 2011, the Finance Bill 2012 will contain legislation permitting the authorisation of tax transparent funds and the Government will publish draft regulations (to be made under the power in the Finance Bill 2012) after taking into account the responses to its consultation on tax transparent funds. Regulations will be made to establish the tax treatment of UK investors' holdings in such funds and the stamp taxes treatment of transactions.

Unauthorised Units Trusts ("UUTs")

A further consultation into the reform of the tax rules for UUTs will commence in April 2012 with a view to legislating in Finance Bill 2013. It will be recalled that the Government launched a consultation in this area on 30 June 2011, seeking suggestions for improving the rules governing the taxation of UUTs with the aim of removing tax avoidance opportunities and reducing administrative complexity. Legislation effecting the resulting changes is intended to be included in the Finance Bill 2013.

REITs: previously announced improvements and other possible changes

The Finance Bill 2012 will contain legislation relaxing a number of the requirements of the real estate investment trusts ("REITs") tax regime. It may be recalled that on 6 December 2011, HMRC published for comment draft legislation for the Finance Bill 2012 that implements the changes. The Finance Bill 2012 legislation will either not differ from the draft legislation or will only contain small, technical amendments to the draft legislation.

The Government will also consult on the role REITs can play in supporting the social housing sector and whether to change the treatment of income received by a REIT when it invents in another REIT.

Regulatory capital instruments

The Finance Bill 2012 will include a power for HMRC to determine the tax treatment of regulatory capital instruments issued in accordance with the Basel III and the EU Capital Requirements Directive IV ("CRD IV"). The Government states that regulations to be made under this power will take effect from the commencement of the CRD IV provisions. (This measure follows a consultation announced as part of the 2011 Budget).

FATCA: Information powers

On 8 February 2012, HM Treasury published a joint statement setting out an agreed approach to implementation of the Foreign Account Tax Compliance Act of the United States ("FATCA"), which aims to combat cross-border tax invasion. The statement was issued jointly with the governments of France, Germany, Italy, Spain and the United States. The US Government has now announced that HMRC will consult with affected financial institutions about how to facilitate exchange of information between those institutions and the US Internal Revenue Service, with a view to introducing legislation in the Finance Bill 2013.

Venture Capital Trusts ("VCTs")

As previously announced, the Finance Bill 2012 will introduce legislation to simplify the VCT regime, with the changes applied to shares issued on or after 1 April 2012.

HMRC's Retail Distribution Review VAT Guidance

On 29 February 2012, HMRC circulated its final guidance on the VAT treatment of retail investment advisers' services under FSA's Retail Distribution Review ("RDR") rules, effective 31 December 2012. HMRC previously circulated revised draft guidance for comment. The final guidance differs from the revised draft in the following substantive ways:

- HMRC has omitted SIPPS from the list of "wrappers" in which retail investment products can be held without changing their status as such products.
- The draft guidance stated that general financial advice "not associated with intermediation in exempt products" would be continue to be taxable. The final guidance omits the words in quotes, making the definition of "general financial advice" somewhat less precise.
- HMRC has clarified the range of adviser services that benefit from exemption. If the adviser performs the intermediary service and can evidence this, the adviser's services that are typically preparatory and subsequent to that intermediary service and agreed with the customer are also exempt.
- If there is no evidence of such arrangement services or if at least one of the typical services is contracted for separately (so that the service is of general advice or recommendation only), the adviser's charges will be VATable. The draft guidance contemplated a VATable supply simply if there was no evidence of agreement by the customer.
- The final guidance adds that the VAT liability depends on what the adviser does. Whether there is a fee up-front or over the product's life is irrelevant.

Investment Trusts: Draft HMRC guidance on the new rules

HMRC has published draft guidance on the new definition of "investment trust" and the approval provisions. This is to be included in HMRC's Company Taxation Manual and comments are invited by 1 June 2012.

For the most part, the draft guidance merely follows the legislative provisions. However, it:

- states that HMRC will accept listing under Chapter 15 of the UK Listing Rules as indicating that an investment trust aims to spread investment risk unless, exceptionally, the evidence suggests otherwise: if an investment trust is not listed, it should consider whether it would meet the Chapter 15 requirements and HMRC will apply a similar approach;
- states that, for the purpose of the income distribution requirement "income" means gross income before deducting tax and management expenses; and
- provides some examples, including how the income distribution requirement applies to investment in offshore reporting funds.

The Capital Requirements (Amendments) Regulations 2012

On 26 March 2012, the above Regulations (SI 2012/917) ("the Amendment Regulations"), were published with an explanatory memorandum.

The Amendment Regulations amend the Capital Requirements Regulations 2006 (SI 2006/3221) to reflect aspects of CRD III (2010/76/EU) and the Omnibus I Directive (2010/78/EU). Amongst other things, the Amendment Regulations:

- insert provisions enabling the European Banking Authority (the "EBA") to settle disagreements between competent authorities relating to various joint decisions required to be made under the Banking Consolidation Directive (2006/48/EC) (the "BCD"), which forms part of the Capital Requirements Directive (the "CRD");

- include references to the EBA and the European Systemic Risk Board in relation to various co-operation and notification obligations required by the BCD; and

- impose new duties on the FSA to benchmark remuneration trends and practises in credit institutions and investment firms, collect information about employee remuneration and notify that information to the EBA.

The Amendment Regulations also make minor amendments to primary and secondary legislation, including the Financial Services and Markets Act 2000 (FSMA) and the Banking Act 2009, to incorporate references to the CRD III and Omnibus I directives.

The Amendment Regulations were made on 23 March 2012 and come into force on 16 April 2012.

Banks now face £1bn of funded claims from interest rate swaps mis-selling

Press reports have appeared that venture capital firms are backing litigation worth up to £1bn against major banks over the alleged mis-selling of interest rate hedging contracts, the latest mis-selling debacle to be missed by the FSA when it occurred.

A group of cases identified by the company that has secured the backing of funds for the claims, Norton Accord, is to represent the largest set of funded claims faced by UK banks to date. This group of cases could dwarf various high-profile customer claims. It is understood that claims will average £2m-£4m, placing them in a value range that the Financial Services Ombudsman has said it is reluctant to adjudicate. The estimated length of the litigation is expected to be 12-18 months.

It may be recalled that hedging contracts became a common pre-condition for many high street banks' loans to small and medium-sized businesses from at least as far back as 2005. The swap was a form of insurance against interest rate rises. But with interest rates falling, many borrowers were trapped on a higher rate by these products.

Research has indicated that there are around 4,000 possible claims suitable for funding using these products. Based on counsel's opinion and Norton Accord's own research it is estimated that customers could recover 80-90 per cent of their losses. The litigation is backed by three sources. Two are funds with an international focus. The third backs only cases involving UK solicitors. (Norton Accord is working with seven law firms in making this claim.)

The Financial Services Bill

On 22 March 2012, the Financial Services Bill 2010-12 completed its committee stage in the House of Commons, following 16 sittings of the public bill committee for the Bill. A revised version of the FS Bill, showing amendments made in the committee stage, is available on the UK parliament website.

The FS Bill will now pass to the report stage in the House of Commons, although a date for the report stage has yet to be announced.

FSA policy statement on the distribution of retail investments

Also on 22 March 2012, the FSA published a policy statement on the distribution of retail investments, which focuses on retail distribution review (the "RDR") adviser charging and Solvency II Directive (2009/138/EC) disclosures (PS12/5). PS12/5 follows the FSA's November 2011 consultation on the distribution of retail investments (CP11/25) and reports on the feedback received thereto. The FSA confirms that only minor changes have been made to the rules and guidance consulted on and that:

- rules on the facilitation of payment of adviser charges will take effect from 31 December 2012;

- the rule on reporting investment amounts where payment of adviser charges or consultancy charges is being facilitated will apply to firms' first full reporting period after 31 December 2012;

- the Solvency II disclosures rules are "near final" because they include new Glossary definitions to be made with the main Solvency II rules, and they will be made at the same time as the main Solvency II rules, which the FSA expects to be at the end of 2012 and the FSA currently expects them to come into effect on 1 January 2014.

FSA finalised guidance on Retail Structured Products

On 23 March 2012, the FSA published finalised guidance on retail structured products (FG12/9) following its November 2011 guidance consultation on retail product development and governance (GC11/27).

The guidance is designed to assist firms with how best to develop structured products to meet clients' needs, and to ensure a robust post-sale process. In particular, firms should:

- identify their target audience and then design products that meet the target audience's needs, rather than merely contributing towards the firm's profitability;
- stress test new products to ensure they are capable of delivering fair outcomes for the target market;
- ensure a robust product approval process for new products, which means being clear about what is a new "new" product; and
- monitor the progress of a product through to the end of its life cycle.

(The FSA's Retail Conduct Risk Outlook for 2012 also identified the development and marketing of structured investment products as a current issue.)

FSA Discussion Paper on implementing the AIFM Directive

On 27 March 2012, the CLLS published its response to the January 2012 discussion paper from the FSA on implementing the Alternative Investment Fund Managers Directive (*2011/61/eu*) (the "AIFM Directive") (DP12/1). Points of note in its response include:

- the CLLS is concerned that any attempt at a precise definition of a joint venture or a family investment vehicle may bring with it a presumption that anything falling outside that definition must be an alternative investment fund. (This could damage a wide range of normal commercial and non-commercial activities and as an alternative to a precise definition, the CLLS suggests it would be helpful to use "have regard" factors that would indicate circumstances where arrangements are likely to be exempt from the scope of the AIFM Directive;
- the remuneration provisions in the AIFM Directive are described as presenting many challenges and as a general principle, the CLLS recommends as a proportionate application of the AIFM Directive remuneration provisions by aligning them to the Tier 4 provisions contained in the CRD III (*2010/76/eu*) and
- the CLLS indicates the types of practice that should not be considered as marketing, i.e. passive solicitation.

Other National Regulatory Developments

France and Belgium end their temporary bans on short selling

The French AMF has announced that the temporary prohibition on creating or increasing net short positions in certain French equity securities of financial sector firms came to an end on 11 February 2012. However, the AMF reminds market participants that, with regard to equity securities, the previous net short position disclosure regime remains in force and that, pursuant to French regulation, all investors must be in a position to deliver the securities they have sold within three trading days (T+3).

Taking into account the lower volatility of the markets and a consistent approach within the Euronext zone, the Belgian financial services authority has also announced the end of its temporary ban on holding of certain net short positions as of 13 February 2012. While waiting for the implementation of the European Short Selling Regulation (the "ESR") on 1 November 2012, it has introduced a reporting obligation for significant net short positions in the Belgian financial sector companies that were subject to the ban and a continuation of the so-called "locate rule", modified to correspond to the ESR.

France's financial transaction tax (the "FTT")

Legislative provisions are now contained in the First Amending Finance Bill for 2012. The FTT (at 0.1 per. cent), is payable on the first day of the month following that during which the acquisition took place and the text sets out who is responsible, in various circumstances, for payment of the tax. In general, acquisitions completed as of 1 August 2012 fall within the scope of the tax; there are several exemptions, such as acquisitions made in relation to the issue of shares or acquisitions of bonds convertible or exchangeable into shares.

Germany – Extended disclosure rules on net short positions

On 26 March 2012, new German rules on disclosure obligations for net short positions came into effect. Section 30i of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) and the Regulation on Net Short Positions (Netto-Leeverkaufspositionsverordnung – NLPosV), *inter alia*, have extended the notification and disclosure requirements for net short positions in securities issuers to all issuers admitted to trading on the regulated market of a German stock exchange. The new rules will apply until the EU Short Selling Regulation comes into effect on 1 November 2012.

Dublin: Irish China A Funds

It may be recalled that since December 2002, foreign institutional investors have been permitted to invest in China A Shares listed on the Shanghai Stock Exchange and the Shenzhen Stock Exchange through the Qualified Foreign Institutional Investor ("QFII") programme. The QFII programme allows licensed foreign investors to invest in China A Shares in the local currency provided that certain minimum criteria are met. The return on the investment, including dividends and capital gains, can be legally exchanged into foreign currency and repatriated.

The number of QFII licences granted by the China Securities Regulation Commission ("the CSRC") and the level of foreign investment in Chinese securities as a result has increased dramatically over the last two years. (At the end of 2011, more than US$20 billion was invested through this facility, by 112 licensed foreign entities. These QFII licences are generally held by fund managers and institutional investors.)

The Cayman Islands – Master Fund Registration

Further to announcements made in June 2011, the Cayman Islands Government is preparing legislation to require certain master funds to be registered. It is expected that new requirements will apply to all mutual funds that are incorporated or established in the Cayman Islands which hold investments and conduct trading activities and have one or more regulated feeder funds. Whilst not expected to be onerous, the registration requirements are likely to include the annual filing of a new form and payment of an annual fee of approximately US$3,000 (which is double the amount proposed when the provisions were originally announced).

Hong Kong OTC Derivatives Reforms

It may be recalled that in October 2011, the Hong Kong Monetary Authority (the "HKMA") and Securities and Futures Commission (the "SFC") published a joint consultation on the proposed regulatory regime for Hong Kong's over-the-counter ("OTC") derivatives market. The consultation by the HKMA and the SFC sought comments on proposals that would implement G20 commitments by Hong Kong concerning the trading, central-clearing and reporting of OTC derivatives. The proposals are similar to those put forward by the European Commission in the European Markets Infrastructure Regulation (EMIR) and by the US authorities in Title VII of the Dodd-Frank Act.

Singapore – Proposed regulation of OTC derivatives

The Monetary Authority of Singapore (the "MAS") has published a consultation on the Proposed Regulation of OTC Derivatives. The MAS is proposing a new regime for the mandatory clearing of certain suitable OTC derivatives, booked in Singapore, with domestically regulated or recognised foreign central counterparties ("CCPs") and the reporting of data on all OTC derivatives traded or booked in Singapore with domestically regulated or recognised foreign trade repositories.

In line with the increase in QFII licences granted, there is also now significant interest in the establishment of new Irish funds targeting China A Shares. This is also symptomatic of the increased attraction of the Chinese market from international investors and the opportunities this is opening up. (China's equities market has grown from US$400 billion in 2005 to US$4.2 trillion in the first quarter of 2011, albeit with a subsequent dip more recently.)

While it is noted that fund structures in other domiciles (in particular the Cayman Islands) can also facilitate the China A Shares market, various Irish regulated fund structures may also be suitable in this context.

STOP PRESS: Hector Sants to leave the FSA in June 2012

On 16 March 2012, the FSA announced that Hector Sants, its chief executive ("CEO"), will leave the FSA on 29 June 2012. In February 2010, Mr Sants announced his resignation from the FSA, but then changed this mind and agreed to stay on as CEO in order to assist with the transition to the new regulatory structure, with most of the FSA's current functions transferring to two new organisations: the Financial Conduct Authority (the "FCA") and the Prudential Regulation Authority (the "PRA"). Andrew Bailey (currently executive director and deputy CEO designate of the PRA) will take over Mr. Sants' role as head of the Prudential Business Unit, the part of the FSA mirroring the future PRA.

The FSA intends to announce in due course further details of management structure changes following Mr. Sants' departure.

Sir Mervyn King, Governor of the Bank of England ("BoE"), has commented that the BoE will work closely with HM Treasury in searching for the first chief executive of the PRA, who will also be the deputy governor responsible for prudential regulation. That appointment will be made by the Chancellor of the Exchequer and the person appointed will take up the position when the PRA comes into existence, expected to be in early 2012. Meanwhile Sir Mervyn has come to be regarded in the City as "a man of letters." (For the past several years he had been required to write successive periodic letters to the Chancellor of the Exchequer attempting to explain why the Bank of England's monetary policy has consistently overshot the Government's inflation target). Before there are too many cheers for the BoE resuming its role as overseer of the prudential financial services regulator in the UK it is worth reflecting on the reasons why the first Blair Government removed the BoE from its then role as the UK's banking regulator. Plus ça change.

■ ■ ■

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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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