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A legal update from Dechert's Financial Services Group

Financial Services Europe and International Update

Regulatory Developments

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

EU Regulatory Developments

European Parliament Votes on EMIR, Short Selling and Investor Compensation Proposals

On 5 July 2011, the European Parliament published details of the votes it has taken on financial services proposals in its plenary session. The votes related to the following proposed measures:

- **The European Market Infrastructure Regulation ("EMIR"):** the Parliament voted to adopt the report on EMIR (dated 7 June 2011) prepared by the rapporteur;

- **The Regulation on short selling and certain aspects of credit default swaps ("CDSs"):** the Parliament voted to adopt the report on this regulation (dated 19 April 2011) prepared by the rapporteur. (MEPs inserted a requirement that short sale transactions be reported less often and beefed up the rules to ensure that fines are dissuasive); and

- **Amendments to the Investor Compensation Schemes Directive *(97/9/EC)* (the "ICD")**: the Parliament voted to adopt the report on this legislative proposal (dated 19 April 2011) prepared by the rapporteur. The Parliament also voted to add "bad advice" as a case for claiming compensation and to enable local authorities and non-governmental organisations to file compensation claims. It states that very significant differences are expected between the Parliament's position and that of Member States on the proposed directive.

The Parliament closed its first reading procedure on the ICD amendments, but postponed final votes on legislative resolutions on EMIR and the short selling regulation to allow more time for negotiations with the European Council.

ESMA Consults on AIFM Directive Implementing Measures

On 13 July 2011, the European Securities and Markets Authority ("ESMA") published a consultation paper on possible implementing measures for the Alternative Investment Fund Managers Directive (*2011/61/EU*) (the "AIFM Directive"). The consultation was in response to the European Commission's December 2010 request for assistance on the content of implementing measures.

The consultation contained ESMA's formal proposals for advice and explanatory text on:

- general provisions for managers, authorisation and operating conditions;

- governance of depositaries;

- transparency requirements and leverage.

- The deadline for responding to this ESMA consultation is

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13 September 2011. In the light of feedback received from stakeholders, ESMA will then finalise its proposals and aim to submit its advice to the Commission by 16 November 2011.

European Commission Public Consultation on Social Investment Funds

A third regulatory regime for funds is now proposed by the Commission when, on 13 July 2011, the Commission published a Consultation on social investment funds. The Commission seeks options for aiding social businesses by means of investment from private individuals channelled through investment funds. In this context, the Commission considers setting up a separate regulatory framework for social investment funds, alongside the UCITS Directive and AIFMD.

Amongst other things, this consultation considers:

- **the role of investment funds:** in this context, the consultation refers to the UCITS IV Directive (*2009/65/EC*), noting that "existing UCITS-like funds already target social businesses in one form or another" and that some funds are designed to specifically promote social businesses. The fact that UCITS IV in principle permits up to 10 per cent investment in non-listed shares suggests, in the Commission's view, that the current framework "is capable of acting as a conduit for finding to social businesses". However, the UCITS IV requirements on diversification, rules on liquidity and rules on eligible assets may limit its effectiveness to promote targeted investments in social businesses. The consultation raises the question of whether a new bespoke social investment fund framework might be more effective at channelling funds to social businesses, and if so, what measures it should contain.

- **the role of investors:** to ensure the effectiveness of a framework for investment funds aimed at social businesses, the Commission considers it essential to determine what investors would want from such funds. Targeting professional investors to promote investment in social businesses is one option, with the Alternative Investment Fund Managers Directive (*2001/61/EU*) ("AIFMD") identified as a framework establishing an EU-wide passport for marketing investment vehicles exclusively targeted at such investors. The Commission's current consultation on potential new European rules for venture capital funds is also mentioned in this context. However, the Commission notes that there appears to be strong retail interest in social businesses. It acknowledges that providing retail access to social investment funds would entail additional safeguards (such as the provision of clear, effective and balanced information) and would raise costs; and

- **the possible shape of a social business fund framework:** the Commission has used the core features of UCITS IV as the basis for this, and asks for feedback on issues including liquidity, risk diversification, types of assets and strategies, asset valuation, investor participation, risk management, the depositary function and remuneration and cost structures.

Responses should be sent to the Commission until 14 September 2011.

European Commission Initiatives for 2011: Update on Expected Adoption Dates of Financial Services Measures

On 20 July 2011, the Commission published an update of its agenda and timetable for legislative proposals and non-legislative acts that it expects to adopt between 1 July and 31 December 2011.

The document includes details of initiatives that were not included in the June 2011 version of the document, including legislative proposals on:

- a European regime for venture capital: this is expected to be adopted in November 2011. (The Commission published a consultation on new EU regime for venture capital funds in July 2011); and

- social investment funds: this is expected to be adopted in Q4 of 2011.

No mention is made in the updated document of a legislative instrument creating a framework for standardising pre-contractual information on packaged retail investment products ("PRIPs"). (The June 2011 version of the document indicated that this was expected to be adopted in Q4 of 2011.)

ESMA Consults on Guidelines on Systems and Controls for Highly Automated Trading

On 20 July 2011, the European Securities and Markets Authority ("ESMA") published a consultation setting out its proposals for detailed guidelines for trading platforms, investment firms and competent authorities to address the challenges of a highly-automated trading environment. High frequency trading ("HFT") is an important part of this environment.

HFT involves the use of computer algorithms to trade securities in a fraction of a second, and is used by some participants to profit from tiny price discrepancies across different trading platforms. It has come to play a critical role in US and European markets and now accounts for 77 percent of turnover on some UK markets. However, the practice has come under intense scrutiny by regulators who want to know whether high-frequency trading provides liquidity to markets and whether it increases or reduces volatility in markets.

The proposed guidelines seek to clarify the obligations of trading platforms and investment firms under the existing EU legislative framework. ESMA considers that they contribute to the efficiency, orderly functioning and resilience of trading in a highly-automated environment.

The proposed guidelines set out separate standards in relation to the organisational requirements applicable to trading platforms on the one hand, and investment firms on the other. They cover four broad areas:

- electronic trading systems;
- fair and orderly trading;
- preventing market abuse and, in particular, market manipulation; and
- direct market access and sponsored access.

The proposed guidelines are part of extensive work carried out by ESMA in the area of micro-structural issues and highly-automated trading.

The guidelines sit under the existing legal framework provided by the Markets in Financial Instruments Directive (*2004/39/EC*) ("MiFID") and the Market Abuse Directive (*2003/6/EC*) ("MAD"). Although these two directives are currently under review, ESMA considers that given the importance of the issues raised by automated trading, it is appropriate to introduce harmonised guidelines during 2011. Once MiFID and MAD have been revised and the European Market Infrastructure Regulation ("EMIR") is finalised, ESMA will revisit the guidelines to see whether they need to be adapted in the light of the new legislative framework or transformed into technical standards.

Comments on the proposed guidelines are invited until 3 October 2011. (ESMA expects to publish the final guidelines at the end of 2011.)

ESMA Discussion Paper on UCITS Exchange-Traded Funds and Structured UCITS

On 22 July 2011, the European Securities and Markets Authority ("ESMA") published a discussion paper on guidelines for UCITS exchange-traded funds ("ETFs") and structured UCITS.

ESMA has reviewed the current regulatory regime applicable to UCITS ETFs and structured UCITS and considers that existing requirements are not sufficient to take account of the specific features and risks associated with these types of fund. It examines possible measures that could be introduced to mitigate the risk that complex products are made available to retail investors. The discussion paper also highlights the potential systemic risk caused by these funds and their impact on financial stability.

The period for comments closes on 22 September 2011.

European Commission Publishes CRD IV Legislative Proposals

On 20 July 2011, the European Commission published legislative proposals for a regulation and a directive, which are intended to implement the Basel III reforms and replace the existing Capital Requirements Directive (*2006/48/EC* and *2006/49/EC*) (the "CRD"). This package of reforms is known as "CRD IV".

The proposed regulation contains detailed prudential requirements for credit institutions and investment firms. As well as implementing the majority of the key Basel III reforms, it also sets out the Commission's proposals for a single rule book (i.e., a single set of harmonised prudential rules).

The proposed directive reflects many of the existing CRD provisions, such as passporting and principles for prudential supervision. It also includes proposals relating to the Basel III capital buffers as well as non-Basel III proposals, relating to the following issues:

- corporate governance;
- sanctions;
- supervision; and
- reliance on external ratings.

Comment

CRD IV will apply Basel III to EU credit institutions, but will also apply parts of that framework to a large number of MiFID investment firms, for whom Basel III was **not** designed, CRD IV is not simply about implementing Basel III. It pursues a number of EU specific policy objectives, such as harmonising the minimum enforcement powers of national supervisors across the EU, enhanced corporate governance standards and provisions designed to reduce a perceived over-reliance on credit ratings agencies when calculating capital requirements. One of the most significant changes is the legal form of the proposal. Under CRD IV, the qualitative requirements are set out in a directive. Despite the protestations of a number of EU member states (including the UK), most of the detailed quantitative requirements of CRD IV are contained in a regulation. That will significantly limit the flexibility of national supervisors when applying these requirements.

<u>Note</u>: The Investment Management Association has subsequently published some helpful guidance on the likely impact of the new CRD on investment managers.

Based upon the draft text of CRD IV as published on 20 July 2011 the IMA considers the following to be the main issues for UK investment managers currently subject to the CRD:

- minimum capital requirements will increase, and equate to approximately one third of fixed annual expenditure. In addition, the format of capital will require greater volumes of equity to be held. However, in practice many firms are likely to exceed these requirements at present;
- a countercyclical buffer and liquidity ratios will be applied, but could be as low as zero per cent;
- goodwill must be deducted at solo level, but the investment firm consolidation waiver will remain available to groups of investment firms;
- no changes are proposed to the remuneration requirements;
- new limits will be introduced on the number of non-executive directorships which may be held by an individual; and
- guidance will be issued on the skills and diversity requirements for boards.

The IMA also points out that one of the objectives of the Commission with the CRD IV proposal is to generate a single rule book, and to the extent relevant, remove national options and discretions. With this in mind, the Regulation will create uniform provisions which all Member States will have to implement, thereby developing the required level playing field. This would not in theory provide the FSA with any flexibility in implementation. However, Member States will be able to adopt the requirements within the Directive to reflect their individual markets.

It is also important to note that not only are both the Directive and Regulation in **draft** format, and must undergo the formal approval process with reviews by both the European Parliament and Council, but they are also both provisional versions which may yet be changed by the Commission. Amendments to these texts can therefore be expected as individual Member States discuss and negotiate the final text.

The proposals amount to almost 700 pages of text, although much of the Directive relates to general provisions applicable to banking activities and their supervision, whereas the Regulation contains the more detailed requirements (many of which relate to internal models and will not be relevant to investment managers). In more detail, the key elements are:

- the capital requirements for an investment manager continue to be calculated by reference to fixed overheads (therefore the concept of a limited licence firm within the FSA Handbook should be retained);
- all firms must hold:
  - a Common Equity Tier 1 ratio of 4.5 per cent, of total risk exposure;
  - a Tier 1 ratio of 6 per cent; and
  - a total capital ratio of 8 per cent;

  Common Equity Tier 1 capital is defined as equity, share premium accounts, retained earnings, accumulated and other comprehensive income and other reserves;
- for an investment manager, the 'total risk exposure' is calculated as the higher of: (a) the sum of credit and markets risks; or (b) 12.5 multiplied by one quarter of fixed annual expenditure. The inclusion of a 12.5 factor multiplied by the 8 per cent total capital ratio results in the same capital requirements as now. The higher Common Equity Tier ratio of

4.5 per cent will however result in more capital being held in the form of equity.

- all firms must maintain a Capital Conservation Buffer of an additional 2.5 per cent of their total risk exposure. This must be held in the form of Common Equity Tier 1;

- in addition, all firms must maintain a Countercyclical Capital Buffer. The amount will be between zero and 2.5 percent of the firm's total risk exposure, held in the form of Common Equity Tier 1. The FSA will be responsible for determining the amount by reference to macroeconomic factors which indicate the position within the credit cycle. Despite this buffer being intended to protect the banking sector and real economy from aggregate credit growth, it is being applied to all firms in order to achieve a level playing field;

- firms which are unable to meet their combined buffer requirements would need to submit a resolution plan to the FSA within five business days;

- the combined effect of the capital requirements and the buffers will see investment managers having to hold a minimum of 10 percent of 'total risk exposure'. In practice, this will equate to approximately one third of fixed annual expenditure (the existing one quarter, plus 2.5 per cent of 12.5 multiplied by one quarter of fixed annual expenditure);

- there are no proposed changes to the initial capital requirements (thereby held at €125k for investment managers who hold client money and €50k for those investment managers who do not hold client money);

- the investment firm consolidation waiver will remain, and the conditions under which it may be grated have not changed;

- however, all goodwill must be deducted at a solo level (the ability for firms to choose whether to deduct material holdings or illiquid assets has been removed);

- the large exposure requirements do not apply;

- the new Liquidity Coverage Ratio ("LCR") will apply to all firms. Under this ratio, a firm must hold liquid assets (essentially cash, government debt and high quality covered and corporate bonds) which in total exceed the liabilities which would fall due during a 30-day stressed period. However, liabilities resulting from the firm's own operating expenses would receive a zero percent requirement (which should not therefore result in an investment manger having a material LCR);

- the management of liquid assets would need to be performed by a liquidity management function, with reporting of the LCR provided on a monthly basis;

- in addition to the LCR, all firms would have to report quarterly their Net Stable Funding Ratio ("NSFR"). Like the LCR, the NFSR is derived from the Basel III text, and would require all firms to report their funding profile and their asset composition. At present, there is no ratio which firms would need to comply with (the Basel Committee has been tasked with recalibration of this ratio before full implementation);

- all firms would have to report their leverage ratio by reference to their total Tier 1 capital and total exposures. Again, there is no maximum, but such will be developed in future by the European Banking Authority (the "EBA");

- all firms must establish a Risk Committee, but there is ability for the FSA to waive this requirement;

- with no exceptions, all firms must have a risk management function, independent of the operational and management functions;

- a new section on governance is introduced. This includes the requirement for all firms to have a nomination committee with responsibility for determining the size, structure and composition of the management body. The FSA will be able to waive this requirement on the grounds of proportionality;

- members of the management body cannot combine one executive directorship with two non-executive directorships, or hold four non-executive directorships. However, the FSA can permit these requirements to be exceeded provided it would not prevent the individual committing sufficient time and resource to the regulated entity. In addition, the EBA will issue guidance on the collective knowledge which a board should possess;

- all firms must take diversity into account as part of the selection of members of the management body. The EBA has been tasked with developing technical standards in this area;

- no material changes are proposed to the remuneration obligations;

- most Pillar 3 obligations remain the same, including the exemptions, but firms will need to disclose details of their governance arrangements, and information relating to their leverage and capital buffers; and

- as part of any supervisory process, the FSA will be provided with the ability to maintain a permanent presence at a firm and to increase the reporting content or frequency.

(The FSA will be required to implement both the Directive and Regulation with effect from 1 January 2013. The requirements relating to the amount of capital, the buffers and the liquidity obligations will be phased in, however).

EMIR: The Polish Presidency's Further Compromise Proposal

Derivatives were brought to the forefront of regulatory concerns as the financial crisis developed, from the near-collapse of Bear Stearns to the default of Lehman's and the bail-out of AIG. In October 2009, the Commission published a Communication outlining the range of legislative measures that it has now published as a draft regulation. On 15 September 2010 the Commission issued its formal Proposal for a Regulation on OTC Derivatives, central counterparties and trade repositories ("EMIR").

The Polish Presidency has now issued a further compromise proposal in relation to EMIR which includes the following amendments:

- a number of changes have been introduced into the "Definitions" under Article 2 including the possibility of the references to 'frontloading' and 'class of derivatives' being limited to OTC;

- 'Pension schemes arrangements' has now been given a 4 part definition; and

- Article 2a relating to intra group transactions has been amended to cover counterparties that are included in the same consolidation on a full basis and they are subject to an appropriate centralisation risk evaluation.

If the European Parliament's vote takes place in September this should enable a general approach to be agreed at the next full ECOFIN meeting scheduled for October 2011. If this is followed closely by agreement within the trialogue it is possible that ESMA will be able to begin its consultation process fairly soon thereafter.

TARGET 2 Securities: Bank of England Decision

TARGET 2 securities ("T2S") is a major initiative of the European Central Bank/Eurosystem to stimulate the integration of the securities post-trading infrastructure in the EU. T2S will provide a single harmonised venue where almost all heavily traded securities circulating in the EU can be settled against euro (and potentially other European currencies) with standardised communication protocols and harmonised market practices. It is due to come into being in 2012.

It has recently been reported that the Bank of England has taken the decision to opt out of this initiative. (It had previously raised concerns about both the cost and corporate governance of T2S.)

A Framework Agreement between the ECB and those central securities depositories ("CSDs") that wish to be involved is due to be finalised by the end of October 2011. CSDs will then have until the end of 2011 to decide if they wish to sign the Framework Agreement.

Stress Tests in the Banking Sector: EBA Results of 2011 Tests

Readers will recall that the European authorities undertook a first round of stress-tests on European financial institutions in the summer of 2011 to assess the resilience of the EU banking system to hypothetical stress events under certain restrictive conditions. The results of these initial tests were widely criticised as lacking credibility. (Indeed Irish banks which passed these tests became insolvent shortly afterwards.)

The European Banking Authority (the "EBA") launched a new round of stress tests in March 2011 with the aim of restoring credibility to the process and confidence in the EU banking sector.

The EBA has recently published the results of its 2011 EU-wide stress testing exercise, which show that at the end of 2010, twenty banks would fall below the 5 per cent Core Tier 1 Ratio ("CT1R") threshold over the two-year horizon of the exercise, the overall shortfall would total €26.8 billion. However, the EBA noted that, between January and April 2011, a further net amount of €50 billion of capital was raised, and that, taking into account of these capital raising actions, eight banks fall below the capital threshold of 5 per cent CT1R over the two-year time horizon, with an overall CT1 shortfall of €2.5 billion, and sixteen banks display a CT1R of between 5 and 6 per cent.

The EBA now intends to monitor the implementation of these recommendations and produce progress reports in February and July 2012.

European Commission Initiatives for 2011: Update on Adoption of Financial Services Measures

The European Commission has published an update setting out its agenda and timetable for legislative proposals and non-legislative acts that it expects to adopt between 1 June and 31 December 2011.

Changes have been made to the expected adoption dates of a number of legislative and non-legislative initiatives which will have an impact on the financial services sector since the Commission published the previous version of the document, on 17 May 2011. These include:

- CRD 4 (i.e. amendments to the Capital Requirements Directive (*2006/48/EC* and *2006/49/EC*) (the "CRD")) is now expected to be adopted on 20 July 2011;
- recasting of the Market Abuse Directive (*2003/6/EC*) ("MAD") is now expected to be adopted in October 2011;
- revisions to the Markets in Financial Instruments Directive (*2004/39/EC*) ("MiFID") are now expected to be adopted in October 2011;
- the regulation amending the CRA Regulation (*1060/2009/EC*) is now expected to be adopted in Q4 of 2011;
- the regulation on central securities depositaries is now expected to be adopted in October 2011;
- the recommendation of the European Parliament and Council of the EU on access to a basic bank account is now expected to have been adopted by 13 July 2011;
- the legislative instrument creating a framework for standardising pre-contractual information on packaged retail investment products ("PRIPs") is now expected to be adopted in Q4 of 2011;
- the communication on financial sector taxation is now expected to be adopted in Q3 of 2011; and
- a new legal framework for data protection is now expected to be adopted on 9 November 2011.

UK Regulatory Developments

Authorised Investment Funds: Equalisation

The Investment Management Association (the "IMA") has received a number of queries from its members regarding the allocation of equalisation to group II units as part of a distribution. HMRC have now confirmed to the IMA that the longstanding market practice, which is to allocate the total amount of equalisation equally to all group II units, remains acceptable.

It had been suggested that the HMRC guidance on equalisation (CTM 48425) did not mention the possibility of using an averaging approach, and therefore such an approach should not be used. However, HMRC have recently confirmed that this guidance should not be read as suggesting any particular basis on which equalisation must be allocated – it simply explains the concept of equalisation. In other words, it is not a requirement to operate equalisation on an investor-specific basis.

<u>Comments</u>: It has long been the market norm for average equalisation (i.e. total purchase income/total number of units purchased in the distribution period) rather than investor specific equalisation to be operated. Calculating equalisation for each new investor is generally accepted as being too complex in practice and therefore too costly, in particular for widely-held retail funds. HMRC are interested in equalisation to ensure that the total amount of equalisation returned as capital is not overstated, but they are less interested in how that equalisation is split between the group II investors. Indeed, the Offshore Funds (Tax) Regulations specifically allow reporting funds to choose to operate equalisation on either an averaging or an investor-specific basis.

Details on the approach to calculating, paying and accounting for equalisation should be included in a fund's prospectus (in accordance with COLL 4.2.5R 4(b)(iii)) and it is this disclosure that establishes the Manager's obligation in respect of the allocation of equalisation.

The FCA's Approach to Regulation

On 27 June 2011, the FSA published a paper on the regulatory approach of the new Financial Conduct Authority (the "FCA").

The aim of the paper is to set out the FSA's initial thinking on how the FCA will approach the delivery of its statutory objectives. The paper is also intended to provide input for the pre-legislative scrutiny and Parliamentary debate on the Financial Services Bill, the primary legislation for the structural reforms to UK financial services regulation. (A draft version of the Bill was published on 16 June 2011 in the Government's white paper on the reforms.)

The paper includes details on:

- the FCA's scope and the number of firms it is expected to regulate either solely or jointly with the Prudential Regulation Authority (the "PRA");
- the FCA's objectives and powers, including its approach to its new competition role;
- the FCA's regulatory approach, including details of its attitude to proactive intervention and how it will build on existing FSA initiatives, such as credible deterrence;
- the FCA's regulatory activities, setting out the main elements of the FCA's possible risk framework and supervisory framework and considering how the FCA will supervise markets, particularly in its role as the UK Listing Authority, and its approach to wholesale conduct; and
- how the FCA will co-ordinate with other regulatory authorities, particularly the PRA.

The FSA intends to publish further proposals on the FCA's operating model which will include further detail on its risk framework and its approach to transparency.

UCITS IV Implementation in the UK

In order to implement the UCITS IV Directive in the United Kingdom, Parliament needed to amend the Financial Services and Markets Act 2000, the Open Ended-Investment Companies Regulations 2010, and related secondary legislation on financial services to implement in part Directive 2009/65/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ("UCITS IV").

UCITS IV is the fourth directive made by the European Parliament and the Council on the regulation of UCITS. It consolidates, and repeals, the earlier directives. It also makes new provision in the following areas:

- for the removal of administrative barriers to the cross-border marketing of UCITS, enabling units of a UCITS established in one Member State to be sold in another Member State as soon as the regulator of the fund has given notice to the regulator in the EU Member State where the units are to be sold;
- the introduction of "passport" rights enabling a management company to operate a fund in Member States without being established there;
- for improved investor disclosure;
- for a framework for mergers between UCITS funds;
- for "master-feeder" structures allowing a feeder UCITS to invest 85 percent of its assets into another UCITS (the master UCITS); and
- for improved supervisory co-operation (particularly where a UCITS and its management company are established in different EU Member States).

The first three UCITS Directives were implemented in the UK primarily through provisions in the Financial Services and Markets Act 2000 (and in particular Part 17 of that Act) and the Open-Ended Investment Companies Regulations 2001. The UK Parliament has now amended that legislation, and other secondary legislation made under the Financial Services and Markets Act 2000 and made other consequential amendments, and implemented provisions of UCITS IV in relation to mergers. The Directive has also been implemented by changes incorporated into the rules of the Financial Services Authority (the "FSA").

On 29 June 2011, also the FSA updated its collective investment schemes authorisation team webpage to announce that, with effect from 1 July 2011, new CIS sourcebook application and notification forms reflecting the provisions of the UCITS IV Directive (2009/65/EC) would be available on its website (having, on 20 June, published a draft of the UCITS IV Directive Instrument 2011 which set out near final rules and guidance for the FSA Handbook to implement those provisions of UCITS IV for which the FSA is responsible). The FSA was subsequently granted the necessary statutory powers under the UCITS Regulations 2011, laid before Parliament on 13 June 2011 and which have now been approved and came into force with effect from 1 July 2011. The FSA has also made the final version of its rules and guidance.

The FSA will also be publishing a policy statement summarising feedback to its UCITS IV implementation consultation proposals and explaining any changes made.

On 4 July 2011, the UCITS Regulations (SI 2011/1613) were published by HM Treasury, accompanied by an explanatory memorandum and final impact assessment in the UK. HM Treasury made no substantive policy choices in drawing up the UCITS Regulations as UCITS IV allows Member States little flexibility in how it should be implemented.

The explanatory memorandum published with the UCITS Regulations also contained a transposition table. This sets out how each provision of UCITS IV has been implemented in the UK and which authority (FSA or HM Treasury) is responsible.

The final impact assessment which is also available contains details about the benefits and costs of implementing UCITS IV in the UK.

The UCITS IV Directive Instrument made by the FSA's Board on 1 July 2011 came into force on that date and contains FSA Handbook rules and guidance to implement parts of UCITS IV. The Instrument amends the FSA Handbook. Major amendments include the Glossary and the SYSC, COBS, SUP and COLL sourcebooks. However, amendments have also been made to the GEN, GENPRU, UPRU, DEPP, DISP, COMP, RCB and DTR sourcebooks. This instrument has now been consolidated into the full version of the FSA Handbook.

The FSA indicated that there were only a small number of changes to the final instrument, compared to the near final draft which it published earlier this year.

Although the new UCITS Regulations came into force on 1 July 2011, there are certain transitional provisions, which can be broadly grouped into two categories.

In respect of the requirement to use key investor information documents ("KIID"), existing firms may continue to use simplified prospectuses, rather than KIIDs, until 30 June 2012. These provisions do not, however, apply to UCITS funds incorporated on or after 1 July 2011, which are subject to all requirements relating to KIIDs.

In respect of UCITS mergers, the FSA rules require prescribed information to be provided to unitholders in durable medium. However, until 31 January 2013, this requirement is relaxed in certain circumstances, so that it may be provided by making the information public in an appropriate manner.

Finally, in a joint consultation paper in December 2010, HM Treasury and the FSA confirmed that the Government believes that its tax policy in respect of the UK funds industry and its investors should be aligned with modern business practice and that commercial decisions should not result in adverse tax consequences. It intends, therefore, to ensure that UK businesses can take full advantage of opportunities created by UCITS IV. In particular, the Government will consult on how to ensure that there will be no adverse UK tax consequences for a foreign UCITS fund as a result of having a UK management company.

In addition, it will be recalled that the Government intends to launch a UK tax transparent vehicle some time in 2012 which it intends should be suitable for UCITS IV master funds.

FSA Passporting Forms

The FSA has published the following new and updated Handbook forms:

Passporting: Notification of intention to establish a branch in another EEA state: the form is for UK firms to use when exercising a passport right to establish a branch in an EEA state. Notification is given under the Supervision manual (SUP 13.5.1R).

Passporting: Notification of intention to provide cross-border services in another EEA state: the form is for UK firms to use when exercising a passport right to provide cross-border services in another EEA state under UCITS IV. Notification is given under SUP 13.5.2R.

The forms took effect from 1 July 2011.

(New and updated FSA collective investment scheme sourcebook (COLL) forms reflecting other UCITS IV provisions were made available by the FSA in June 2011.)

FSA Issues Modification by Consent to Authorised Fund Managers of NURSs

On 4 July 2011, the FSA announced that it has issued a modification by consent that is available to authorised fund managers ("AFMs") of non-UCITS retail schemes ("NURSs"). The modification relates to certain rules in the Conduct of Business Sourcebook ("COBS") and the Collective Investment Schemes sourcebook ("COLL").

The modification allows AFMs of a NURS to choose to produce an equivalent document to the UCITS IV Directive key investor information document ("KIID") which can then be used by the AFM and all other firms selling or advising on the NURS, instead of the key features document, or the simplified prospectus (if the AFM has opted to produce one). (The document is referred to as "the NURS-KII document.")

The form and content of the NURS-KII document must closely follow that of the KIID of a UCITS scheme, subject only to the necessary modifications as set out in the modification direction. An AFM cannot opt to follow the UCITS key investor information requirements in part: it must either produce a fully-compliant NURS-KII document, or continued with its existing disclosure documents. The FSA has, however, decided not to allow AFMs to include a synthetic risk-reward indicator for NURSs that have a significant exposure to immovables (directly-held land and buildings), as it is not satisfied that the methodology for the indicator would produce an appropriate result for that asset class. Instead, there must be full narrative disclosure of risks that are materially relevant to the fund.

Notwithstanding this, the rules relating to provision of the NURS-KII document are largely the same as those applying to a NURS for which a key features document or simplified prospectus is produced. Those rules will require the NURS-KII document to be provided to retail clients in most circumstances but will allow firms to offer it to professional investors. The existing concessions about the timing of delivery that derive from the Distance Marketing Directive also continue to apply to NURSs. Firms offering KIID for both UCITS schemes and NURSs should be aware of these differences and ensure that their procedures result in timely delivery of each type of document.

The modification is valid until 30 June 2014 unless subsequently withdrawn. (Firms wishing to take advantage of it should contact the FSA Central Waivers Team.)

Consolidated Version of FSMA Reflecting the Draft FS Bill

On 5 July 2011, HM Treasury published a version of the Financial Services and Markets Act 2000 ("FSMA") which shows how it would be amended by the draft Financial Services Bill (the "FS Bill").

HM Treasury emphasises that the consolidated version is for illustration purposes only to aid scrutiny of the draft FS Bill by Parliament and interested parties.

The draft Bill was published on 16 June 2011, with the Government's white paper on its proposals for reform to the UK financial services regulatory structure.

Government Announces Timing for the Financial Services Bill Legislative Process

On 6 July 2011, Lord Sassoon, the Commercial Secretary to HM Treasury stated that:

- pre-legislative scrutiny ("PLS") of the FS Bill by an ad hoc Joint Committee of both Houses of Parliament will commence shortly;
- the Government will introduce the FS Bill shortly after it receives the Joint Committee's report; and
- the FS Bill is expected to receive Royal Assent by the end of 2012, subject to Parliamentary scheduling considerations.

Lord Sassoon also stated that the PLS is currently scheduled to conclude by 1 December 2011. (However, an order on the formation of the Joint Committee, announced in the House of Commons order of business for 7 July 2011, had suggested that the deadline for the Committee to report would be 29 February 2012.)

Joint Committee Calls for Evidence on Financial Services Bill

The joint committee of the House of Lords and Commons for pre-legislative scrutiny of the draft Financial Services Bill has launched a call for evidence as part of its enquiry into the Bill.

The call for evidence contains twenty-two questions about the Bill and reforms to the UK financial services regulatory structure. In addition to the questions, the committee is interested in whether the Bill:

- will or could better:
  - prevent another financial crisis;
  - handle a financial crisis; and
  - deal with bank failure and protect the public purse.
- will increase or decrease the risk of regulatory arbitrage of financial businesses.

Written submissions to the call for evidence should be sent by 2 September 2011. A schedule of oral evidence sessions will be confirmed by the Committee in September 2011.

FSA Consultation on Guidance on Prominence of Financial Promotions

On 8 July 2011, the FSA published a consultation on guidance on the prominence of financial promotions (GC11/15).

Prominence of relevant information plays a key role in ensuring that a communication is clear, fair and not misleading. The FSA is aware from monitoring financial promotions that prominence can be interpreted in many different ways, which often leads to inconsistent standards. It is attempting to clarify some of these inconsistencies in the proposed guidance.

The FSA expects firms to demonstrate a clear understanding of its expectations in this area. It advises that there are many promotional features that must be considered in relation to prominence, including:

- interest rates;
- fees;
- charges;
- relevant risk statements; and
- other key product information.

The list above is not exhaustive. Firms need to ensure that they check all relevant areas of the FSA's conduct of business sourcebooks to ensure that its expectations on prominence are addressed for all different product types and services. Firms need to consider the positioning of text, background, colour and type size to ensure that prescribed information meets it requirements. They also need to consider the target audience, the nature of the product or business, and the likely information needs of the average recipient.

The FSA will look at prominence in the context of the promotion as a whole.

It remind firms that it can take action if any firms fails to show due regard to its rules on prominence.

The FSA sets out examples of good and poor practice it has identified in this area in the proposed guidance, together with examples of financial promotions.

Comments can be made on the proposed guidance until 5 August 2011.

Prospectuses: Prospectus Regulations 2011

On 8 July 2011, the *Prospectus Regulations 2011 (2011/1668)* and an accompanying explanatory memorandum were published. The regulations amend the Financial Services and Markets Act 2000 ("FSMA") to:

- increase from 100 to 150 the number of persons, other than qualified investors, to whom an offer of transferable securities may be made or directed at before it ceases to be exempt from the requirement for a prospectus (*section 86(1)(b), FSMA*); and
- increase from €2.5 million to €5 million the limit for the total consideration of an offer in the EU in respect of which a prospectus is not required (*paragraph 9(1) of Schedule 11A, FSMA*).

The amendments to FSMA implement certain provisions of the directive to amend the Prospectus Directive (*2003/71/EC*). Although the amending directive is not required to be implemented by member states until 1 July 2012, the Government announced on 1 November 2010 that it proposed to implement the two measures referred to above in advance of that date. A consultation on the early implementation proposal and draft regulations was launched in March 2011. The final regulations are in the form set out in the draft regulations.

The regulations were made on 7 July 2011 and laid before Parliament on 8 July 2011. They will come into force on 31 July 2011.

FSA Financial Promotions Industry Update on EIS and VCT Investments

On 13 July 2011, the FSA published its eighth financial promotions industry update on Enterprise Investment Scheme ("EIS") and Venture Capital Trust ("VCT") investments.

In this, the FSA discusses what it expects from firms when they advertise EIS and VCT investments. It focuses particularly on how firms satisfy the clear, fair and not misleading requirement in relation to balance and risk and tax warnings.

The FSA lists a number of questions for firms to ask themselves when considering an EIS/VCT promotion:

- does the promotion make clear what the associated risks are when investing in an EIS/VCT investment?
- do the tax features and benefits of an EIS/VCT investment overshadow the risk warning information?
- are the risk warnings featured prominently enough?
- is the promotion accurately targeting a suitable target audience and is this clear through the placement of the advertisement, language used and any disclaimers, among other things?
- are the key drawbacks of an EIS/VCT investment explained clearly; and
- does the promotion make it clear what the customer commitment is?

Controlled Foreign Companies: HMT Consultation

HMT has opened a consultation on its proposals for reforming the UK's Controlled Foreign Company ("CFC") rules, which will be introduced in the Finance Bill 2012. The deadline for responses is 22 September 2011.

<u>Comment</u>: A UK authorised investment fund has the potential to be caught by the current UK CFC rules if its invests in offshore funds. Given the existence of the reporting funds regime and the FINROF rules, there is no rationale for the inclusion of UK funds in a reformed CFC regime.

Unauthorised Unit Trusts: HMRC Consultation

This recent consultation by HMRC concerns the tax rules for both unauthorised unit trusts and their investors. The aim is to explore ways of simplifying a complex part of the tax code to reduce administrative burdens and at the same time remove avoidance opportunities.

Finance Act 2011: Provisions of Interest to the Financial Services Industry

On 19 July 2011, the Finance Bill 2011 received Royal Assent.

Key provisions of the Act that are likely to be of interest to financial services practitioners include:

- Section 48 and Schedule 13, which introduce changes relating to a corporation tax exemption on the profits of foreign branches of UK companies.
- Sections 49 and 50, which relate to investment trust companies.
- Section 59, which relates to changes to the residence of offshore UCITS schemes.
- Section 73 and Schedule 19, which introduce changes to the bank levy.
- Section 82 and Schedule 21, which introduce changes relating to stamp duty land tax avoidance.
- Section 84, which extends the definition of "exempt investments" for the purposes of a stamp duty reserve tax exemption for collective investment schemes.
- Section 89, which remedies potentially adverse tax consequences for some types of debt securities from amendments made to article 77 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (*SI 2001/544*).

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