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Financial Services Europe and International Update

Regulatory Developments

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

EU Regulatory Developments

EMIR Update

As mentioned in our previous *DechertOnPoint* (February 2012/Issue 3), after nearly four months of dialogue meetings, agreement has finally been reached on the EMIR proposal.

The agreement includes the following elements:

- all OTC derivatives contracts must be cleared through central counterparties, to reduce counterparty credit risk;
- all derivatives contracts (listed and OTC) must be reported to trade repositories, which will publish aggregate positions by class of derivatives, to provide market participants with an overview of the derivatives market;
- ESMA will have responsibility for the registration and supervision of trade repositories as well as a role in relation to disputes between national authorities on CCP authorisation;
- a less onerous regime will apply to pension schemes with regard to the clearing obligations, and will initially apply for three years but can be extended;
- third-country CCPs will be recognised in the EU if the legal regime in the third country provides for an effective equivalent system of recognition;

- the implementation of the Regulation will be evaluated (no longer than three years after its entry into force) to assess the effectiveness of the CCP supervisory framework, including the role of the colleges and of ESMA;

The European Parliament is now expected to consider EMIR formally in its plenary session from 28 to 29 March 2012.

Final European Union Council agreement is also required before the legislation can come into force (twenty days after it has been published in the Official Journal);

ESMA was planning to produce many of the implementing measures for EMIR by the end of June 2012. Concerns were expressed by industry at this very tight deadline, with a three month extension now secured so that the deadline is now 30 September 2012. The financial sector has regularly stressed that the priority should be for robust and efficient regulation, which it believes should take precedence over the need to adhere to a strict deadline, which mirrors concerns expressed by ESMA itself at the tight deadlines for implementation of EMIR.

On 17 February 2012, the European Securities and Markets Authority ("ESMA") published a discussion paper on draft technical standards for the regulation on the OTC derivatives, CCPs and trade repositories provisions of EMIR. The paper seeks views on the regulatory and implementing technical standards ESMA is required to draft under EMIR as agreed at the

trialogue meeting held on 9 February 2012. A joint discussion paper on regulatory technical standards is also expected from the EBA, EIOPA and ESMA in the next few weeks. This will focus on risk mitigation techniques for OTC derivatives that are not cleared by a CCP. A discussion paper on draft regulatory technical standards on capital requirements for CCPs is also expected to be published by the EBA shortly. Responses to ESMA's discussion paper close on 19 March 2012.

On 24 February 2012, the Council of the European Union announced it has adjusted its general approach on the proposed provisions on OTC derivative transactions, CCP and trade repositories, having agreed to this at a meeting of ECOFIN. This is designed to help the Council reach rapid agreement with the European Parliament, and enable EMIR to be adopted at its first reading.

The principal change to the Council's previous general approach (which was agreed in October 2011) relates to the procedures for authorising CCPs. In particular, it concerns the powers of the CCP's home member state and those of the college of supervisors and ESMA. The European Parliament has been arguing for a stronger role for the college and ESMA and the Council has now approved a proposal by the Council Presidency that would introduce two additional safeguards:

- following a negative opinion of the college, with "unanimity minus one", the CCP's home member state can refer the matter to ESMA for binding mediation; and
- when a "sufficient" majority in the college opposes authorisation of a CCP, this majority may then decide to put the issue to ESMA for binding mediation. (The Council's position defines a sufficient majority as two-thirds of college members, with votes in the college limited to two for each member state for colleges of up to and including 12 members, and three for colleges above that size.)

Proposed Regulation on Central Securities Depositories

A Regulation on Central Securities Depositories ("CSDs") (in order to fulfil G20 commitments) is expected to be adopted by the Commission on 7 March 2012. With the adoption of this Regulation the European regulatory framework for securities markets will nearly be complete. Securities transactions consist of the following main steps:

- trading, which is regulated at EU level by MIFID (Directive 2004/39/EC);

- clearing, which will be regulated by EMIR (see the item above); and
- settlement (which has not yet been regulated).

According to the Commission, the proposal will now introduce common standards across the EU for securities settlement and for the CSDs as the institutions responsible for these transactions.

The settlement proposal is expected to:

- increase the safety of settlements, in particular for cross-border transactions, by ensuring that buyers and sellers receive their securities and money on time and without risk;
- increase the efficiency of settlements, in particular for cross-border transactions, by introducing a true internal market for the operations of national CSDs; and
- increase the safety of CSDs by applying high prudential requirements in line with international standards.

The FICOD Review

In February 2012, the European Commission launched its review of the Financial Conglomerates Directive (2002/87/EC) ("FICOD"). The review is also sometime referred to as "FICOD II".

The Commission asks stakeholders to respond by 19 April 2012 to three sets of issues and questions:

- **FICOD I:** the Commission is required to consider certain issues as part of its fundamental review of FICOD relating to supplementary supervision and the possibility of mandatory stress tests for financial conglomerates.
- **Joint Forum consultation:** in December 2011, the Joint Forum published a consultative report setting out draft principles for the supervision of financial conglomerates and the Commission is requesting stakeholders to provide a European perspective on the Joint Forum's proposals.
- **Additional issues:** the Commission is also seeking comments on further issues including:
 - whether legal certainty and clarity in FICOD could be improved;

- ❑ how the definition of which entities in the groups are subject to supplementary supervision could be improved; and
- ❑ whether the FICOD supervision framework could benefit from “legal tandem” with EU company law developments relating to governance.

(The Commission intends to publish its FICOD II review report after the summer of 2012, with any legislation following in 2013.)

IOSCO Consultation on Updated CIS Valuation Principles

On 16 February 2012, the International Organisation of Securities Commissions (“IOSCO”) published a further consultation on draft principles for the valuation of collective investment schemes (“CIS”) (CR01/12).

The paper sets out 13 draft principles to be used by the industry and regulators to assess the quality of regulation and industry practices regarding the valuation of CISs, the key objective of which is to ensure that investors are treated fairly. They update IOSCO’s principles for CIS valuation (first published in 1999) and clarify some of the concepts put forward by IOSCO in its report on principles for the valuation of hedge fund portfolios (such as the establishment of a policy governing valuation and the independence of the duty of valuation).

The draft principles apply to the development and implementation of comprehensive policies and procedures for valuing CISs. As well as seeking comments on the principles, IOSCO now seeks to establish whether they adequately address the regulatory issues raised by the valuation of CISs, and whether potential conflicts of interest are appropriately addressed. IOSCO also seeks comments on whether the principle of net asset value at which the purchase and redemption of CIS interests should be effected adequately covers the issues.

The consultation closes on 18 May 2012.

ESMA Consultation on Draft Technical Advice on Possible Delegated Acts on Short Selling

On 15 February 2012, ESMA published a consultation paper on its draft technical advice to the European Commission on possible delegated acts regarding the EU regulation on short selling and certain aspects of credit default swaps. ESMA’s

draft technical advice includes advice on the following:

- the definition of when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale;
- the net position in shares or sovereign debt, covering the concept of holding a position, when a person has a net short position and the method of calculation of such a position, including cases when different entities in a group have long or short positions or for fund management activities related to separate funds;
- what constitutes a significant fall in value for various financial instruments: the consultation paper also contains consultation on a regulatory technical standard on the method of calculation of the fall in value of a financial instrument; and
- the criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments arise that might be a serious threat to financial stability, market confidence, orderly functioning and integrity of markets in the EU.

The deadline for responses to the consultation is 9 March 2012. ESMA will then consider the feedback it receives to the consultation and at an open hearing held on 29 February in March 2012. It expects to publish a final report and to submit its draft advice on delegated acts to the Commission by mid-April 2012.

Revised Hedge Fund Standards Board Standards

On 17 February 2012, the Hedge Fund Standards Board (the “HFSB”) published a revised version of its standards, advising that the revisions are intended to make the standards more international (i.e. to make them more suitable for managers outside the EU market that may have a different governance structure). The key change in this area has involved strengthening fund governance so that investors have a vote on significant issues if there is no independent governing body to protect their interest. The standards have also been strengthened in a number of areas in the light of the financial crisis, including investor disclosures, risk management, valuation and safeguards to prevent market abuse.

Existing HFSB signatories will need to review their approach to compliance with the standards, and potentially adapt their disclosure statements to accommodate the revisions, where appropriate. To give signatories time to carry out this exercise, the revised standards will not come into force until 1 September 2012.

IOSCO Consultation on Suitability Requirements for Distribution of Complex Financial Products

On 21 February 2012, IOSCO published a consultation on suitability requirements in relation to the distribution of complex financial products.

The consultation focuses on protection for consumers and proposes nine principles, including suitability and disclosure obligations, relating to the distribution by intermediaries of complex financial products to retail and non-retail customers.

For the purposes of the consultation, the term “complex financial products” means financial products whose terms and features are unlikely to be understood by an average retail customer, where those products have a complex structure, are difficult to value and have a very limited or no secondary market. (Examples put forward in the consultation include structured instruments, asset backed securities, credit linked notes, collateralised debt securities and credit default swaps, although a definitive or complete list of complex financial products is not provided.)

The consultation makes clear that the term “distribution” is intended to be interpreted broadly, to capture not only selling by intermediaries, but also activities connected with selling, such as advising, recommending and managing discretionary accounts or individual portfolios, which result in holdings by investors of complex financial products.

The nine proposed principles also cover (in broad terms) customer classification, disclosure and suitability requirements, protection of customers for non-advisory services, compliance function and internal suitability policies and procedures, incentives and enforcement.

This consultation closes to comments on 21 May 2012.

The Proposed Short Selling Regulation

Also on 21 February 2012, the Council of the European Union announced that it has adopted the proposed regulation on short selling and certain

aspects of credit default swaps. The decision was taken without discussion at a meeting of the Economic and Financial Affairs Council. The UK abstained.

The version of the regulation adopted by the Council contains a number of amendments to the version adopted by the European Parliament on 15 November 2011. These amendments are mainly of a stylistic or linguistic nature and do not affect the substance of the version adopted by the European Parliament.

The regulation is expressed to come into force on the day after it is published in the Official Journal and will apply from 1 November 2012.

ESMA Discussion Paper on Key Concepts of the AIFM Directive

On 23 February 2012, the European Securities and Markets Authority (“ESMA”) published a discussion paper on key concepts of the Alternative Investment Fund Managers Directive (2011/61/EC) (the “AIFM Directive”) and types of alternative investment fund managers (“AIFMs”). The discussion paper covers a number of areas, including:

- **The definition of AIFM:** in particular, clarification of the range of functions an AIFM must carry out under the AIFM Directive and the extent to which it may delegate those functions is discussed.
- **The definition of alternative investment fund (“AIF”):** guidance is proposed on the definition of AIFs in Article 4(1)(a) of the AIFM Directive: whether or not an entity falls within the definition of an AIF will be relevant when determining whether an entity managing it falls within the definition of AIFM and is therefore within the scope of the Directive.
- **The treatment of UCITS management companies:** ESMA’s interpretation is given on the interaction between the AIFM Directive and the UCITS IV Directive (2009/65/EC), in particular on the services that a management company authorised under one of these Directives may provide under the other: ESMA’s analysis is that a single management company may hold both a UCITS IV and an AIFM Directive authorisation.
- **The treatment of MiFID firms and credit institutions:** clarification is given that investment firms authorised under the Markets in Financial Instruments Directive (2004/39/EC) (“MiFID”) and credit institutions authorised under the Banking

Consolidation Directive (2006/48/EC) may not be authorised as AIFMs: however, they may provide investment services, such as individual portfolio management in respect of AIFs, without falling within the scope of the AIFM Directive.

Comments can be made in response to the discussion paper until 23 March 2012. ESMA will develop a consultation paper in the second quarter of 2012 setting out proposals for draft regulatory technical standards (“RTs”) required under Article 4(4) of the AIFM Directive. Following consultation, ESMA will finalise the draft RTs and submit them to the European Commission for endorsement by the end of 2012.

The Proposed EU Financial Transactions Tax

It will be recalled that in September 2011, the Commission published a proposal for an EU Financial Transaction Tax (“the FTT”). The 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.

The Rapporteur in the European Parliament on this proposal has now published a draft report in the ECON committee relating to the proposal. The report is generally supportive of the proposal, citing an externally commissioned report which shows that the FTT could have a positive effect on GDP of 0.25% rather than the minus 1.76% predicted by the Commission in its impact assessment. The draft report, however, includes some important amendments, including:

- **the issuance principle:** the FTT would be levied not only on transactions which involved parties resident in the EU but also any trades involving instruments which are issued within the EU and derivatives would be taxed by reference to where the underlying instrument is issued;
- **legal enforceability:** the report also includes a clause which renders the transfer of legal title unenforceable if the FTT has not been paid: instruments where no FTT has been paid will also not be eligible for central clearing under EMIR nor will they fulfil capital adequacy requirement under CRD 4;
- **review clause:** the report calls for the review of the FTT to examine both the scope of the tax and whether the rates of tax should be further differentiated for different assets classes; and

- **enhanced cooperation:** the report also calls for the possibility of a group of Member States to introduce a FTT under enhanced cooperation procedures if no agreement is reached on the FTT.

UK Regulatory Developments

The FSA’s Retail Distribution Review: Draft VAT Guidance

HMRC recently circulated revised draft guidance on the VAT treatment of retail investment advisers’ services after the introduction of new regulatory rules on 31 December 2012 implementing the FSA’s Retail Distribution Review (the “RDR”). From that date, payment of commission for advised sales in investment products will be banned. Instead, investors will agree the adviser charge and choose whether this should be paid as a fee or facilitated through a product.

HMRC confirms that if the investor agrees to the adviser acting as an intermediary and the adviser performs the type of services typical of such arrangements, the fee of the adviser will continue to be exempt from VAT (even if a sale does not materialise). If there is no such agreement, the fee will be standard-rated. The VAT treatment of ongoing services will depend on the services that the adviser has agreed to perform. If the ongoing services includes an intermediation brief, VAT exemption will apply to those services.

If evidence supporting the VAT treatment applied is not kept, HMRC will treat the services as standard-rated advice.

(HMRC’s guidance is now being incorporated into HMRC’s VAT Finance and Insurance Manuals.)

Supply of the KIID for Direct Sales: FSA Waiver by Consent

As indicated in a letter to the Investment Management Associates in December 2011, the FSA has now made available to fund managers a “modification by consent” whereby the KIID can be supplied to direct investors after the transaction has taken place.

This would occur where a customer has given instructions by a means of distance communication, in writing or by telephone, and the manager is not able to provide the document in good time before the transaction is concluded.

Consolidated Version of FSMA Reflecting the Financial Services Bill as Introduced to Parliament

On 22 February 2012 HM Treasury published a revised consolidated version of the Financial Services and Markets Act 2000 ("FSMA") which reflects how it will be amended by the Financial Services Bill (the "FS Bill") in the form the Bill took when introduced into Parliament on 26 January 2012.

(HM Treasury makes it clear that this version of FSMA is intended only as an illustrative document to aid scrutiny of the FS Bill by Parliament and interested parties.)

The FS Bill is currently progressing through the Parliamentary legislative process and has now reached the Public Bill Committee stage.

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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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