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Dechert LLP

DIFC Funds: A New Investment Vehicle for the Middle East

by **Chris Harran**

Until recently, the Kingdom of Bahrain was the only choice for domiciling a collective investment vehicle within the Middle East and North Africa (“MENA”). Since 2005, however, the Dubai International Financial Centre (“DIFC”) has provided an attractive alternative. The DIFC is a free zone established within Dubai, in the United Arab Emirates (“UAE”), with its own laws, regulations, court systems and, critically for those looking to establish a fund here, its own regulatory authority, the Dubai Financial Services Authority (“DFSA”).

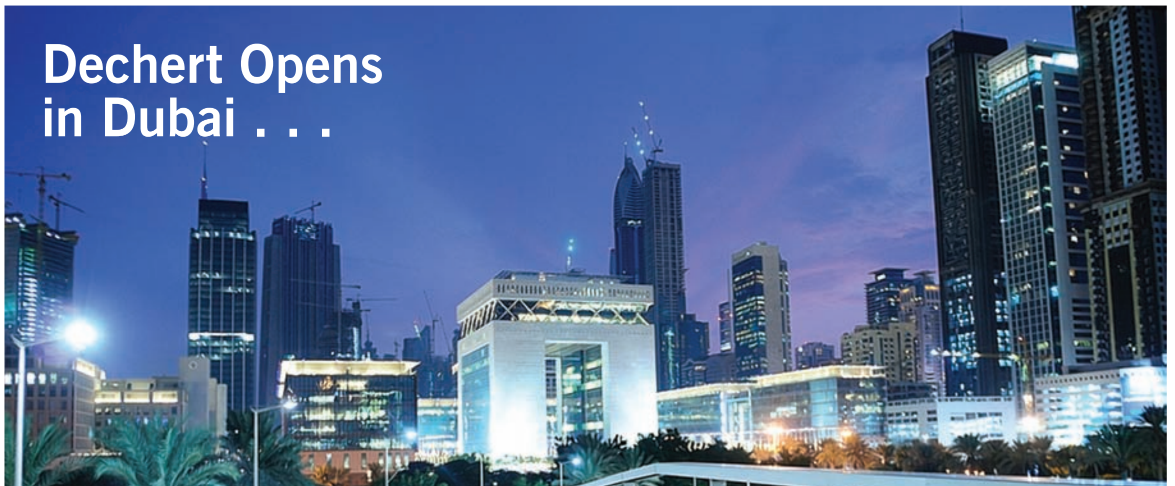
This article describes opportunities available for investment in the Middle East through the DIFC.

Benefits of a DIFC Investment

Recent revisions to the DIFC funds regime, in addition to other developments under the DIFC Companies Law, have placed the DIFC front and centre within the Middle East as a credible domicile, both for those seeking to raise investor commitments and deploy capital in the region, and for those pursuing investment objectives outside of the region, but requiring a Middle East domicile.

Clear advantages to establishing a fund within the DIFC exist, and include the following:

- The DFSA regulations governing DIFC funds are based on best practice from more established fund jurisdictions, thereby bringing a level of familiarity and comfort to investors.
- DIFC funds are classified as GCC (Gulf Cooperation Council)[1] vehicles. This enables them both to take advantage of certain advantageous tax treatment between the six members of the GCC, and to mitigate



The opening of our doors in Dubai — one of the world’s leading global cities and business hubs — marks a significant expansion of Dechert’s Middle East capabilities and emerging markets practice.

local ownership and asset-specific investment restrictions that exist in the region with respect to "non-GCC" investment.

- On the basis of current law and practice, any investment fund established within the DIFC (and indeed, any company incorporated within the DIFC) will be exempt from any DIFC income, capital gains and corporation tax for a guaranteed period of 50 years from the date of enactment of DIFC Law No. 9 of 2004. This zero rate of tax also extends to transfers of assets, profits or salaries in any currency to any party outside the DIFC for the same period of time.
- In most circumstances, DIFC entities benefit from the UAE's extensive, and continually expanding, double taxation treaty and agreement network.[2]

The Exempt Funds Regime

Highlights

The end of 2010 saw wholesale regulatory reforms to the DIFC funds regime. In particular, a new "Exempt Funds Regime" was introduced.

The Exempt Funds Regime is principally targeted at sponsors wishing to attract investment into a DIFC fund vehicle (an "Exempt Fund") from no more than 100 investors (although the fund may be marketed to more than 100 potential investors), each of whom must qualify as a "Professional Client" (broadly, an investor who can certify to prescribed criteria as to wealth and investment expertise), and who is able to subscribe for an initial subscription amount of not less than USD 50,000 (or currency equivalent).

Exempt Funds benefit from a lighter regulatory regime than other DFSA-regulated funds. By way of example:

- Notification requirements are relaxed — the DFSA need only be notified two weeks prior to an Exempt Fund's launch (as distinguished from certain funds not qualifying as Exempt Funds, which require DFSA *approval* prior to launch);
- There are no prescribed requirements for the content of the information memorandum provided to potential investors (save for prescribed regulatory disclosures and core requirements under the "Specialist Fund" regime, as described below), with the only requirement being that the information memorandum must, at a minimum, contain all information that an investor would "reasonably require"; and

- An "External Fund Manager" (broadly, an entity authorised to establish and operate an investment fund in a jurisdiction other than the DIFC) is able to sponsor and establish a DIFC-domiciled fund without being separately licensed by the DFSA.

An Exempt Fund may be established as a company, a limited partnership or an investment trust. Sponsors may also constitute an umbrella fund as a protected (or segregated) cell company under applicable DIFC laws. An Exempt Fund may be open or closed ended (with the exception of a fund classified as a real estate fund under the Specialist Fund criteria, which must be closed ended), denominated in any currency and may have either individual or corporate directors.

The Exempt Funds Regime – Specialist Funds

In addition to the basic provisions regulating Exempt Funds, the DIFC funds regime has prescribed additional regulations for those categories of fund deemed as Specialist, such as "real estate", "hedge", "private equity", "feeder", "fund of funds" and Islamic. An Exempt Fund may be classified within more than one definition of Specialist Fund, such as an Islamic private equity fund, or a fund of funds hedge fund.

Simply, a fund classified as Islamic is one that invests and conducts its operations in accordance with the principles of Islamic Shari'a. A private equity fund is so-called where the main objectives of the fund would be to invest in unlisted companies or to participate in management buy-outs or buy-ins. A fund is classified as a hedge fund where it has a broad mandate and flexibility in the investment strategy pursued, aims to achieve absolute returns rather than returns relative to market, and employs certain investment techniques such as short selling, use of derivatives and leverage.

Likewise, a real estate fund and a real estate investment trust are both fund vehicles that invest directly and/or indirectly via special purpose vehicles into real estate assets.

While the additional provisions related to these classes of funds impose further regulations on Exempt Funds falling within a Specialist category, they also remove or exempt such funds from provisions that do not apply to that Specialist class (by way of example, private equity funds are not subject to the requirement for a separate custodian to be appointed) and that are otherwise imposed on other categories of Exempt Fund. It is to be welcomed that the provisions impose only those requirements that make sense in relation to a given asset class or strategy. Further, the DFSA has demonstrated on various occasions that it is willing to waive, on a case-by-case basis, provisions in relation to Specialist Funds that are otherwise applicable to Exempt Funds.

External Fund Manager

A key development under the new Exempt Funds Regime is the ability of an External Fund Manager to establish an investment fund in the DIFC without having to obtain a separate licence from the DFSA.

External Fund Managers must:

- be domiciled in a "Recognized Jurisdiction"[3] and regulated by the appropriate regulator in that Recognized Jurisdiction (with an applicable licence that includes the establishment, operation and management of investment funds or applicable permission encompassing the same);
- submit to the jurisdiction of the DIFC Courts; and
- appoint a DIFC-based administrator in relation to any DIFC funds that they operate.

Otherwise, the provisions regulating External Fund Managers and "Domestic Fund Managers" (broadly, an entity established in the DIFC and authorised by the DFSA to establish and operate an investment fund) are substantially the same.

For entities not appropriately authorized in a Recognized Jurisdiction, or not domiciled in a Recognized Jurisdiction, fund sponsors may wish to consider engaging a Domestic Fund Manager for the purpose of compliance with DFSA regulations, with appropriate sub-advisory and investment management agreements in place (which is permissible under the DFSA regulations).

Dechert Expands Global Footprint With Addition of Four New Offices

Dechert LLP continues to significantly expand our global footprint and the services we provide to clients worldwide, with new offices in Dubai, Almaty, Tbilisi and Chicago. Our team in Dubai is part of a broader emerging markets group, led by partner Camille Abousleiman, focused on capital markets, corporate finance, private equity, fund formation and restructuring, which also has members based in London and in Tbilisi, Georgia.

Our team in Almaty, Kazakhstan focuses on serving clients in the energy sector.

Lawyers in our Chicago office focus on securities litigation.

Conclusion

Although off to a slow start, interest in DIFC-domiciled Exempt Funds has gathered pace. DIFC-domiciled Exempt Funds represent a real option for asset managers and fund management organizations seeking to raise commitments or deploy capital in the MENA region. While Cayman, BVI, Luxembourg and Ireland remain popular, the DIFC should be added to the list of possible jurisdictions of choice.

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1 The Gulf Cooperation Council comprises the Kingdom of Bahrain, the State of Kuwait, the Sultanate of Oman, the State of Qatar, the Kingdom of Saudi Arabia and the United Arab Emirates.

2 As at March 2012, the UAE had entered into 63 double taxation treaties or agreements. Source – UAE Ministry of Economy and Finance.

3 The current list of Recognized Jurisdictions includes most EU Member States, the Channel Islands, Singapore, India, Switzerland, Malaysia, Hong Kong, the United States, Australia, Canada and South Africa. The DFSA has discretion to allow fund managers from other jurisdictions. See www.dfsa.ae for the full list.

Chris Harran
Dubai
+971 4 425 6329
chris.harran@dechert.com

An Analysis of the EU and U.S. Regulations Affecting OTC Derivatives

By **Richard Frase**, **Alexander Pannett** and **Philip Hinkle**

The financial crisis that started in 2008 saw the collapse, nationalisation or merger of a number of major financial institutions. The ensuing liquidity crisis prompted governments to pledge reform of the regulation of over-the-counter ("OTC") derivatives, with the aim of reducing counterparty risk and improving transparency. World leaders at the G20 summit in October 2009 proposed that OTC derivatives should be cleared through central counterparties ("CCPs"), and that these transactions should be reported to trade repositories.

Various global initiatives are being implemented to enact the proposed reforms, most importantly the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in the United States and both the European Market Infrastructure Directive ("EMIR") and a revision of the Markets in Financial Instruments Directive ("MiFID") (the revisions being collectively known as "MiFID II") in the European Union.

This article looks at the scope of the above regulations and their approach to clearing, margin, trading venues, position limits and reporting.

Scope of Regulations

EU

OTC derivatives contracts are defined as derivative transactions that are executed neither on an EU regulated market nor on a non-EU country market considered as equivalent to a regulated market.

A regulated market is defined under MiFID as a multilateral system operated and/or managed by a market operator. It brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments in the system and in accordance with its non-discretionary rules in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems. A regulated market must be authorised and function regularly in accordance with MiFID.

The definition of OTC derivatives covers a wide range of swaps, options, futures and other derivatives contracts on securities, currencies, interest rates, financial indices, credit, commodities and other underlyings specified under MiFID. Spot foreign exchange and forward foreign exchange contracts are currently not deemed to be OTC derivatives though this may be subject to revision.

U.S.

Dodd-Frank is intended to cover nearly all OTC derivatives, which are regulated by both the U.S. Commodity Futures Commission ("CFTC") and the U.S. Securities and Exchange Commission ("SEC") and are divided into "swaps", which are regulated by the CFTC, and "security-based swaps", which are regulated by the SEC. Entities that use both "swaps" and "security-based swaps" are subject to regulation by both the CFTC and the SEC.

"Swaps" include options, contingent forwards, exchanges of payment or transactions that are based on an underlying financial product, and products that become known as swaps in the market. These include, among other things, interest rate swaps, commodity swaps, credit default swaps, currency swaps, foreign exchange swaps, forwards and options and total return swaps.

"Security-based swaps" are defined as swaps that are based on (i) a narrow-based security index (generally defined as containing nine or fewer components), (ii) a single security or loan or (iii) the occurrence or non-occurrence of an event relating to a single issuer of a security in a narrow-based security index, provided that such event directly affects the financial statements, financial condition or financial obligations of the issuer concerned.

These terms are defined in Dodd-Frank, which requires that the CFTC and SEC further define them via rulemaking (scheduled to be adopted in a joint rulemaking in 2012).

Clearing

EU

EMIR requires that certain classes of OTC derivatives between financial counterparties must be cleared through a CCP.

Financial counterparties include:

- investment firms;
- credit institutions;
- insurance, assurance and reinsurance companies;
- UCITS funds;
- pension funds; and
- alternative investment funds.

The CCP will be an intermediary and will be contractually placed in between the two financial counterparties to a given transaction. The CCP will be a buyer to every seller and a seller to every buyer. The CCP maintains its relationship with counterparties through clearing members, who complete the contractual link between CCPs and counterparties. CCPs reduce counterparty risk should one of the financial counterparties fail to make a payment or delivery due to insolvency, because the CCP will assume all counterparty risk and guarantee payment or delivery.

Non-financial counterparties are required to comply with the above central clearing obligation if they exceed a clearing threshold (still to be specified by the EU Commission). A non-financial counterparty is defined as any EU undertaking that is not a "financial counterparty", and so would include entities such as airlines and energy companies.

The following criteria will be used to determine whether a class of OTC derivatives should be subject to the central clearing obligation:

- the degree of standardisation within the contractual terms of the OTC derivatives concerned and the operational processes applicable to such contracts;
- the availability of fair, reliable and generally accepted pricing information in respect of the relevant class of OTC derivatives; and
- the volume of trading and liquidity.

Financial counterparties and certain non-financial counterparties who are subject to the central clearing obligation, but whose class of derivatives are deemed not to be subject to central clearing (i.e., highly bespoke, illiquid OTC derivatives), must make arrangements to monitor and mitigate operational and credit risk, which should include ensuring timely confirmation of transactions (ideally by electronic means) and the holding and exchange of appropriate capital.

The new central clearing obligation will require financial counterparties that use OTC derivatives to supplement their existing ISDA contracts to allow for a contractual relationship with a clearing member and, where relevant, enable the level of collateral required by the CCP concerned to be provided. The financial counterparty must also appoint clearing members to allow it to perform its clearing obligation, which will accrue additional cost.

EMIR provides for an exemption from the clearing obligation for intra-group transactions.

U.S.

Dodd-Frank requires clearing of all designated swaps and security-based swaps, where accepted by a "derivatives clearing organisation" ("DCO") or "security clearing agency" and approved by either the SEC or the CFTC, as applicable. Swaps that are required to be cleared will also be required to be executed on a board of trade designated as a "contract market", an exchange or a swap execution facility ("SEF") (discussed below).

Dodd-Frank sets forth mandatory considerations for the relevant DCOs and review by the CFTC and SEC in determining whether an OTC contract must be cleared and exchange traded. The process pursuant to which contracts will be designated for clearing and exchange trading is subject to definition by further rulemaking.

There is an "end-user" exemption to the centralised clearing requirement for an entity that is not a "financial entity" (defined below) and that is using the relevant swap or security-based swap transaction to hedge or mitigate commercial risk. The exemption does not include speculative hedges or provide for an "intra-group" exemption. Financial entities that do not benefit from the end-user exemption include swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, commodity pools, some types of private funds, ERISA plans and banking entities.

Non-cleared contracts will still be subject to CFTC or SEC substantive recordkeeping, reporting and capital and margin requirements.

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Enhancing the Investment Advisory Contract Review Process for U.S. Sub-Advised Funds

by **Koji Felton**

In light of recent SEC enforcement and private class action litigation developments regarding sub-advised mutual fund fees, mutual fund boards and management companies should review and consider ways to enhance their investment advisory contract approval process pursuant to Section 15(c) of the Investment Company Act of 1940, as amended (the "Act"). This article will discuss a number of strategies that can enhance the Section 15(c) process.[1]

Both the SEC and private plaintiffs' bar have focused recently on sub-advised fund fees. The SEC brought an enforcement action last year against an investment adviser that hired a sub-adviser to help it manage a Malaysian sector fund.[2] The SEC alleged that the adviser represented to the board that the sub-adviser was providing services to the fund and recommended that the board approve the sub-advisory contract, even though the sub-adviser provided no real services to the fund. The SEC's enforcement action alleged violations of Section 15(c) and other securities laws. At the same time, the plaintiffs' class action bar is pursuing a new theory of liability against sponsors of sub-advised funds, alleging that they receive a disproportionately large portion of the investment advisory fee while the sub-adviser purportedly does most of the work.[3]

Boards should compare their fund's performance with that of an appropriate peer group and an appropriate benchmark.

Advisers should structure their Section 15(c) presentations to disprove the primary factual premise in the recent class action lawsuits against managers of sub-advised funds: that the investment adviser performs little or no services in connection with the fee that it receives. Investment advisers in fact perform a variety of functions in the course of overseeing sub-advisers, including: researching and selecting the sub-advisers; performing due diligence on the sub-advisers from an investment process, operational and compliance perspective; portfolio construction (that is, combining multiple sub-advisers, and allocating fund assets among them, in a manner designed to serve fund investment objectives); monitoring their ongoing performance; ensuring compliance with the investment objectives of the fund and consistency with the fund's disclosures; oversight of third-party service providers; and reporting to the fund board, to name a few.

If the investment advisory contract does not clearly delineate the responsibilities of the investment adviser, however, the adviser should consider ways it can clarify for the board and the record the work it performs pursuant to its advisory contract. One way would be for management to clearly specify (for example, in the Section 15(c) meeting board materials) the various services it actually performs for the funds, and differentiate these services from those performed by the sub-adviser. Another approach would be to

amend the investment advisory agreement to specify the responsibilities of the investment adviser. Before undertaking such an amendment, however, it would be necessary to determine whether the amendment would be material and require a shareholder vote under Section 15(a).

Enhancing the Contract Approval Process

Management and boards should consider ways that they can improve upon their process and address some of the concerns raised by the SEC and plaintiffs' bar about mutual fund fees in general and sub-advised fund fees in particular. The case law under Section 36(b) and SEC disclosure rules in this area provide a framework for considering how to improve the Section 15(c) process.

Care and Conscientiousness of the Board

In both *Gartenberg*[4] and *Jones v. Harris*, the courts focused on the role of the board, the care and conscientiousness with which the directors approached the contract review process, and their independence.[5] Courts and the SEC are most likely to defer to the business judgment of boards where the record demonstrates that a thorough review process took place, the board reviewed all of the information necessary to evaluate the investment advisory contract, and the board asked relevant questions and received meaningful responses from management.

Section 15(c) places an affirmative obligation on the board to request and evaluate such information as may reasonably be necessary to evaluate the terms of the investment advisory contract and requires that the investment adviser furnish such information to the board.[6] Boards typically fulfill their obligation in a written request to the management company prepared by board or fund counsel. Boards should review this letter with counsel to make sure that their request is well-crafted to capture all of the relevant information based on each fund's particular circumstances. Boards and counsel should update the request to reflect developments during the year, including any performance, compliance or asset flow issues with particular funds. If the board of a sub-advised fund does not clearly understand the allocation of responsibilities between the investment adviser and the sub-adviser, they should ask the adviser for clarification.

Boards and management should consider the best way for their fund group to structure their 15(c) meetings, given the complexity of review and time and resource constraints on directors and management. For some fund groups, a single meeting may be sufficient, but other groups may prefer to spread the process over two or more meetings to allow for a more thorough discussion of issues requiring in-depth analysis and follow-up. Another option is to create a contract review committee of the board that meets throughout the year and is able to delve more deeply into substantive questions. Other fund groups may allocate among the directors responsibility for more focused attention on particular funds, assigning each director responsibility for reporting on several funds at the contract approval meeting.

There may be good explanations as to why a sub-advised fund may be more expensive than its peers, including the fact that high quality sub-advisers can command higher fees.

The independent directors should make sure the agenda for the meeting includes ample time to meet among themselves with their counsel to review management's presentation and identify issues for further inquiry. They should also make sure that they receive the board materials well in advance of the meeting to allow for a thorough review. The board should have a process for asking questions and communicating them to management through a single point of contact, such as a lead independent director or independent directors' counsel. Independent directors may also find it helpful to schedule time prior to the meeting to discuss the materials and raise questions for management to address at the meeting.

Management can enhance the board's effectiveness by proactively identifying issues and raising them with the board. If the management company knows that a fund has challenges under one or more of the *Gartenberg* factors (for example comparatively high expenses relative to peers combined with poor relative performance), it should bring that to the attention of the board and provide an explanation that addresses the board's concerns, or it should explain what steps it is taking to address the issues.

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Amendments to the Luxembourg Law on Specialised Investment Funds

by **Antonios Nezeritis**, **Edouard d'Anterroches** and **David Heinen**

Although the perception may be that no longer being able to launch without prior CSSF approval removes one of the key advantages of the SIF in terms of flexibility, experience shows that this amendment should not have a major impact and should not be viewed as a burden for SIF initiators.

On 26 March 2012, Luxembourg adopted a new law (the "Law"), which came into force on 1 April 2012 and amended the Luxembourg law of 13 February 2007 on specialised investment funds ("SIFs") (the "SIF Law"). The amendments to the SIF Law that are contained in the Law represent the first step in the implementation of the Alternative Investment Fund Managers Directive (the "Directive") in Luxembourg. The Directive is required to be implemented into national law by each EU Member State by 22 July 2013 at the latest. The Law includes new provisions with respect to portfolio management, the delegation of certain functions to third parties, risk management and conflicts of interest.

The Law also introduces some further flexibilities to the SIF Law and changes the regulatory approval process for SIFs and removes the ability to launch a SIF prior to receiving the approval of the Luxembourg regulator, the *Commission de Surveillance du Secteur Financier* (the "CSSF").

Launch with Prior CSSF Approval

The Law has repealed the possibility of launching a SIF (or a sub-fund of an existing SIF) without CSSF approval. In addition, SIFs will have to communicate to the CSSF any substantial changes to documents and other information that has previously been approved by the CSSF.

Although the perception may be that no longer being able to launch without prior CSSF approval removes one of the key advantages of the SIF in terms of flexibility, experience shows that this amendment should not have a major impact and should not be

viewed as a burden for SIF initiators in light of the following current market practice:

- "Plain vanilla" SIFs were, in principle, usually approved by the CSSF within a very short time frame as they did not raise any particular concerns;
- "Complex" SIFs (having features or investment purposes that might have triggered comments from the CSSF) have generally sought to obtain the prior approval of the CSSF before launching; and
- Certain service providers were not in favour of opening accounts for a SIF before they were provided with sufficient comfort as to the (likelihood of) approval by the CSSF.

Approval of the Portfolio Manager(s)

The CSSF must now approve the persons in charge of the portfolio management of the SIF. These persons must be of good repute and have adequate experience with respect to the investment policy and strategy of the SIF.

Delegation of Functions to Third Parties

Delegation of Functions

In order to conduct operations in a more efficient manner, SIFs may delegate one or more functions to third parties, provided that each of the following conditions is met:

- The CSSF must be adequately informed of the delegation;
- The delegation must not prevent the effective supervision of the SIF, and in particular it must not prevent the SIF from acting, or from being managed, in the best interests of investors;
- The directors of the SIF (or its management company) must be able to demonstrate that the delegate is qualified and capable of undertaking the functions in question and was selected with all due care, and that the SIF is in a position to (i) monitor the delegated activity effectively at all times, (ii) give further instructions to the delegate at any time and (iii) terminate the delegation with immediate effect in order to protect the interests of investors;
- Investment management functions may not be delegated to the depositary; and
- The offering document of the SIF must list the delegated functions.

Delegation of the Investment Management Functions

SIFs will only be able to delegate investment management functions to entities or persons that are (i) authorised or registered for the purpose of asset management and (ii) subject to prudential supervision by a supervisory authority. If the investment management function is delegated to a non-Luxembourg entity, cooperation arrangements must exist between the CSSF and the third-country supervisory authority that regulates the delegate.

Should these conditions not be met, the Law grants some flexibility to the CSSF to decide whether the delegate is nevertheless acceptable — for instance, if the delegate can demonstrate that it is of sufficiently good repute and sufficiently experienced. This decision will be taken by the CSSF on a case-by-case basis, and it is expected that the CSSF will grant such exemptions only on a limited basis.

As noted below, existing SIFs will benefit from grandfathering provisions to comply with these requirements. SIFs that currently do not have compliant delegation arrangements will therefore be required to appoint a new, compliant asset manager, or terminate their existing delegation arrangements and assume the responsibility for investment management themselves. An option in order to preserve the continued involvement of a non-compliant delegate would be to amend the existing delegation agreement so that this takes the form of an investment advisory agreement, pursuant to which the asset manager will provide non-binding investment advice.

Risk Management and Conflicts of Interest

SIFs are now required to implement risk management systems to identify, measure, manage and monitor appropriately the risks associated with the investment positions taken by the SIF in question and their contribution to the SIF's overall investment portfolio.

SIFs must also be structured and organised in such a way as to mitigate the risk of any conflict of interest arising with any person involved in or related, directly or indirectly, to the SIF's activities that might

adversely affect the interests of investors. In the case of a potential or actual conflict of interest, the SIF is required to protect the interests of its investors.

The Law provides that regulation will be adopted by the CSSF to clarify the implementation of the measures on risk management and conflicts of interest. The CSSF issued a press release on 20 April 2012 (the "CSSF Press Release") to provide guidance prior to the adoption of such regulation, as to the level of information that has to be communicated to the CSSF, either immediately (for SIFs set up after 1 April 2012) or by 30 June 2012 (for existing SIFs).

The guidance indicates that SIFs must file with the CSSF a concise description of their risk management systems and processes, based on a proportionality principle, in order to identify, assess, mitigate and control the material risks to which that SIF (or its sub-funds) is or may be exposed. This description should include the risk management function (including how the various responsibilities have been attributed), its independence, the specific measures put in place to deal with conflicts of interest and the process and methodology implemented to assess and address the specific risks deriving from the SIF's (or its sub-funds') investment strategy and risk profile.

The risk management process and the conflicts of interest policy must be expressly approved by the directors.

Subsequent to the CSSF Press Release, the Association of the Luxembourg Fund Industry (ALFI) issued recommendations when establishing the risk management system. ALFI suggests to define and document the risk management function and, based on the investment strategy of each SIF, identify the risks and define the appropriate measures, control limits and escalation procedures per risk category.

Valuation of Contributions In Kind

The Law stipulates that contributions in kind must be valued by an independent auditor, with the costs of the valuation borne by the investor in question. While this requirement was, to some extent, already required by law for certain types of SICAVs, this new requirement reflects the administrative practice of the CSSF.

Efficiency Measures

The Law has introduced into the SIF regime certain measures that had already been introduced for UCITS and non-UCITS retail funds by the Law of 17 December 2010 on undertakings for collective investments.

Cross Investments between Sub-Funds

A sub-fund of an umbrella SIF may (if permitted by the offering document of the SIF) invest in other sub-funds of the same SIF, provided that:

- The target sub-fund does not itself invest in the investing sub-fund;
- The voting rights of the target sub-fund in the umbrella SIF are suspended during the period of investment; and
- For as long as shares/units in the target sub-fund are held by the SIF, their value will not be taken into account in calculating the SIF's net assets in the context of meeting the minimum net assets requirements.

For SIFs established prior to 1 April 2012, cross investments between sub-funds will only be permitted if their offering documents are duly amended to expressly permit this.

Annual Report

The requirement to provide an annual report (including the auditor's and the management reports) to shareholders along with the convening notice for the annual general meeting no longer applies to corporate SIFs. This cost-saving measure does, however, require that the convening notice must indicate the means for accessing these documents and specify that each shareholder may request that the annual report be sent to him or her free of charge.

Record Date

The convening notices for general meetings of shareholders (of corporate SIFs only) may provide that the quorum and the majority shall be determined according to the shares issued and outstanding at midnight (Luxembourg time) on the fifth day prior to such meeting. This provision will be an improvement for funds with a large number of investors, for whom the drawing up of a meeting attendance list is not always an easy task.

Articles of Incorporation: Language Requirements

The articles of incorporation of a corporate SIF must be drawn up in English, French or German. If the

articles of incorporation of such SIF are drawn up in English, a French or German translation will no longer be required.

Withdrawal of a Sub-fund's Authorisation

The CSSF may withdraw the authorisation of a sub-fund without withdrawing the authorisation of other sub-funds, or of the SIF as a whole. This will ensure that if, say, one sub-fund does not comply with applicable laws and regulations, investors in other sub-funds will not suffer any penalty.

Transitional Provisions

Existing SIFs will benefit from the following grandfathering provisions:

- They have until 30 June 2012 to comply with the provisions on the monitoring of risk management and conflicts of interest; and
- They have until 30 June 2013 to comply with the provisions in relation to the delegation of functions.

Conclusion

With these amendments, Luxembourg has given a clear supportive signal to the investment fund industry. Indeed, while Luxembourg both acknowledges lessons learned from changes in recent market and regulatory practice and looks forward to the continued evolution of non-UCITS funds, it still continues to offer a modern, flexible and "investor friendly" investment structure to sophisticated investors so as to maintain the attractiveness of the SIF regime.

Antonios Nezeritis
Luxembourg
+352 45 62 62 27
antonios.nezeritis@dechert.com

Edouard d'Anterroches
Luxembourg
+352 45 62 62 34
edouard.danterroches@dechert.com

David Heinen
Luxembourg
+352 45 62 62 30
david.heinen@dechert.com

Impact of New Luxembourg-Germany Double Tax Treaty on the Funds Industry

by **Hans Stamm**

On 23 April 2012, Germany and Luxembourg signed a new double tax treaty (the "Treaty"), which will replace the original treaty that has been in force since 1958. The impact of the new Treaty will not be felt solely by Luxembourg-domiciled funds, but also is likely to have an effect on many UK, U.S. and offshore funds if they use Luxembourg structures as part of their tax planning for German inbound investments (including private equity, real estate and infrastructure investments).

At a high level, the main changes that the Treaty will bring about, when compared to the existing regime, include the following.

The impact of the new Treaty will not be felt solely by Luxembourg-domiciled funds, but also is likely to have an effect on many UK, U.S. and offshore funds if they use Luxembourg structures as part of their tax planning for German inbound investments (including private equity, real estate and infrastructure investments).

Explicit Treaty Access for Funds

A Luxembourg investment fund that is structured as a SICAV, SICAF or SICAR will be able to claim Treaty benefits in relation to its German investments in its own name, which will mean a reduction in the rate of German withholding tax from 26.375% to 15% on portfolio dividends (i.e., dividends from German investments) and a tax rate of 0% on interest payments made by a German borrower to a Luxembourg lender.

A Luxembourg investment fund that has a contractual structure, such as an FCP, will only qualify for Treaty benefits in so far as it is able to show that its investor

base has German tax residency. To the extent a proof of the tax residency of investors cannot be made, the Fund would not qualify for Treaty benefits.

Whether the German tax administration establishes a pragmatic approach to this requirement, at least for UCITS funds, is unclear.

Investment into Real Estate Companies

The Treaty includes a new provision which covers capital gains from shares in companies that derive more than 50% of their value, directly or indirectly, from real estate assets. Investments in German real estate holding companies, held through a Luxembourg holding company, may therefore be subject to German tax under the new Treaty. Accordingly, capital gains from such companies will be taxed in Germany (if the respective shareholding exceeds 1% of the share capital of such German real estate company).

Hybrid Debt Instruments

Investments in German target companies (e.g., by private equity and real estate funds) are often financed at the portfolio company level through the use of hybrid debt instruments (for instance, through the use of profit participating loans, or “PPLs”), under the terms of which a certain portion of German-derived profits is repatriated. Under the current treaty, these financial instruments are (subject to their terms) not subject to any German withholding tax. Under the new Treaty, however, Germany will be entitled to apply its withholding tax rate (of 26.375%) to payments made under the terms of such financial instruments, if they qualify as so-called “profit participating instruments” (i.e., if the payment of interest under the terms of the financial instrument is linked to the profit of the German borrower).

Any restructuring of existing investment structures would therefore need to be implemented during the remainder of this year to address, in particular, the hybrid debt instrument issue.

Application of New Rules

It is expected that the new Treaty will be ratified by the Luxembourg and German parliaments in due course and should, in principle, come into force on 1 January 2013. Any restructuring of existing investment structures would therefore need to be implemented during the remainder of this year to address, in particular, the hybrid debt instrument issue.

Hans Stamm
Munich
+49 89 21 21 63 42
hans.stamm@dechert.com

Applying FATCA in Asia: Still Oceans Apart

by **Karl J. Paulson Egbert**

When the U.S. Department of the Treasury ("Treasury") and Internal Revenue Service ("IRS") issued proposed regulations relating to the Foreign Account Tax Compliance Act ("FATCA") earlier this year,[1] there was a sense that the financial services industry in Asia could finally begin to untangle the knot of FATCA's obligations. However, a review of comment letters submitted by Asian trade groups to the IRS suggests that compliance remains a challenge without further revision of FATCA.

Issues in Asia Generally

The comment letters came from a variety of Asian jurisdictions, including Hong Kong, Singapore, Japan and Australia. While these jurisdictions each face unique obstacles with FATCA compliance, many comment letters shared a general unease with FATCA's scope, as well as skepticism that FATCA's rewards (an estimated US$1 billion in additional tax revenue annually) justified its expenses.[2] Generally, FATCA attempts to combat U.S. tax evasion by requiring that non-U.S. financial institutions report the identities of U.S. shareholders or clients — or face a 30% withholding tax on their U.S. source income. But comment letters from higher tax jurisdictions in Asia questioned whether U.S. tax evaders would cheat on their U.S. taxes only to pay local taxes elsewhere.[3] Comment letters from both higher and lower tax jurisdictions noted that U.S. taxpayers made up a tiny percentage of total accounts, further complicating the search.[4]

Some comment letters suggested that cultural differences in Asia needed to be considered. In certain situations, FATCA requires that financial institutions ask a customer who was born in the United States to submit documents explaining why the customer abandoned U.S. citizenship or did not obtain it at birth. The Japan Securities Dealer Association ("JSDA") notes that "asking such a delicate and private question is not something Japanese financial institutions could ask to their customers" and requested "IRS understanding [...] that the general perception relating to nationalities in Japan differs from the situation in the U.S. and/or Europe."[5] Even apparently straight-forward requirements may pose challenges in Asia: FATCA requires that customers make representations about their identities "under penalty of perjury" in certain situations. But, as the JSDA notes, Japan has no custom of making legal oaths, so Japanese customers will be extremely reluctant to give them.

FATCA contains partial exemptions (i.e., "deemed compliance") for certain financial institutions that are less likely to be used by U.S. tax evaders. Based on the feedback in the Asian comment letters, these exemptions have limited utility in Asia.

Even where cultural differences were not noted, concerns about privacy abounded. FATCA requires that financial institutions report to the IRS certain information about U.S. persons. In some jurisdictions, like Hong Kong, many funds and insurance companies are permitted to disclose information with client consent. But the organizational documents for these institutions might not include these provisions, and the process to change them is not easy. In other cases, such as in Japan or for Hong Kong's mandatory

provident plans (*i.e.*, retirement funds), such disclosure is prohibited without further changes to domestic law.[6] Proposed legislation in Singapore could ultimately have the same effect.[7]

"Deemed Compliance" in Asia

FATCA contains partial exemptions (i.e., "deemed compliance") for certain financial institutions that are less likely to be used by U.S. tax evaders. Based on the feedback in the Asian comment letters, these exemptions have limited utility in Asia. For example, the proposed regulations include an exemption for retirement funds. But comment letters indicated that many local retirement plans in Japan and Hong Kong would not qualify for this exemption. The JSDA Comment Letter suggested that this category be revised to offer deemed compliance to any investment vehicle sanctioned under domestic law for "employee wealth accumulation." The Hong Kong Joint Comment Letter offered a similar suggestion: that any government-mandated plan be deemed compliant on the basis that local governments are better positioned than the IRS to determine what types of plans are adequate for the local retirement market.

Some comment letters suggested that cultural differences in Asia needed to be considered. . . . Even where cultural differences were not noted, concerns about privacy abounded.

The proposed regulations also partially exempt "restricted funds" — funds that prohibit investment by U.S. persons. Although many non-U.S. funds have long restricted investment by U.S. persons because of the U.S. federal securities laws, the comment letters suggest that this exemption is less useful than it first appears. Both the JSDA Comment Letter and the Hong Kong Joint Comment Letter pointed out the exemption also requires that funds be sold exclusively to limited categories of FATCA-compliant or exempt institutions and distributors. These categories are themselves difficult for Asian institutions to comply with. For example, a restricted fund may sell to certain distributors who agree not to sell to U.S. persons ("restricted distributors").[8] But restricted distributors must operate solely in the country of their incorporation, a true obstacle in smaller markets such as Hong Kong and Singapore where many distributors must operate regionally to attain scale. In order to make the exemption viable, comment letters suggested that restricted distributors instead be permitted to operate regionally in Asia.[9] Other permitted distribution channels for restricted funds are "local banks," which are not allowed to have any operations outside of their jurisdiction of incorporation and may not advertise the availability of U.S. dollar denominated investments.[10] But investors in Hong Kong routinely make U.S. dollar investments; Hong Kong's currency is pegged to the U.S. dollar and over 90% of funds are either denominated in U.S. dollars or have U.S. dollar share classes. The Hong Kong Joint Comment Letter suggests that this requirement must be removed for the exemption to be workable.

When No Exemption Applies – Challenges in FATCA Compliance in Asia

Because of the challenges of applying the "deemed compliance" categories in Asia, many financial institutions must now consider what steps to take to prepare for FATCA compliance. Comment letters identified issues with the following FATCA requirements: (1) account due diligence; (2) closure of non-compliant "recalcitrant" customer accounts; and (3) withholding against recalcitrant accounts and non-compliant financial institutions.

The best approach may be for Asian trade groups to continue their dialogue with the IRS and Treasury, while Asian financial institutions begin to assess their FATCA burdens as they prepare for compliance.

The core of FATCA is the process of reviewing customer records to search for "U.S. indicia" — that is, evidence that a customer might be a U.S. taxpayer. While the proposed regulations suggested that financial institutions could rely on their existing anti-money laundering procedures for this requirement, the comment letters noted that this might not always be possible. Under certain circumstances, FATCA requires financial institutions to look through their customers and counterparties' ownership to find "substantial

U.S. owners" (generally, certain U.S. persons holding more than 10% of an entity).[11] In both Hong Kong and Japan, existing anti-money laundering legislation generally requires that financial institutions look through entities only when there is a 25% owner, leaving a gap between information that may be needed for FATCA compliance and existing procedures.[12]

Where customers fail to provide requested information to ascertain their U.S. status, FATCA eventually may require closure of their accounts. But in Asia, this mandate bumps into local legal requirements: comment letters from Japan, Singapore and Australia all noted that compulsory redemption was impermissible, impractical or a possible breach of contract. In the case of retirement plans where participation is mandatory, forced redemption would defeat the express purpose of the product.[13] In Hong Kong, forced redemption may be allowed in retail funds, if it is expressly permitted in organizational documents. But many funds' organizational documents never contemplated that compulsory redemption would be necessary, so costly shareholder approvals are needed before such funds can become FATCA-compliant.

Local law may also complicate compliance with FATCA's withholding obligations. In some situations, an institution may be required to withhold 30% from payments that have no connection to the United States (e.g., with respect to pass-thru payments). The JSDA Comment Letter openly questioned whether Japanese law would permit such withholding and queried whether it would also violate customers' property rights under Japanese law. In Hong Kong, retirement plan providers face a similar issue. The Mandatory Provident Fund Schemes Ordinance (1995) permits deductions from plans only for certain specified purposes, which do not include FATCA withholding.

Conclusion

The breadth of issues presented by the comment letters suggests that FATCA can be implemented efficiently in Asia only with significant changes to existing local laws or equally significant accommodation from the IRS and Treasury. But the timeline for FATCA compliance remains tight — financial institutions must enter into "foreign financial institution agreements" in 2013. Inter-governmental cooperation may not come soon enough to beat that deadline.

The best approach may be for Asian trade groups to continue their dialogue with the IRS and Treasury, while Asian financial institutions begin to assess their FATCA burdens as they prepare for compliance.

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1 Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities (February 8, 2012) ("Proposed Regulations").

2 Joint Committee on Taxation, Publication JCX-6-10, *Estimated Revenue Effects Of The Revenue Provisions Contained In An Amendment To The Senate Amendment To The House Amendment To The Senate Amendment To H.R. 2847, The "Hiring Incentives To Restore Employment Act" Scheduled For Consideration By The House Of Representatives On March 4, 2010*.

3 Investment Trusts Association, Japan, Comment Letter to the IRS (April 26, 2012).

4 For example, U.S. citizens account for 0.04% of Japan's 127 million residents and less than 0.30% of Hong Kong's residents. Japan Securities Dealers Association, Comment Letter to the IRS (April 30, 2012) ("JSDA Comment Letter"); Hong Kong Federation of Insurers, Hong Kong Investment Funds Association, Hong Kong Trustees' Association, Joint Comment Letter to the IRS (April 30, 2012) ("Hong Kong Joint Comment Letter").

5 JSDA Comment Letter.

6 Hong Kong Joint Comment Letter.

7 Investment Management Association of Singapore, Comment Letter to the IRS (April 30, 2012) ("Singapore Comment Letter").

8 Proposed Regulations Section 1.1471-5(f)(4).

9 Hong Kong Joint Comment Letter; Singapore Comment Letter.

10 Proposed Regulations, Section 1.1471-5(f)(2)(i).

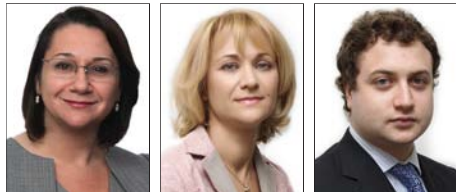
11 Proposed Regulations, Section 1.1473-1(b).

12 JSDA Comment Letter; Hong Kong Joint Comment Letter (the letter notes that Hong Kong anti-money laundering regulations require looking-through to 10% owners in certain high-risk situations).

13 In the case of Hong Kong's mandatory provident funds, employers have an obligation to ensure that employees remain in the program. Hong Kong Joint Comment Letter.

Karl J. Paulson Egbert
Hong Kong
+852 3518 4738
karl.egbert@dechert.com

Russia Finally Establishes a Central Securities Depository Increasing Transparency in the Russian Securities Market



by **Laura Brank**, **Evgenia Korotkova** and **Kirill Skopchevskiy**

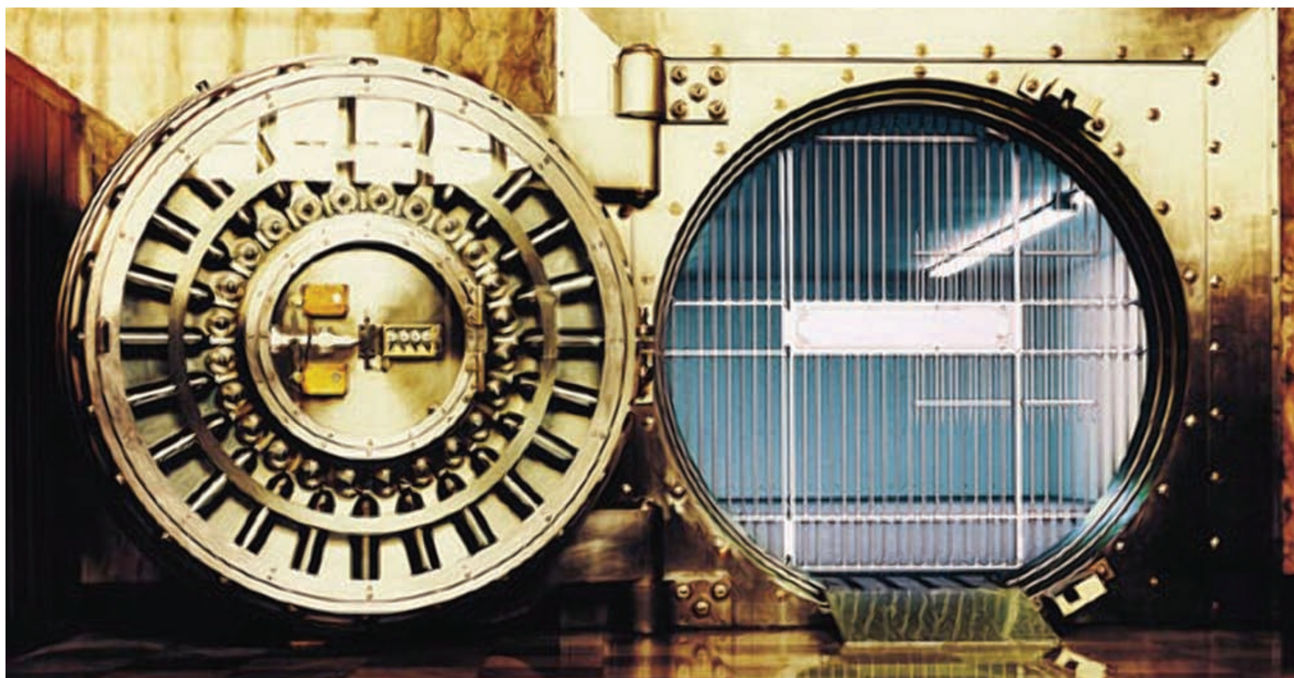
Russia's ambitious goal of transforming the country into a leading global financial center by 2020 has finally gained momentum. Among the recent measures aimed at radically improving the investment climate in Russia is the Federal Law on the Central Securities Depository (the "CSD"). The CSD is a fundamental institution that has been lacking from the Russian securities market infrastructure, and has been long anticipated by Russian and foreign investors. Once the CSD Law (as defined below) comes into full force on July 1, 2012, it should help allay the fears of many investors by ensuring the transparency and finality of settlement of transactions involving certain Russian securities. However, there is still considerable confusion surrounding the new system, as will be discussed in this article.

After almost a decade in the making, then-Russian President Dmitry Medvedev finally signed into law Federal Laws No. 414-FZ "On the Central Securities Depository" (the "CSD Law") and No. 415-FZ "On Amendments to Laws in Connection with the Law on the Central Securities Depository" (the "Law on Amendments") in December 2011. Most provisions of these laws came into force on January 1, 2012, with the remainder due to come into force on July 1, 2012, subject to several exceptions.

Moreover, the CSD will most likely meet the requirements of Rule 17f-7 under the U.S. Investment Company Act of 1940, as the CSD will not only be subject to independent annual audits of its records, but will also be required to undergo organizational audits and to ensure the transparency of its fees.

Establishment and Functions of the CSD

The CSD is a non-banking credit institution, to be formed as a joint-stock company, duly authorized to act as the CSD by the Federal Service for Financial Markets (the "FSFM"), the Russian securities regulator, on the basis of an implementing regulation that is



being developed jointly by the FSFM and the Russian Ministry of Finance. The CSD Law sets out a list of requirements that a legal entity must comply with in order to be considered a candidate for CSD status. Among other requirements, a prospective CSD must have net assets of no less than RUB 4 billion (approximately 125 million US dollars) and be duly licensed by the FSFM to act as a depository in the securities market, as well as a solid track record as a depository of no less than three years. It is widely speculated in the Russian media that the primary contender for the CSD role is the settlement depository of the MICEX group (a leading Russian stock exchange), CJSC National Settlement Depository. The regulation on granting CSD status will become effective on June 12, 2012, after which the FSFM will have four months to review the applications. Accordingly, the market expects that the CSD will be created in early fall 2012.

According to the CSD Law, the CSD will have certain exclusive rights; in particular, it will be the only entity authorized to open depository accounts in the registers of securities owners of the following issuers:

- Issuers that must disclose information under Article 30 of the Russian Federal Law "On the Securities Market" (the "Securities Market Law"), which comprises almost all Russian public companies. These include issuers that have registered a securities prospectus and are, therefore, required to disclose certain information to the FSFM, their shareholders and the general public.
- Issuers of "investment units" (for example, in a Russian investment fund), or the issuers of mortgage certificates, if these instruments may be traded on a Russian stock exchange.

The CSD will have one year from its foundation to become the nominee in the registers of these issuers. Thus, in effect, the CSD will become the only settlement organization for publicly traded Russian companies and investment funds in Russia. At the same time, it should be noted that the CSD Law will not apply to certain issuers of securities in Russia.

The creation of the CSD should radically improve and simplify the existing market structure, where settlement is performed either (i) directly on the books of the registrars of Russian issuers of securities acquired by investors in the OTC market and held through local custodians, or (ii) in case of exchange transactions, through two settlement depositories — National Settlement Depository Closed Joint Stock Company (for trades on the MICEX) and Depository Clearing Company Closed Joint Stock Company (for trades on the RTS, a second leading Russian stock exchange).

From July 1, 2012, the CSD Law will also allow for the creation of nominee accounts for global custodians, foreign brokers and foreign banks, in the form of:

- foreign nominee holder ("FNH") accounts, if a foreign organization is authorized to register and transfer rights to securities under its domestic legislation (i.e., foreign global custodians, national custodians, banks and broker-dealers); and
- foreign authorized holder ("FAH") accounts, if a foreign organization is authorized to act in its own name on behalf of other persons under its domestic legislation (i.e., foreign trustees).

These changes will significantly improve the protection of foreign investors, as the current securities laws do not recognize foreign nominees, and therefore global custodians and brokers are considered the ultimate owners of securities that they hold for their clients. In practice, this has meant that, for example, votes at shareholders' meetings represented by shares held by custodians on behalf of foreign investors cannot be split to reflect different investors' views, since the custodian is obliged to vote with its entire stake in the same manner. Also, investors that accumulate an aggregate of 25% or more in certain Russian companies through their custodian are obliged to apply to the Russian anti-monopoly authority, or make a mandatory tender offer to all remaining shareholders if the aggregate stake held through a custodian exceeds 30%, even though the investors' individual holdings may be well below the respective thresholds of 25% and 30%. Although, in practice, parties have tended to circumvent this requirement, the new law will resolve this inconsistency. Once foreign investors are allowed to open FNH and FAH accounts under the CSD Law, these and other obstacles to investing in Russian securities should clear up.

Further, the new laws are also widely expected to enhance the Russian federal bond market by allowing foreign investors to settle ruble bond trades through international clearing houses such as Euroclear and Clearstream, thus having a positive impact on the spreads between ruble-denominated federal debt and Eurobonds.

Disclosure Obligations

Significantly, the Law on Amendments introduces new disclosure obligations for foreign nominees. Specifically, as of January 1, 2013, foreign nominee holders of securities will be obliged to disclose information regarding their ultimate beneficiaries to:

- the CSD, and/or
- other Russian custodians, where foreign nominees have opened "depo" accounts.

It is not yet clear to what degree of ultimate ownership this disclosure must be made. The Law on Amendments is not specific on this point and the regulation on how and in what form this information needs to be provided has yet to be adopted by the FSFM.

Further, the same information regarding ultimate beneficiaries must be disclosed by foreign nominee holders of securities upon demand of a Russian issuer of these securities, courts, judges, the FSFM and/or enforcement agencies (investigators). This provision will come into legal effect on July 1, 2012.

Depository Receipts Programs

The CSD Law will also facilitate the creation of accounts in a special Depository Receipts Program. Specifically, the issuers of foreign securities that are derived from Russian securities (for example, various depository receipts programs) ("Institutional Issuers") will be allowed to open special depository program accounts with Russian depositories, which, in turn, will be obliged to open nominee accounts with the CSD. The CSD Law requires Institutional Issuers to disclose the actual holders of depository receipts on a quarterly basis, in a manner to be promulgated by the FSFM. Failure to comply with this disclosure obligation may result in the suspension of operations for the applicable depository program accounts. Institutional Issuers will also be obliged to disclose the holders of depository receipts on an ad hoc basis, in order to exercise the voting rights attached to the underlying securities and to receive dividends.

Additional Considerations

As mentioned above, the CSD will be subject to annual financial and operational audits. The CSD is also obliged to establish an internal oversight department, which will be responsible for regulatory compliance.

In order to ensure transparency of operations and non-discriminatory treatment of its members, the CSD will be obliged to publicly disclose a number of its internal documents and regulations, including (but not limited to) its charter, audited year-end financial statements and the terms, conditions and fees for the CSD's services.

The new legislation is widely expected to improve the efficiency and increase the transparency of the Russian securities market.

The Law on Amendments also implements a range of important changes to other Russian securities legislation, most notably by introducing the concept of a "transfer agent" into the Law on the Securities Market. A number of revisions necessitated by the CSD Law are also being introduced in the Joint Stock Companies Law, the Law on Enforcement Proceedings and the Bankruptcy Law.

The new legislation is widely expected to improve the efficiency and increase the transparency of the Russian securities market. It should enhance liquidity, lower settlement costs and ensure that domestic broker-dealers and international investors are operating on the same post-trading platform and in the same fashion. Combined with the recent merger of the two leading Russian trading platforms — RTS and MICEX — there is a lot of enthusiasm that once the CSD is fully functional, it will improve the appeal of purchasing securities of Russian issuers.

Laura Brank
Moscow: +7 499 922 1100
Washington, D.C.: +1 202 661 3484
laura.brank@dechert.com

Evgenia Korotkova
Moscow
+7 499 922 1160
evgenia.korotkova@dechert.com

Kirill Skopchevskiy
Moscow
+7 499 922 1164
kirill.skopchevskiy@dechert.com

UK Investment Banks: Up to FSA Standard?

by **Jonathan Pickworth** and **Kelly Hagedorn**

On 29 March 2012, the UK Financial Services Authority ("FSA") published its report "Anti-bribery and corruption systems and controls in investment banks" (the "Report"). The Report was compiled following the FSA's thematic review into how investment banks regulated by the FSA mitigate and manage bribery and corruption risk. The FSA visited 15 investment banks (eight major global investment banks and seven smaller firms carrying on niche investment banking activities) to review the compliance of their policies and procedures with FSA guidance on the subject.

Anti-bribery and corruption compliance is currently an area of focus for the UK authorities. The implementation of the Bribery Act 2010 (the "Act") on 1 July 2011 has increased the powers of the prosecuting authorities to bring cases against companies for corporate bribery. The Act contains a new strict liability offence of failing to prevent bribery, which applies to all commercial organisations that carry on a business, or part of a business, in the UK.

The only defence to the new strict liability offence is for the commercial organisation to show that it has in place "adequate procedures" designed to prevent bribery. This has led to an increase in the number of organisations designing and implementing anti-bribery compliance programmes.

In addition, firms regulated by the FSA continue to be, as they were before the implementation of the Act, required to have in place systems and controls designed to prevent and detect all types of financial crime, including bribery.

FSA Requirements

The FSA does not have specific requirements relating to bribery and corruption controls, and it is not part of the FSA's remit to enforce the Act (prosecutions under the Act require the permission of one of the Directors of Public Prosecutions, the Serious Fraud Office or Revenue and Customs Prosecutions). It does however, require, under SYSC 6.1.1R (which forms part of the FSA's handbook of rules applicable to

financial services institutions), that regulated firms establish, implement and maintain adequate policies and procedures sufficient to ensure compliance of the firm (and those employed by or working for it) with its obligations under the UK regulatory system and for countering the risk that the firm might be used to further financial crime. There are also related requirements, for example, to ensure that properly qualified and experienced individuals are employed to fulfil the roles allocated to them, and to ensure that there is a mechanism for recording compliance with relevant regulations.

The only defence to the new strict liability offence is for the commercial organisation to show that it has in place "adequate procedures" designed to prevent bribery.

Previously, when considering financial crime, regulated firms have concentrated their efforts on the prevention and detection of fraud, money laundering and terrorist financing. There is a large amount of guidance for firms in these areas, and most firms generally have well implemented and developed procedures in relation to these types of financial crime. With this as a backdrop, the FSA undertook the investigatory work

of visiting the selected sample of investment banks in preparation for the Report.

The Key Findings

The Report indicates that, to date, amongst investment banks at least, bribery and corruption have not formed part of firms' wider consideration of the risks of financial crime.

The Report has a number of key findings:

- Most firms reviewed by the FSA did not take into account the FSA's rules on bribery and corruption.
- Nearly half of the firms reviewed did not have in place an adequate risk assessment.
- Management information on bribery and corruption issues was poor.
- Little progress had been made around plans to monitor the effectiveness of anti-bribery programmes that had been put in place.
- The understanding of bribery and corruption risks faced by investment banks was in some cases limited.
- There were weaknesses in dealings with third parties used to win or retain business, including due diligence, compliance approval, and risk assessment.
- Although there was a marked improvement around gifts and hospitality policies, only a few of the firms reviewed by the FSA had in place a process for recording gifts and hospitality to monitor that these were reasonable, both individually, and cumulatively, on a per-client and per-project basis.
- Although anti-bribery vetting was well established when recruiting new staff, identification of high-risk roles requiring enhanced vetting was not usually undertaken.
- Further work was needed on training staff in higher-risk roles and assessing the effectiveness of training.

It is clear from the tone of the Report that the FSA considers that, if the sample is to be taken as representative of the industry as a whole, more work needs to be done across the board to ensure compliance not only with the Act, but with the FSA's regulatory requirements in relation to financial crime.

What Should Firms be Doing Now?

While the Report focuses on the investment banking industry, there are lessons for companies and firms, both regulated by the FSA and not, arising out of the Report. The Report contains helpful updated guidance and examples of good and bad practice when implementing an anti-bribery programme, which are instructive across the entire financial services industry.

For firms that have not already done so, a bribery and corruption risk assessment should be carried out. Regulated firms should take particular care to ensure that this covers the FSA's requirements for systems and controls around financial crime, as well as the requirements of the guidance issued by the Ministry of Justice in relation to the Act. The FSA is able to sanction regulated firms for failure to comply with its requirements, even if no bribery or corruption has occurred. This is in contrast with the Act, which only applies if there has been an act of bribery for which the commercial organisation has been charged, following which there will be an assessment of the adequacy of the anti-bribery measures if the organisation claims a defence of adequate procedures.

For all firms, particularly those that have not yet started or completed the process of implementing an anti-bribery programme, the Report provides useful pointers as to where other firms have not made as much progress as the regulators would like — this should provide information as to particular areas of focus. Some of the key areas are covered below.

Risk Assessment

Key questions that should be addressed include: Has such assessment been carried out? By whom? Have relevant staff members been sufficiently trained to understand the bribery and corruption risks that the business faces?

Risk assessments should be specific to the business, and not an exercise carried out according to a template or precedent. It may be that several risk assessments need to take place to cover different business areas or different geographical locations, if there is a marked difference in the risk prospects between those areas or locations.

Management Information (''MI'')

Firms should be asking themselves the following, among other, questions: Consider the quality of your MI. Does it cover bribery and corruption issues? Does

it provide an update on developments in the area, look at risks to your business, or particular issues that have been encountered? Do you have an individual or committee to whom responsibility for anti-bribery has been delegated? Do they have a clear, written remit?

Third Parties

If a firm does not have policies and procedures in place to deal with third parties, this should be rectified. In particular, consideration should be given to providing guidance on assessing the risks posed by particular third parties and additional measures to be taken for high-risk third parties. This could include, for example, involving legal and/or compliance teams in the take-on process and the use of detailed contractual protections.

Gifts and Hospitality

Firms should ensure that there are procedures in place to monitor cumulative expenditures on particular clients or projects. Bribes do not have to be one-off payments. A series of gifts or events, which on their own would not cause suspicion, may when taken together be considered to be a bribe.

Having identified these publicly once, it is unlikely that the FSA would look kindly on firms that failed to address them going forward.

Staff Vetting

There should be a mechanism for identifying those issues that are at a higher risk of bribery and corruption. Enhanced vetting of individuals being considered for those roles should be carried out. This could include, without limitation, checks of credit records, annual records and financial sanctions lists, and searches of databases such as WorldCheck.

Assessment of Understanding

The Report noted that the understanding of bribery and corruption by investment banks was inadequate and that the monitoring of the effectiveness of the anti-bribery programmes within banks was very limited. This correlates closely to the one principle in the Ministry of Justice Guidance on adequate procedures that is most frequently overlooked — namely, the monitoring and evaluation of the programme. There are plenty of training programmes available, both off-the-shelf and bespoke, all of which help to meet the training and communication requirement. However, what is needed most of all is a process to help assess not just employees' knowledge, but also their understanding of appropriate behaviours. Information about the level of employees' understanding, within a firm-wide culture of compliance, is critical to any evaluation as to the effectiveness of a firm's compliance programme. This is, incidentally, something that we have been working on at Dechert for a period of months, and we believe that we have developed a unique process to address this issue.

For all firms, particularly those that have not yet started or completed the process of implementing an anti-bribery programme, the Report provides useful pointers as to where other firms have not made as much progress as the regulators would like.

The areas listed above are not intended to be an exhaustive agenda for the implementation of an anti-bribery compliance programme. There are many other topics that firms need to consider and address when considering the appropriate structure of a programme. However, these are areas in which the FSA identified failings in the sample of institutions it reviewed when preparing the Report. Having identified these publicly once, it is unlikely that the FSA would look kindly on firms that failed to address them going forward. It is therefore worth a review of your procedures in light of the Report, to determine if anything could or should be improved.

Jonathan Pickworth
London
+44 20 7184 7608
jonathan.pickworth@dechert.com

Kelly Hagedorn
London
+44 207 184 7630
kelly.hagedorn@dechert.com

The Asia Region Funds Passport: Myth or (Almost) Reality?

by **Angelyn Lim** and **Kylee Zhu**

Introduction*

The finance ministers of the Asia Pacific Economic Cooperation countries issued a joint announcement on 10 November 2011 supporting the establishment of a pilot Asia region funds passport scheme ("ARFP").

At the time, it was anticipated that this pilot scheme could be launched as early as in the second half of this year. It was expected that Hong Kong, Singapore and Australia would form the core common regulatory framework and determine the initial list of eligible investment products.

After years of talk and lobbying by certain countries and sectors, notably the Australia and New Zealand asset managers, this seems like it may be a significant step towards the establishment of an ARFP framework. But how realistic is it?

Like a UCITS?

The proposal is modelled after its famous European cousin, UCITS, which the Asian funds industry has been keen to emulate. Such a scheme would allow fund managers in participating Asian countries to promote their products to investors in other participating Asian countries, although the existing impediments of different local regulatory, legal and tax requirements would still need to be overcome.

These different local regulatory, legal and tax requirements currently already impact on the reach of UCITS in different parts of Asia:

- China and India, the two largest retail markets in Asia, as well as Indonesia and Australia, do not recognise UCITS at all.
- In Taiwan, UCITS can be registered for retail investment only if they do not utilise derivatives at all, and the registration process is a lengthy one.
- In Japan, UCITS registration is also a notoriously slow and expensive process.
- In Malaysia and Thailand, a locally registered feeder fund is required to invest into a UCITS. The situation is similar in South Korea, although it has also introduced tax disincentives for foreign funds.

As things currently stand, UCITS are not truly pan-Asian passport-able.

Existing Initiatives

In the absence of an ARFP, individual countries in Asia have already taken steps to advance different levels of market access with bilateral or multi-lateral reciprocity:

- Australia has entered into bilateral mutual recognition agreements with each of New Zealand and Hong Kong, whereby funds, which have been authorised in one country, can be distributed to retail investors in the other country. They do not have to comply with the full range of the other country's authorisation requirements.
- Hong Kong and Taiwan have put in place reciprocal cross-listing of exchange-traded funds ("ETFs"). An approved ETF that is licensed by the Securities and Futures Commission in Hong Kong or the Financial Supervisory Commission in Taiwan will be mutually recognised by the other jurisdiction.
- Members of the Association of Southeast Asian Nations ("ASEAN") have also undertaken tangible efforts to create a single integrated marketplace for listed securities by adopting the ASEAN and

Plus Standards Scheme in 2008, which facilitates multi-jurisdictional share or debt offerings.

Benefits

The advantages of an ARFP are obvious: potentially enhanced portfolio management by promoting access to larger pools of funds. This would encourage better diversified portfolios at lower transaction costs, improved internal management, greater investor choice, economies of scale resulting from registering funds across different jurisdictions and a common offering mechanism. Smaller managers would have the opportunity to tap into new markets for their products.

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Asia is made up of 48 countries with differing local regulatory and taxation requirements as well as stages of economic development and evolution. While the benefits of an ARFP may be evident, the task of reconciling such differences across the region is surely much easier said than done.

Obstacles

Liberal markets, such as Hong Kong and Singapore, generally encourage (or at least facilitate) local market access by offshore investors, whereas India and China only offer restricted access to foreigners. Australia, which has inherently prohibitive local tax treatments of foreign investors, last month also increased withholding taxes from 7.5% to 15%, becoming even less attractive to offshore investors than before.

Although differences in tax treatment and national political and regulatory agendas continue to exist in Europe, the UCITS regime has the advantage of being enacted and implemented by a single supranational body. Asia, on the other hand, does not have such a body and it is not anticipated that it will establish one soon.

The fact that Asia does not have a common currency is not an insurmountable hurdle, although it is entirely possible that the de facto common currency for the ARFP may be the Renminbi. The de facto common currency for most funds at the moment (including UCITS) is the U.S. Dollar.

Participating Asian countries would also need to agree on common product licensing, monitoring, disclosure, sales practices and enforcement. Consequently, an ARFP would be dependent on the initiative of individual countries in Asia to pass identical (or at least substantially similar) laws and regulations to facilitate the establishment of the ARFP. Such an initiative is likely to be hampered by differing political agendas among the different jurisdictions, potentially with some degree of protectionism as well.

While the benefits of an ARFP may be evident, the task of reconciling such differences across the region is surely much easier said than done.

Impetus for an ARFP

The Alternative Investment Fund Managers Directive presented a real possibility of Asian managers being left out of the European fund-raising market. And the looming prospects of the Foreign Account Tax Compliance Act ("FATCA") now lend added impetus to the establishment of an ARFP. For further information on FATCA, please refer to Applying FATCA in Asia: Still Oceans Apart, in this Report.

An ARFP is also likely to be supported by Asian regulators, who generally prefer an Asia-centric (rather than EU-centric, in the case of UCITS) approach to the regulation of funds available in Asian jurisdictions.

With the mindset of Europe's UCITS experience, it is theoretically feasible for an ARFP to begin with a core group of countries that are already on par in their development and prepared to agree on a common set of regulations. The likely candidates for this core group are Hong Kong, Singapore and Australia, all of which have developed mature markets with comparable regulatory systems. This is notwithstanding the recent announcement by the Australian tax authorities, which will still likely adversely impact foreign direct investment into Australia, although it may not have as significant an impact on the prospects for a pilot ARFP scheme which includes Australia's participation. It also remains to be seen if the Australian tax and regulatory authorities will consider any specific tax breaks or waivers to incentivise foreign participants in the Australian financial services sector.

A Retail or Alternative Funds Passport?

It may be more palatable to local regulators if the first step in the establishment of an ARFP is the establishment of a passporting system extended at the outset to only non-retail funds.

Once the regulation of asset managers is finessed in this manner and that project is successfully off the ground, with the goal of seeking a harmonisation of private placement regimes Asia-wide, it may be easier to transpose or extend the ARFP to apply to retail products as well.

In the post-global financial crisis investment and regulatory landscape the time is now ripe for a real, sustained effort at establishing an ARFP — whether for retail or private funds, or both.

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* This article is based on an article originally published by Global Funds Asia.

Angelyn Lim
Hong Kong
+852 3518 4718
angelyn.lim@dechert.com

Kylee Zhu
Hong Kong
+852 3518 4708
kylee.zhu@dechert.com

Enhancing the Investment Advisory Contract Review Process for U.S. Sub-Advised Funds

(continued from page 7)

Nature, Extent and Quality of the Services Provided by the Adviser

Management should explain to the board how the services it performs add value to the sub-advised fund structure. If there are specific functions that the adviser performs, such as managing cash, allocating assets among multiple sub-advisers, or performing compliance testing for the portfolio, these should be explained. Management should maintain policies and procedures regarding the oversight of sub-advisers and other service providers, and keep records that demonstrate those services were actually performed during the year. Management should highlight for the board relevant information demonstrating the quality of the services it provides, including shareholder satisfaction surveys, industry awards, and other recognition from unbiased sources, such as the media and independent mutual fund research firms.

Investment Performance of the Fund and Adviser

Boards should compare their fund's performance with that of an appropriate peer group and an appropriate benchmark. Boards often hire independent firms such as Morningstar and Lipper to prepare this information. The vendors that assemble these peer groups are not infallible, and management should discuss with the board any peer funds that it believes should not be in the group. For example, two funds in the same peer group may have similar investment objectives, but may utilize strategies with very different risk profiles. The board and management should also consider what are the most appropriate performance time periods to review (for example, one-, three-, five- or 10-years), based on their investment philosophy, investor time horizon, and other relevant considerations.

Costs of the Services Provided and Profitability of the Adviser

The courts have cautioned not to place too much emphasis on fund expense comparisons because mutual funds generally do not change investment advisers, and therefore competition to reduce fees

may be lacking.[8] Still, this factor continues to receive attention, and a fund with higher expenses relative to peers should prompt further inquiry by the board. All else being equal, an outlier fund with higher expenses relative to peers is more likely to draw the attention of regulators and the plaintiffs' bar.

There may be good explanations as to why a sub-advised fund may be more expensive than its peers, including the fact that high quality sub-advisers can command higher fees. Also, an investor in a sub-advised fund may be getting a better overall product, especially where the adviser is adept at researching and selecting the best sub-advisers or allocating assets among a group of sub-advisers that results in a portfolio with superior risk-adjusted performance. Management should explain to the board why higher than peer expenses are justified by superior services or better risk-adjusted performance. As with performance peer groups, if management believes that particular funds are not appropriately included in the expense peer group, or that relevant funds were inappropriately excluded, it should raise that with the board. In certain circumstances it may be appropriate for management, in consultation with the board, to create a custom peer group.

Profitability and cost accounting, the courts have said, is "an art rather than a science."[9] Cost accounting systems that management relies on for business planning and accounting purposes likely will be given more weight by courts than systems that are used solely to calculate profitability for Section 15(c) purposes. Management and the board should evaluate the cost allocation methodologies in order to satisfy themselves that cost allocations to the investment advisory business are appropriate. An internal review by the firm's accounting department may help the board understand the cost allocation process. Some firms hire outside accounting firms to perform an analysis of the cost allocation methodology.

It is also important when evaluating profitability to allocate revenues properly to the investment adviser's business. Management is required to disclose and the board should evaluate any "fall-out" benefits that the adviser or its affiliates would not have earned but for the investment advisory relationship with the mutual fund.[10] For example, the courts have held that float revenue earned by investment advisory affiliates on free credit balances awaiting sweep into a money market fund should be considered as a fall-out benefit of the adviser's contract with the money market fund.[11]

Extent to which Economies of Scale Are Realized as the Fund Grows

As fund assets grow, the fund may experience economies of scale. These economies of scale ordinarily should be shared with investors, for example, through reductions in advisory fees as fund assets reach specified levels (breakpoints). The first question that needs to be answered, however, is whether the adviser is experiencing economies of scale as a fund increases in size. The courts have defined economies of scale for purposes of Section 36(b) to mean decreasing unit costs as fund assets increase in size.[12]

Profitability and cost accounting, the courts have said, is "an art rather than a science."

In order to address this *Gartenberg* factor, the adviser must determine what the appropriate drivers of cost are, and whether unit costs are actually decreasing as fund assets grow. For example, if the number of accounts in a sweep money market fund is increasing proportionately with the increase in fund assets, and the number of sweep transactions per account remains constant, the unit costs might not decrease if the primary driver of cost is the number of transactions in the fund.

Similarly, if a fixed income fund is forced to invest in a larger number of issuers as its assets grow, and that increasing number of issuers requires a larger number of research analysts to evaluate new issuers, its per unit costs may not decrease due to the added research expenses.[13] Conducting this analysis is important for fund companies that experience significant asset growth. In the sub-advised model, there may be fewer opportunities for economies of scale depending on the ability of the adviser to negotiate fee reductions with the sub-adviser. Portfolio management is a variable, rather than fixed, cost.

Whether Fee Levels Reflect Economies of Scale for the Benefit of Investors

The courts have held that economies of scale can be reflected in fund fees in different ways. Breakpoints, or reductions in the investment advisory fee as assets reach specified levels, are a common way for fund managers to pass along economies of scale to investors. Alternatively, the manager may set fund

fees low to begin with and not have breakpoints because the low fee incorporates economies of scale throughout the life of the fund.[14] The manager may pass along economies of scale to investors by increased investment in infrastructure and staffing, resulting in improved fund performance. Waivers of fees and contractual expense limitations are another way that managers may pass along economies of scale to investors.

To the extent that the management company actually experiences economies of scale with respect to its management of a fund, it should disclose that to the board and explain how it has shared those benefits with shareholders. Management and the board should satisfy themselves that the benefits are reasonable in relation to the amount of economies of scale.

Comparable Products Analysis

Management and the board should make sure that they review the investment advisory fees of mutual funds managed by the investment adviser with any comparable products it manages. In *Jones v. Harris,* the court refused to set forth a categorical rule that comparisons between mutual fund fees and institutional account fees are never relevant, and instead ruled that each case must be determined based on the facts and circumstances.[15]

The management company should identify any products that are arguably comparable and, if applicable, explain to the board how the services provided to institutional or other clients are materially different from those provided to mutual fund clients. Management companies have identified a number of differences in services and business expenses between managing retail mutual funds and institutional accounts, including: the heightened regulatory, compliance, and disclosure burdens for mutual funds; the need for managers to hire specialized personnel who are fully or substantially dedicated to mutual fund operations; the added burden of oversight of mutual fund service providers such as transfer agent, distributor, fund accountant, fund administrator, auditor and legal counsel; the greater class action litigation risk with respect to mutual funds as compared to institutional accounts; the added difficulty of managing a portfolio to be able to meet daily redemption requests from retail mutual fund investors as compared with the relatively stable asset base of institutional investors; and others.

Conclusion

Enhancing the contract renewal process may significantly improve the record that a court or regulator will be asked to review in the context of a lawsuit or investigation. If the board can demonstrate that it exercised appropriate diligence in evaluating all of the relevant information in approving the investment advisory contract, it will enhance the likelihood that a court or regulator will defer to the board's sound business judgment.

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1 This article is an abridged version of an article that appeared in the June 2012 edition of *The Investment Lawyer*, available at http://www.dechert.com/Enhancing_the_Investment_Advisory_Contract_Review_Process_Can_Mitigate_Recent_Increased_Litigation_and_Enforcement_Risk_of_Sub-Advised_Funds_06-01-2012/.

2 *In the Matter of Morgan Stanley Inv. Mgmt. Inc.*, Advisers Act Rel. No. 3315, 2011 WL 5562535 (Nov. 16, 2011).

3 *See, e.g., Sivolella v. AXA Equitable Life Ins. Co.*, No. 11-CV-4194 (D.N.J. filed Jul. 21, 2011); *Curran v. Principal Mgmt. Corp.*, No. 09-CV-433 (S.D. Iowa filed Oct. 28, 2009); *Southworth v. Hartford Inv. Fin. Servs.*, LLC, No. 10-CV-878 (D. Del. Filed Oct. 14, 2010).

4 *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982). Under the *Gartenberg* standard, a plaintiff must prove that the fee was so disproportionately large that it bore no relationship to the services rendered and could not have been the result of arms-length negotiation. *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010).

5 *Id. (citing Gartenberg*, 694 F.2d at 930).

6 15 U.S.C. § 80a-15(c).

7 *Jones, supra* n.4, at 1429.

8 *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 412 (2d Cir. 1989), *cert. denied*, 493 U.S. 919 (1989).

9 *Gartenberg, supra* n.4.

10 *Id.*

11 *Krinsk, supra* n.8; *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1 222, 1238-41 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991), *cert. denied*, 502 U.S. 818 (1991).

12 *See Kalish, Id.*

13 *Id.* at 1239.

14 *Id.*

Koji Felton
San Francisco
+1 415 262 4521
koji.felton@dechert.com

An Analysis of the EU and U.S. Regulations Affecting OTC Derivatives

(continued from page 5)

Margin

EU

Counterparties to OTC derivatives transactions will be required under EMIR to post both initial margin and variation margin to the clearing member, who in turn will post the margin with the CCP. Variation margin is intended to cover the risk of fluctuations in the market value of a derivatives contract, while initial margin is an additional protection against potential risks not covered by variation margin.

A CCP can only receive highly liquid collateral with minimal credit and market risk to protect against initial and ongoing exposure to clearing members.

Under current bilateral contractual relationships between OTC derivatives counterparties, margin is not posted — instead, collateral is called based on negotiated collateral terms that are commonly found in a Credit Support Annex. This collateral can be one-way, where one of the counterparties is better capitalised, ensuring it receives rather than posts collateral. Under EMIR, both counterparties would have to meet the more stringent and frequent margin requirements that would be based on exposure to the other counterparty rather than bilateral negotiated terms.

Alternative investment funds that are required under the Alternative Investment Funds Managers Directive ("AIFMD") to maintain a depositary may experience operational issues by having to make frequent transfers of margin between the depositary they are required to appoint under the terms of the AIFMD, and the CCP.

U.S.

Both initial and variation margin will be required for each swap and security-based swap that is entered into with a swap dealer, major swap participant, security-based swap dealer or security-based major swap participant.

For cleared swaps and security-based swaps, the margin requirement for swap dealers and major swap participants will be determined by the DCO or securities clearing agency, as applicable. Only a CFTC registered futures commission merchant ("FCM")

can accept and hold margin for a cleared swap and only a SEC registered broker, dealer or security-based swap dealer can accept and hold margin for a cleared security-based swap. Buy-side users are currently negotiating annexes to their trading account agreements pursuant to which they will post required margin. The intermediaries will in turn be required to post certain amounts of margin to the relevant DCO or SEF.

Dodd-Frank put in place certain customer protection principles relating to margin posted to support OTC derivatives. The CFTC has adopted rules that impose requirements on FCMs and DCOs to protect cleared swap customer contracts and related collateral and enhance portability of cleared swaps in the event of an FCM's bankruptcy. The SEC is currently working on similar rules.

For non-cleared swaps, the margin requirement for swap dealers and major swap participants, security-based swap dealers and security-based major swap participants will be determined by the appropriate federal banking agency, or the CFTC or the SEC, as applicable.

For non-cleared swaps, Dodd-Frank provides that the counterparty that is a commercial end-user may require that the initial margin is segregated and held with a third-party custodian.

Many of the substantive margin requirements imposed by Dodd-Frank remain yet to be implemented by the CFTC or SEC, as applicable.

Reporting

EU

EMIR places reporting obligations in relation to cleared and uncleared derivatives contracts on financial and non-financial counterparties. Details of all concluded

OTC or exchange-traded derivatives contracts must be reported to a registered or recognised trade repository no later than the working day following execution, clearing or modification of the relevant contract. At a minimum, the information must include the parties to the contract and the beneficiary of the rights and obligations arising from the contract.

Trade repositories are required to publish aggregate positions by class of derivatives on non-discriminatory terms. Where a trade repository is not available to record the details of an OTC derivatives contract, counterparties and CCPs are responsible for ensuring that the details of the OTC derivatives contracts are reported to the European Securities and Markets Authority ("ESMA").

Non-financial counterparties only have to report the details of OTC derivatives contracts where an information threshold has been exceeded. This threshold is still to be specified. If the threshold is not exceeded, then the reporting obligations will not apply to non-financial counterparties.

MiFID II gives EU Member State regulators the authority to demand information from any entity regarding the size and purpose of a derivative position. They may then require that entity to reduce the size of that position.

MiFID II will also require all trading venues to abide by identical transparency requirements. Pre-trade rules will require prices and the depth of trading interests to be published on a continuous basis during normal trading hours. Post-trade rules will require that the price, volume and time of transactions are published as close to real-time as possible.

In addition to the EMIR reporting obligations above, MiFID II has also extended the scope of its transaction reporting requirements so that the only instruments escaping the reporting requirement will be (i) instruments not admitted to trading on a multilateral trading facility ("MTF") or organised trading facility ("OTF"); (ii) instruments whose value does not depend on that of financial instrument admitted to trading or traded on an MTF or OTF; and (iii) traded instruments that will not have an impact on an instrument admitted for trading or traded on an MTF or OTF.

U.S.

Every party that enters into any swap (or terminates, assigns, transfers or amends a swap, among other things) is potentially required to report such swap to a swap data repository or a security-based swap repository, or the CFTC or SEC, as applicable, if a swap data repository would not accept the relevant swap. The reporting requirements apply to most swaps, except for limited categories such as internal swaps between wholly owned subsidiaries, whether executed on a regulated trading platform (such as a swap execution facility) or off-exchange.

For swaps executed on a regulated trading platform, the platform must report the positions. For off-facility swaps, an entity that participates in such swaps will be required by the SEC or CFTC to maintain books and records in regards to such swaps, which will be open to inspection by the SEC or the CFTC, as appropriate. The responsibility for reporting such off-facility swaps depends upon which counterparty is better suited to make the report as designated in the applicable CFTC or SEC rules. The CFTC has adopted rules in this area, but the Dodd-Frank required reporting requirements have yet to be implemented by the SEC.

Trading Venues

EU

MiFID II requires that trading of standardised OTC derivatives on exchanges or electronic trading venues and which are capable of being cleared under EMIR be moved to one of the following: (i) a regulated market; (ii) an MTF; (iii) a systematic internaliser ("SI"); or (iv) a proposed new trading venue, the OTF.

OTFs have been designed to cover all unregulated trading that has until now taken place outside the official MiFID trading venues in unregulated arrangements such as broker-crossing systems and inter-dealer broker systems.

ESMA will identify and require certain classes of derivatives only to trade through regulated markets, MTFs, OTFs or non-EU trading venues located in a country that imposes requirements equivalent to those in MiFID II. It is envisaged that only ad hoc trading in shares, bonds and non-standardised derivatives will be allowed to continue on an OTC basis and outside of trading venues. In deciding whether a class of derivatives must trade through trading venues, ESMA will consider the liquidity of that class, evaluating such factors as size of positions and average frequency of transactions.

MiFID II will cause EU counterparties to be subject to the trading venue requirement when they enter

into transactions with non-EU entities that would be subject to the EMIR clearing obligations if they were established in the EU. Even if there is no participation by an EU counterparty, third-country entities will be subject to the trading venue requirement where (i) they would be subject to the EMIR clearing obligation if they were domiciled in the EU and (ii) the contract has a "direct, substantial or foreseeable effect within the EU".

U.S.

Dodd-Frank requires that all swaps and security-based swaps that are required to be cleared are also to be made available to trade on a regulated exchange or a swap or security-based swap execution facility ("SEF"), unless no SEF is willing to list the swap. An SEF is defined as a trading system or venue that is not an exchange but that is open to, and allows, multiple participants to execute or trade swaps by accepting bids and offers by other participants.

Position Limits

EU

Where there is a significant price movement in a particular commodity derivative, trading venues that trade such commodity derivatives must apply clear, transparent and non-discriminatory limits to the number of contracts that traders can enter into over a short time period as determined by the EU Commission. In exceptional cases, national regulators can impose more restrictive limits for a period of six months.

U.S.

In accordance with a Dodd-Frank mandate, the CFTC has established position limits for swaps relating to 28 physical commodities, including referenced energy, metal and agricultural exchange-traded futures, incorporating OTC derivatives into the CFTC's existing position limits regime. There is a limited exclusion for bona fide hedges in physical commodities.

These position limits will be aggregated across entities where, subject to certain limitations and exemptions, a person controls the trading decisions and all the positions in which that person has a ten percent or greater ownership interest (directly or indirectly) in the relevant swap (e.g., a 10% or greater owner of a fund). Swap positions entered into prior to the enactment of Dodd-Frank will be exempt from the position limits.

For security-based swaps, the SEC may impose limits on the size of positions held by any person, and may require reporting by such persons. Such limits may be required to be aggregated with positions in the securities or loans that the security-based swap is based upon or references, or to which it is related, or any group or index of securities that is the basis for a material term of the security-based swap or any instrument relating to the same security or group or index of securities.

Conclusion

The U.S. and EU regulations on OTC derivatives will affect financial services participants in profound and material ways. Affected clients will likely face higher operational costs, more stringent reporting requirements and the added burden of higher margin and collateral requirements. Existing ISDA master agreements will likely need to be amended to allow for the new clearing regimes.

The impact on existing derivatives products and what the level of collateral requirements for central clearing will be, is as yet unknown. It is worth noting, however, that the higher global banking capital requirements of Basel III may undermine regulators' commitment to uniformly high collateral requirements for central clearing, as the cost to the already beleaguered global banking industry may be too punitive in the context of a weakening global economy.

Whatever the consequences, institutions likely to be affected by the changes in OTC derivatives regulation should note that the impact of the proposals will be adverse cost implications, stricter operational and reporting requirements and the likelihood that there will be fewer types of derivatives products in the market.

Richard Frase
London
+44 20 7184 7692
richard.frase@dechert.com

Alexander Pannett
London
+44 20 7184 7442
alexander.pannett@dechert.com

Philip Hinkle
Washington, D.C.
+1 202 261 3460
philip.hinkle@dechert.com

Upcoming and Recent Events

JULY 11, 2012
The Euro-Banking Crisis: the Impact on Banks and Their Investors and Clients
Webinar

The impending solutions of the financial crisis in Europe will inevitably impact European banks and their investors. This webinar will focus on bank resolution strategies that may be adopted, recapitalization options and issues, the role of the Federal Reserve Board in approving European bank recaps, and the impact of deleveraging and asset dispositions.

JULY 5, SEPTEMBER 25, OCTOBER 16 AND NOVEMBER 15, 2012
AIFMD Breakfast Briefings
London

The Alternative Investment Fund Managers Directive is the most important European legislative process faced by the alternative funds industry. Directed at general counsels, COOs and compliance officers, this series of breakfast sessions will cover the impact of AIFMD on fund managers. The first session will consider planning strategies and a timetable, with one year to go until implementation. Later sessions will explore: marketing opportunities and restrictions; the effect on funds' relationships with prime brokers, OTC counterparties, administrators and valuers; and operational and compliance requirements.

JUNE 28, 2012
Euro Crisis Webinar Series: Hedge Fund and Trading Considerations: Risks and Mitigants
Webinar

European financial markets have experienced volatility based on concerns regarding rising government debt levels, credit rating downgrades, possible defaults on or restructuring of government debt, and possible contraction or restructuring of the Eurozone. This webinar will focus on how managers of private investment funds can ensure that they can react to a Eurozone event with maximum flexibility while complying with regulatory and contractual requirements. Topics include: possible Eurozone events and consequences; fund structuring and restructuring; disclosure issues; valuation and redemption policies and practices; counterparty and broker exposures; and trading and custodial documentation.

JUNE 21, 2012
Hedge Fund Litigation/Regulation Triple Play
New York

During this seminar, Dechert Financial Services and White Collar and Securities Litigation partners, including the former lead prosecutor in the Galleon insider trading case *United States v. Raj Rajaratnam*, discussed topics in regulatory and litigation issues facing hedge funds, including the SEC's increased focus on GC/CCO liability and DOJ and SEC insider trading investigations.

JUNE 20, 2012
Fundamentals of CFTC Registration and Compliance: What Private Fund Managers Need to Know
Webinar

The U.S. Commodity Futures Trading Commission recently adopted final rules that modify or eliminate certain CFTC registration and operational exemptions widely used by U.S. and non-U.S. private investment fund managers. As a result, private funds (including certain mutual fund subsidiaries) that use commodity futures, commodity options, or many other derivatives face a significantly altered regulatory landscape. This webinar covered the regulatory overhaul and its impact on private funds.

JUNE 13, 2012
Euro Crisis Webinar Series: Issues Affecting Fund Management
Webinar

This webinar focused on potential issues and oversight actions that should be considered by the management and boards of U.S. and non-U.S. funds. Topics included key issues from the Euro Crisis that could impact U.S. registered funds, UCITS and QIFs/SIFs — in particular, what boards should consider, analysis of fund documentation, risk management, portfolio and share class exposure, investment management agreements, service provider and counterparty agreements, custody arrangements and liquidity and valuation. Also discussed were ways to be pro-active, and how the Euro Crisis could impact funds that do not invest in European sovereign debt.

JUNE 12 AND MAY 15, 2012
Offering Your Fund in the United States: Tips and Traps
London and Hong Kong

This seminar was designed to demystify the technical requirements of the U.S. private offering rules. Topics covered included types of U.S. private offerings, Form D requirements, consequences of failure to comply, the JOBS Act and recent CFTC changes.

JUNE 8 AND JUNE 6, 2012
UCITS – A Vehicle of Choice for U.S. Fund Promoters: Current and Future Developments
Boston and New York

This seminar highlighted certain regulatory changes that will impact UCITS and provided an update on UCITS IV and insight into the agenda for UCITS V. Panelists discussed regulatory challenges faced by U.S. managers in the current regulatory environment in organizing and distributing UCITS globally.

For more information, or to receive materials from the seminars and recordings from the webinars listed above, please contact Beth Goulston at +1 202 261 3457 or beth.goulston@dechert.com.

Financial Services Contacts

For more information, please contact the authors, one of the partners or counsel listed or any Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/financial_services.

Karen L. Anderberg
+44 20 7184 7313

David L. Ansell
+1 202 261 3433

Peter D. Astleford
+44 20 7184 7860

Adrienne M. Baker
+1 617 728 7151

Margaret A. Bancroft
+1 212 698 3590

Sander M. Bieber
+1 202 261 3308

Stephen H. Bier
+1 212 698 3889

Gus Black
+44 20 7184 7380

Thomas C. Bogle
+1 202 261 3360

Julien Bourgeois
+1 202 261 3451

Laura M. Brank
Moscow:
+7 499 922 1122
Washington, D.C.
+1 202 661 3484

Kevin F. Cahill
+1 949 442 6051

Susan M. Camillo
+1 617 728 7125

Christopher D. Christian
+1 617 728 7173

Elliott R. Curzon
+1 202 261 3341

Carl A. de Brito
+1 212 698 3543

Douglas P. Dick
+1 202 261 3305

Olivier Dumas
+33 1 57 57 80 09

Karl J. Paulson Egbert
+852 3518 4738

Koji E. Felton
+1 415 262 4521

Carsten Fischer
+49 6977 06 19 42 11

Joseph R. Fleming
+1 617 728 7161

Brendan C. Fox
+1 202 261 3381

Richard Frase
+44 20 7184 7692

Robert M. Friedman
+1 212 649 8735

Allison Harlow Fumai
+1 212 698 3526

David M. Geffen
+1 617 728 7112

John Gordon
+44 20 7184 7524

David Gubbay
+44 20 7184 7420

Chris Harran
+971 4 425 6329

David J. Harris
+1 202 261 3385

Christopher P. Harvey
+1 617 728 7167

Richard L. Heffner, Jr.
+44 20 7184 7665

Robert W. Helm
+1 202 261 3356

Richard M. Hervey
+1 212 698 3568

Richard Horowitz
+1 212 698 3525

Andrew Hougie
+44 20 7184 7373

Martin Huewel
+49 89 21 21 63 35

Basil H. Hwang
+852 3518 4788

Megan C. Johnson
+1 202 261 3351

Jane A. Kanter
+1 202 261 3302

Geoffrey R.T. Kenyon
+1 617 728 5694

Matthew K. Kerfoot
+1 212 641 5694

Steven P. Kirberger
+1 212 698 3698

Robert H. Ledig
+1 202 261 3454

Angelo Lercara
+49 89 21 21 63 22

Angelyn Lim
+852 3518 4718

Stuart Martin
+44 20 7184 7542

George J. Mazin
+1 212 698 3570

Gordon L. Miller
+1 202 261 3467

Michelle Moran
+353 1 436 8511

Jack W. Murphy
+1 202 261 3303

Antonios Nezeritis
+352 45 62 62 27

John V. O'Hanlon
+1 617 728 7111

Declan O'Sullivan
+353 1 436 8510

Reza Pishva
+1 213 808 5736

Edward L. Pittman
+1 202 261 3387

Jeffrey S. Puretz
+1 202 261 3358

Achim Pütz
+49 89 21 21 63 34

Jon S. Rand
+1 212 698 3634

Robert A. Robertson
+1 949 442 6037

Keith T. Robinson
+1 202 261 3438

Antoine Sarailler
+33 01 57 57 80 16

Kevin P. Scanlan
+1 212 649 8716

Marc Seimetz
+352 45 62 62 23

Jeremy I. Senderowicz
+1 212 641 5669

Michael L. Sherman
+1 202 261 3449

Hans Stamm
+49 89 21 21 63 42

Mark Stapleton
London:
+44 20 7184 7591
Moscow:
+7 499 922 1100

Stuart Strauss
+1 212 698 3529

Richard J. Temko
+32 2 535 5430

Patrick W.D. Turley
+1 202 261 3364

Brian S. Vargo
+1 215 994 2880

Thomas P. Vartanian
+1 202 261 3439

David A. Vaughan
+1 202 261 3355

Henry Wang
+8610 5920 4306

Benedikt Weiser
+49 6977 06 19 42 20

M. Holland West
+1 212 698 3527

Jennifer Wood
+44 20 7184 7403

Anthony H. Zacharski
+1 860 524 3937

Robert Zack
+1 212 698 3522

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+1 215 994 2644

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Gus Black
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Megan C. Johnson
+1 202 261 3351

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