ALLEN & OVERY

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Asset Management Group

2012/2013: Challenging years for European asset managers

EDITORIAL

European asset managers face significant regulatory challenges in the remainder of 2012 and in 2013. The impact of new regulation will be substantial and will cause upheaval and change in the sector. Allen & Overy's Asset Management Group has summarised European and US areas of regulation that will impact European asset managers, looking at the policy behind each, timelines for its implementation, business models in scope and, most importantly, the potential impact on your business. Links to more detail are included in each section.

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- Dodd-Frank Act – Volcker Rule
- Dodd-Frank Act – Designation of Systemically Important Financial Institutions
- Securities Exchange Act – Large Trader Reporting

For further information on regulatory change affecting the asset management industry please see **GlobalView**, Allen & Overy's regulatory tracker: www.aoglobalview.com. The site provides forward-looking and historical timelines for policy implementation, as well as links to source materials and Allen & Overy briefings on the relevant regulations.

European regulation

ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

What is the policy?

Like the vast majority of new regulation facing the sector, the AIFMD is a by-product of the financial crisis. In recognition of the size of investments now owned by alternative investment funds (**AIFs**) and controlled by their alternative investment fund managers (**AIFMs**), regulators see it as systemically important to have a co-ordinated pan-European Union (**EU**) approach as to how AIFs wherever established should be (i) managed, (ii) use depositaries and (iii) leverage, value their assets and market their interests to European-based investors. Compliance with this new approach will enable authorised AIFMs to use a pan-EU marketing passport to distribute their AIFs to those target investors who are classified as MiFID "professional clients". The requirement on AIFMs to become authorised and the availability of the European passport will come into effect over a series of phases that will be concluded, at the earliest, in 2018.

When does it come into effect and what is going to happen before it does?

The AIFMD came into force on 1 July 2011 and, as a Level 1 EU directive, is due to be transposed into local law in each of the EU member states by 22 July 2013. Prior to that date the Level 2 measures which add further detail to the rules are to be finalised by the European Commission (the **Commission**). In November 2011 the European Securities and Markets Authority (**ESMA**) issued its final advice on a significant number of those Level 2 measures (the **ESMA Level 2 Advice**).

Since then ESMA has published further AIFMD related consultation and discussion papers, notably a discussion paper on key concepts in the AIFMD (including guidance on the scope of the terms AIFM and AIF under the AIFMD) and a consultation paper on sound remuneration policies under the AIFMD.

The next important milestone will be the publication of the final Level 2 measures by the Commission (the **Final Level 2 Measures**). The Commission has delegated powers to implement Level 2 measures. During the course of spring 2012, the Commission's draft Level 2 measures were sent by the Commission to the European Parliament and European Council and subsequently leaked to the public. Those Commission draft Level 2 measures diverged in several key aspects from the ESMA Level 2 Advice (see further below).

It is expected that the Commission will publish the Final Level 2 Measures in the next few weeks. This will then pave the way for legislators and national regulatory bodies to prepare and adopt further national implementing legislation and work on such local measures is already underway in several member states.

In addition, it is expected that ESMA will, following on from its discussion and consultation papers issued this year, finalise draft regulatory technical standards on key concepts within the AIFMD for Commission endorsement by the end of the year and also adopt a final text of guidelines on sound remuneration policies under the AIFMD.

How could your asset management business be within its scope?

If your regular business is to take investment decisions for, or to provide risk management services to, any fund or other collective investment undertaking (which is broadly and vaguely defined in the AIFMD) which is not authorised as an UCITS (ie that collective investment undertaking is an AIF) then you are likely to be subject to the AIFMD. This is because you fall to be classified as an AIFM and the AIFMD looks to regulate each AIFM (rather than directly regulate the AIF it services). Once the AIFMD is transposed into local law its impact on each

AIFM and that AIFM's AIF(s) will depend on whether that particular AIFM has its registered office in an EU member state (an **EU AIFM**) or outside the EU (a **Non-EU AIFM**), and whether a relevant AIF is authorised, registered or has its registered office in an EU member state (an **EU AIF**) or outside the EU (a **Non-EU AIF**).

If your business is indirectly appointed (eg as a sub-manager) to take investment decisions for, or to provide risk management services to, any AIF then your business may be subject to the AIFMD. This is either because (i) your relationship with the relevant AIF is such that you (rather than the directly appointed manager) are going to be characterised as the AIFM to that AIF or (ii) you are the delegate of the AIFM and that AIFM, if it is an EU AIFM, will be subject to rules on how it can delegate and its retention of liability (which it will probably want to contractually provide for in its delegation to you).

What will it mean for your business?

If you are an EU AIFM and have any AIF(s) that you want to market in your home state or other EU member states then from 22 July 2013 you will have to be authorised by your local regulator and conduct your business in compliance with the AIFMD. However, if you do not wish to market your EU AIF(s) in EU member states from that date, you will have one year to apply for authorisation. If you are already a MiFID firm, getting regulated as an AIFM may be as simple as topping-up your existing license with your regulator. However, the conduct of business upheaval is likely to be significant. For example, the AIFMD introduces rules on remuneration of employees in any authorised AIFM. Being regulated will also impact on the relationships that the AIFM's AIF has with its other service providers due to your status as an EU AIFM which requires you to ensure the AIF(s) meets certain standards (eg on using leverage and having a depositary and an independent valuations process). This is likely to mean the contracts with those other service providers need to be amended. If as an EU AIFM you market your relevant EU AIF(s) in the EU then you must use the pan-EU marketing passport, but for non-EU AIF(s) you can continue to market using any available private placement regimes (**PPRs**) which EU member states decide to retain post 22 July 2013 (nb there is nothing that obliges those members states with PPRs to do so and Germany, for example, has recently announced plans to abolish its PPR post 22 July 2013), provided that such non-EU AIF(s) also meets certain requirements imposed by the AIFMD.

What are the remaining key issues?

There are few concepts and provisions in the AIFMD that have not attracted some form of criticism or contention. The below however is a short overview of certain key points that remain to be settled. It is hoped that closure on many of these will come when the Commission publishes the Final Level 2 Measures.

– Delegation arrangements (letter box entity)

  The AIFMD states that an AIFM must not delegate functions to such an extent that it becomes a "letter box entity" and hence can no longer be considered as an AIFM. Uncertainty still exists over the concept of a letter box entity with the Commissions draft Level 2 measures diverging from the ESMA Draft Level 2 Advice. The ESMA Draft Level 2 Advice had proposed that an AIFM becomes a letter box entity when it no longer has the necessary powers and resources to supervise delegation or no longer has the power to take decisions in key areas falling under responsibility of senior management (in particular in relation to implementation of the general investment policy and strategies).

  The Commission, whilst retaining these two alternative limbs, has added a further alternative limb proposing a quantitative test where an AIFM would be considered a letter box entity if the tasks delegated exceed the tasks remaining with the AIFM. It remains to be seen whether this addition will find its way into the Final Level 2 Measures but at this stage it is unclear how this quantitative test would be assessed and monitored in practice, in particular in the case of self managed AIFs where a significant number of tasks are commonly delegated to third party providers. Further, adoption of this quantitative test would also create a divergence between the UCITS and AIFMD rules on delegation and make it more difficult for those entities that will be authorised under both the UCITS and the AIFMD regime to delegate the AIFM functions to the same entities as under a UCITS delegation.

– Depositaries

The Commission draft Level 2 measures went considerably further in scope than the ESMA Draft Level 2 Advice in fleshing out the obligations of and relating to depositaries, for example by expanding the list of points that need to be covered in the contract appointing a depositary. A key issue that remains unclear is whether certain collateral assets must be held in custody or are subject to a record keeping duty only. The Commission draft Level 2 measures extend the depositary's obligation to hold assets in custody where they have not been provided as collateral under the terms of a title transfer or under a security financial collateral arrangement transferring control or possession to the collateral taker. This potentially means that any collateral must be held in custody and will have implications for stock lending and the relationship between depositaries of an AIFM and custodians for collateral which may need to become sub-depositories. The Commission draft Level 2 measures also did not include several materiality/reasonableness qualifications, in particular in the context of depository liability.

– Professional Indemnity Insurance

The Commission draft Level 2 measures are considerably stricter and less permissive vis-à-vis AIFMs than the ESMA Draft Level 2 Advice. In particular, levels of coverage envisaged in the Commission draft Level 2 measures are higher and the Commission draft Level 2 measures do not allow for a combination of insurance and own funds as an alternative to just insurance. There is also a question mark over whether AIFMs will be able to access non-EU insurers due to the requirement in the Commission draft Level 2 measures that the insurance undertaking must be subject to prudential regulation and on-going supervision in accordance with EU law.

– Calculation of AuM

In calculating the AuM of an AIFM (which determines whether the AIFM is required to become authorised or not), the ESMA Draft Level 2 Advice had envisaged to exclude FX/interest rate hedging positions. The Commission draft Level 2 measures did not exclude hedging positions from the calculation of AuM. If this is tracked through to the Final Level 2 Measures, it may mean that AIFMs that to date had assumed they would fall outside the scope of the regulation will be covered by it.

– Remuneration

ESMA will be consulting with market stakeholders until the end of September on its draft remuneration guidelines. Reponses to the consultation will be considered by ESMA before it publishes its final guidelines before the end of the year. The draft guidelines are based on existing EU rules on remuneration for investment bankers and have received a mixed response from the asset management community. In particular, the draft guidelines, whilst making it clear that the AIFMD's principles on remuneration are to be applied proportionally do not offer much by way of specific guidance in the guidelines that will help AIFMs to determine whether or not their remuneration policies are in line with the AIFMD.

– Key concepts in the AIFMD

As noted above, in February 2012 ESMA published a discussion paper on key issues in the AIFMD that were singled out for further clarification such as the definition of the AIFM, the definition of an alternative AIF and the interaction of the AIFMD with the UCITS Directive and MiFID. A more extensive consultation paper was expected to be published in the second quarter of 2012 but this has not happened and it is currently not clear when this paper will be published. ESMA's stated aim is to issue technical guidance on these issues before the end of the year.

– Third country issues

Considerable concern remains over third country related provisions in the AIFMD, ie relating to Non-EU AIFM and AIFs, the interaction with third country regulators, appointment of third country depositaries and delegation of investment management to third country

managers. In all of these areas the Commission draft Level 2 measures significantly deviated from the ESMA Final Level 2 Advice and have attracted widespread criticism. In addition, two further specific third country related issues are considered in more detail below.

– AIFMD impact on feeder AIFs

To date, little attention has been given to the impact of the AIFMD on the structuring of funds that have a master/feeder structure and the impact of the AIFMD on those master/feeder structures that have a non-EU element whether at the master AIF or feeder AIF level. Feeder funds in such structures can still be offered to investors in the EU next year on the basis of PPRs where available and in compliance with certain conditions, in particular compliance with parts of the AIFMD (depending on how in scope the master/feeder structure is). However, it is ambiguous in the drafting of the AIFMD whether those provisions of the AIFMD that will be binding at the feeder AIF level will also need to be complied with at the master AIF level. This makes structuring any master/feeder structures with a non-EU element complicated and care will need to be taken to fully address the potential implications on distribution avenues in Europe when structuring such funds.

– Continuation of Private Placement Regimes past July 2013

In the initial phase of the AIFMD, the cross border marketing passport will not be available to non-EU AIF(s) (whether managed by a EU AIFM or a non-EU AIFM) and EU AIFs managed by non-EU AIFMs and those AIFs can continue be marketed using any available PPRs which EU member states decide to retain post 22 July 2013. There are growing concerns that from July 2013 certain member states will shut down their PPRs in light of plans announced to that effect by the German government. This may mean that from July 2013 access to an increasing number of markets in the EU will be restricted to EU AIFMs marketing EU AIFs.

Read more

We have prepared a number of client bulletins that go into significant detail about the scope of the AIFMD as well as the conduct of business issues affecting asset managers and other service providers to AIF:

Analysing the impact of the AIFM Directive

We have also prepared a consolidated version of the AIFMD and the ESMA advice on the Level 2 measures as a useful tool for anyone looking into the detail of the rules and principles contained within the directive. This is also available via the link above and will be updated once the Commission has issued the Final Level 2 Measures.

EUROPEAN MARKETS INFRASTRUCTURE REGULATION (EMIR)

What is the policy?

EMIR is the primary vehicle through which the EU is intending to deliver on the G20 commitment for mandatory clearing of standardised derivatives by the end of 2012. It mirrors similar initiatives in the US (as part of the Dodd-Frank Act) and elsewhere globally. The intention is to ensure efficient, safe and sound derivatives markets, reducing counterparty and operational risks, increasing transparency and enhancing market integrity. A key element to this is the increased use of clearing structures through central counterparties (**CCPs**).

EMIR introduces a mandatory CCP clearing obligation for "financial counterparties" in respect of certain "standardised" OTC derivatives – the clearing obligation does not extend to non-financial counterparties except those that deal in material volumes. There are also

potentially significant requirements in relation to OTC transactions which are not centrally cleared and reporting obligations for all OTC derivatives.

Certain elements of the regime remain unclear, particularly in relation to the extra-territorial effect of the requirements for business with a non-EU element and how EMIR requirements will interact with similar legislative initiatives elsewhere, such as Dodd-Frank and related rule making currently in progress in the US.

When does it come into effect and what is going to happen before it does?

EMIR entered into force on 16 August 2012 and is now binding and directly applicable in all EU Member States without the necessity for any further national implementation. However certain regulatory, legal and technical implementing standards (referred to below as the **Technical Standards**) must be drafted and adopted at EU level before the majority of the obligations contained in EMIR will become effective.

A consultation paper related to the draft Technical Standards on OTC Derivatives, CCP's and Trade Repositories (the **ESMA Consultation**) was published by ESMA in June 2012 and in the same month, a consultation paper related to the Technical Standards on capital requirements for CCPs (the **CCP Consultation**) was published by the European Banking Authority (**EBA**). A joint paper by ESMA, the EBA and the European Insurance and Occupational Pensions Authority (**EIOPA**) on draft Technical Standards in respect of risk mitigation techniques for non-cleared OTC derivatives (the **Joint Consultation**) has been delayed. Publication of the Joint Consultation is dependant on the completion of various other consultations - in particular, the Basel consultation on margin requirements for non-centrally cleared derivatives. All of the Technical Standards, once finalised, will need to be adopted into law, which although scheduled for the end of 2012, does not seem likely to be achieved in full at this date, particularly in respect of those Technical Standards relating to non-cleared trades.

How could your asset management business be within its scope?

The definition of "financial counterparties" who will be subject to the mandatory clearing obligation captures a broad range of EU authorised entities, including UCITS, institutions for occupational retirement provision (subject to delayed implementation for certain pension funds) and AIFs under the AIFMD. Even if you do not meet the "financial counterparty" definition, if you engage in material volumes of OTC derivative trading above a certain threshold other than for commercial hedging purposes for your clients, you or other asset managers they employ could cause them to become subject to the mandatory clearing obligation.

The thresholds have yet to be set but the ESMA Consultation proposes that thresholds will be calculated according to the aggregate notional value of OTC derivative contracts per asset class. The five proposed asset classes and thresholds are: credit derivatives (EUR 1 billion), equity derivatives (EUR 1 billion), interest rate (EUR 3 billion), foreign exchange (EUR 3 billion) and commodity/other (EUR 3 billion). When a threshold for one asset class is exceeded, it is proposed that the party will be subject to the mandatory clearing obligation in respect of all classes of OTC derivative contracts.

There are a number of exemptions set out in EMIR which can be summarised as the hedging exemption, the pension fund exemption and the intra-group exemption. Pursuant to the hedging exemption, a non financial counterparty will be able to disregard any transactions "objectively measureable as reducing risks directly related to [its] commercial activity" when calculating whether a threshold had been exceeded. The intra-group exemption means that certain OTC derivatives entered into between group companies will not need to be cleared and/or collateralised. The pension fund exemption is available to certain pension funds and relieves pension funds of the obligation to clear for an initial, extendable period of 3 years.

ESMA will identify which types of OTC derivative will be considered sufficiently standardised to be made subject to the mandatory clearing obligation (**Eligible Derivatives**). In principle, OTC derivatives referencing any type of underlying (including interest rates, FX, credit, commodities, equities) could be caught provided they meet the objective eligibility criteria established in EMIR. In practice, we expect that the regime will focus at the outset on the most liquid, vanilla contract types for which CCPs at that stage currently have live cleared offerings (in particular, interest rates and credit indices).

What will it mean for your business?

– Clearing

Those who are subject to the mandatory clearing obligation and deal in Eligible Derivatives, will be obliged to clear them either (i) by becoming a clearing member of a relevant CCP, (ii) by becoming a client of an entity which is a clearing member, or (iii) through an indirect clearing arrangement (ie becoming a client of a client of a clearing member). In respect of indirect clearing, consultation as to the nature of such a relationship is on-going. You will need to consider establishing any such necessary clearing relationships well in advance of the introduction of the obligation.

Cleared business will be subject to very different documentation, risk management (including CCP margin requirements) and cost considerations from OTC dealings (eg the delivery of liquid assets or cash as margin) so the impact on your business should be assessed as early as possible.

– Risk Mitigation

All parties must take certain risk mitigation measures with respect to all OTC derivative transactions which are not cleared in order to "measure, monitor and mitigate operational counterparty credit risk". These include for example timely confirmation, valuation, reconciliation, compression and dispute resolution in respect of OTC derivative transactions. ESMA have suggested that non-financial counterparties below the threshold would need to confirm their OTC derivative contracts as soon as possible and by the second business day following the trade day at the latest. Non-financial counterparties above the threshold and also financial counterparties are expected to confirm their OTC derivative contracts as soon as possible and at the latest by the end of the day when they entered into the contract.

Financial counterparties and non-financial counterparties above a threshold must also ensure the "timely, accurate and appropriately segregated exchange of collateral" with respect to trades which are not cleared.

This means that for OTC derivatives business that you continue to undertake on an uncleared basis, there are likely to be new prescriptive rules, particularly in respect of financial counterparties and non-financial counterparties above a threshold, to govern operational and credit risk which will lead potentially to intrusive levels of regulatory engagement in determining collateral levels, collateral type and related risk management processes. Guidance is awaited from the Joint Consultation on the details of this aspect of EMIR.

– Reporting

All parties must ensure that the conclusion, modification or termination of any derivative contract is reported to a trade repository no later than the working day following the conclusion, modification or termination of the contract.

Read more

Information regarding EMIR and related guidance is contained in the "Clearing" section of GlobalView and will be updated as matters progress.

UCITS IV, V & POTENTIAL VI DIRECTIVES

What is the policy?

The UCITS Directive, which set-out the first EU harmonised regulatory regime for European-based retail funds, has largely contributed to the development of the European investment funds industry allowing managers to distribute their UCITS in EU member states. UCITS is now considered to be a worldwide label of quality for retail funds deriving mainly from their investment rules and protections granted to the end-investors.

The UCITS IV Directive aims to simplify and reduce the cost of passporting UCITS in EU member states and creates a management passport for the benefit of European managers.

With the UCITS V Directive proposal, the Commission intends to strengthen the strict liability of UCITS depositaries and regulate the remuneration of the employees of UCITS managers in a manner similar to the measures set out for AIFM under the AIFMD, ie aligning the interests of UCITS managers with those of investors and reducing systemic risk.

UCITS VI is not yet at the legislative proposal stage – it is just a consultation – but it reviews various aspects including most controversially the scope of eligible assets as explained below.

When does it come into effect and what is going to happen before it does?

The UCITS IV Directive came into force in 2009 and had to be implemented in each EU member state by 1 July 2011. Member states were given an additional year, until 30 June 2012, to implement the requirement for UCITS to be marketed using key investor information documents (**KIIDs**) instead of simplified prospectuses. Between 1 July 2011 and 30 June 2012, if the local regulator put rules regarding KIIDs in place, it was possible to market a UCITS with either a simplified prospectus or KIID. As of 1 July 2012, the use of KIIDs is mandatory throughout all EU member states and simplified prospectuses will not be permitted anymore. The Level 2 measures were adopted on 1 July 2010.

The Commission has adopted, on 3 July 2012, the UCITS V Directive proposal, in order to amend the UCITS Directive, as regards depositary functions, remuneration policies and sanctions. The proposal has been submitted to the European Parliament and the Council for their consideration under the codecision procedure. Member States are then likely to have two years to transpose the provisions into their national laws and regulations, which means that the new rules could apply by the end of 2014.

How could your asset management business be within its scope?

If you are a UCITS management company or its delegate then you will benefit from the UCITS IV Directive reducing the previous barriers affecting UCITS. The marketing process under UCITS IV is simpler and faster as it only requires a notification to be sent from the UCITS home regulator to the host regulator. The old lengthy local registration process subject to the approval of the local regulator is no longer applicable. The host regulator cannot deny the registration of a structured UCITS, even where it may have doubt about the eligibility of the underlying financial index of the structured UCITS under the UCITS Directive.

As a result of the management passport, a UCITS management company is now authorised to set-up and manage UCITS established in another EU member state on a cross-border basis or through a branch. There is no longer any need to go through a local UCITS management company to set up and manage local UCITS.

The implementation of UCITS IV is an opportunity for the rationalisation of the products range with the new feeder/master and cross border merger regimes, subject to the expected clarification of the applicable tax treatment. This rationalisation will improve the competitiveness of European asset management activities through economies of scale in the marketing of UCITS (mainly through feeder funds) and trigger the increase of the assets under management per UCITS.

The purpose of the UCITS V Directive proposal is to provide (i) a definition of the tasks and liabilities of the depositary of a UCITS fund; (ii) clear rules on the remuneration of UCITS managers, ie by impacting the way they are remunerated and fostering remuneration policies that are better linked with the long-term interest of investors and the achievement of the investment objectives of the UCITS; and (iii) a common approach to how core breaches of the UCITS legal framework are sanctioned, introducing common standards on the levels of administrative fines so as to ensure they always exceed potential benefits derived from the violation of provisions. This could have a significant impact on UCITS management companies and managers insofar as their remuneration policies are in place, but also as breaches of UCITS management rules could lead to potentially higher fines.

What will it mean for your business?

Based on the management passport, the delegation route as well as the up-coming new regulatory synergies with the AIFM regulated status, it is a good time to revisit your organisation and location of fund management companies within or outside the EU to ensure that the investment management, risk management, administrative and marketing functions are run in the best EU or non-EU location, whether within entities locally regulated or not. This may entail a regulatory arbitrage between core and non-core fund/asset management activities driven by a cost/profitability approach.

Once the UCITS V reform is finalised and adopted it may be necessary to revisit your custodian delegation structure as well as your remuneration policies.

ESMA Guidelines on ETFs and other UCITS issues

On 25 July 2012, ESMA published its guidelines on ETFs and other UCITS issues (the **ESMA Guidelines**) along with a consultation for guidelines on recallability of repo and reverse repo arrangements (the **Repo Guidelines**). Once the Repo Guidelines are published, UCITS managers will have 12 months to comply with most provisions of both sets of guidelines.

The ESMA Guidelines will have a significant impact on index-tracking UCITS, including more particularly UCITS ETFs, which will have to increase significantly the level of disclosure to investors, but also ensure that when the stock exchange value of the units of the UCITS significantly varies from its net asset value, investors who have bought their units on the secondary market are allowed to sell them directly back to the UCITS ETF. The level of disclosure to investors is also increased for UCITS using efficient portfolio management techniques and OTC derivatives instruments which are also the subject of additional obligations. These obligations include in particular the requirement that revenues arising from efficient portfolio management techniques are returned to the UCITS and that the UCITS is able at any time to recall any security that has been lent out or terminate any securities lending agreement into which it has entered.

Under the ESMA Guidelines, the agreement with a counterparty to an OTC derivative which has discretion over the composition or the management of the underlyers of such OTC derivative will be considered as an investment management delegation for the purposes of the UCITS Directive. More stringent rules on collateral for both efficient management portfolio techniques and OTC derivatives are also introduced, which include for instance the requirement to ensure appropriate liquidity, composition, diversification, valuation, quality as well as to comply with new rules on the re-investment of such collateral. Specific stress tests will be required where the UCITS receives collateral for at least 30% of its assets.

The ESMA Guidelines have also clarified and restricted the scope of the rules applicable to financial indices in a way that has already started to reshape the investment structure of certain sophisticated UCITS, in particular where such structure's purpose is to give exposure to the commodities universe. These new rules include additional consideration to be given when a UCITS seeks to ensure that a financial index is diversified, appropriately published and represents a benchmark for the market to which it refers. One significant consequence of these new rules is that daily-rebalanced indices and single commodity futures indices will be banned, even as underlyers of OTC derivatives in which a UCITS invests.

UCITS VI?

Building primarily on the ESMA Guidelines, the Commission launched on 26 July 2012 a consultation with a view to improving the UCITS framework on key points such as the regulation of money market funds in the future, the involvement of UCITS in securities lending and repo

arrangements and the exposure to certain OTC derivatives. The consultation also seeks to discuss the approach to investors' redemptions, the possibility of a depositary passport and the means to foster long-term investment. The consultation also seeks to make a first review of UCITS IV by making an assessment of whether the UCITS IV rules may require improvements.

The asset management industry has reacted to the publication of the UCITS VI consultation with fear that the reduction of eligible assets for UCITS could constitute a challenge to the viability of certain existing products and would entail additional restructuring in the future. However, the consultation is worded in very open question explanatory format and it is not possible at this stage to know what a possible draft UCITS VI legislation may look like.

Read more

We have prepared a bulletin on the interactions and overlaps between AIFMD, UCITS IV & V Directives and MFID:

AIFMD, UCITSD and MiFID: Interactions and Overlaps

MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MIFID II)

What is the policy?

The Commission cites several reasons for the revision of MiFID, one of which is investor protection. One aspect of this is the Commission considers that banks and other financial intermediaries give tainted advice, as they are strongly motivated by inducements paid by product providers such as asset managers. The Commission also considers that this applies to asset managers that allocate products for which they receive retrocession payments, rather than stocks or bonds. The Commission intends to prohibit the acceptance of inducements by asset managers. As regards advisors, they will be given the choice to either inform the client that their advice is not independent – in which case they can continue to receive inducements – or to tell their clients that their advice is independent, which means that they would no longer be able to accept inducements.

When does it come into effect and what is going to happen before it does?

MiFID II will probably come into force in 2012, and will have to be implemented by EU member states in 2014 at the latest. While few market participants think that the proposed rules on inducements will become more liberal, it is known that some members of the European Parliament want to ban advisers from accepting inducements completely, rather than giving them the choice of declaring themselves as non-independent.

How could your asset management business be within its scope?

If you are an asset manager that makes, or whose funds make, retrocession payments then you may be indirectly affected by MiFID II. Your third party distributors, who receive those retrocession payments when selling your products may no longer be allowed to accept such fees. Therefore, they may be more inclined to sell other, non-retrocession paying products. Fund-linked insurance products may be favoured by distributors, as such products are not currently be caught by the revised Directive.

What will it mean for your business?

Selling your funds may become less attractive for your third party distributors. This is true for all funds that pay retrocessions. While some fund products that pay little or no retrocession fees may not be affected by the proposals, products such as ETFs may be caught by other current MiFID II proposed changes. For example, synthetic ETFs, which do not physically replicate an index, but through a total return swap, may be adversely affected by MiFID II if they can no longer be sold on an "execution-only" basis. Rather, synthetic ETFs may be considered "complex products", which can only be sold subject to the seller having conducted an appropriateness test. The need to conduct such a test may act as a disincentive for the selling of such complex funds.

Read more

We are preparing a number of bulletins providing more information about MiFID II. The bulletin linked to below explains in more detail the new rules applicable for banks product originators who distribute products to retail clients:

MiFID Review: the impact on your business with private clients

SOLVENCY II

What is the policy?

Solvency II is the new prudential regime for most insurers and reinsurers authorised in the European Economic Area (**EEA**) which will replace the existing framework for prudential supervision. A key aim is to align each undertaking's solvency requirements and assets with the risks inherent in its business.

When does it come into effect and what is going to happen before it does?

The transposition date for Solvency II is not yet final and is the subject of ongoing debate, including the potential to delay by a year. The current scheduled date that Solvency II will have to be transposed into Member State law by is 1 July 2013 – according to a recent draft Directive – and implemented by insurers and reinsurers from 1 January 2014. The Level 2 measures, which contain the detailed provisions of the Solvency II regime, are not yet final, but are expected to be published directly after the entering into force of the so called "Omnibus II Directive" which is expected in late 2012 (the European Parliament plenary vote is scheduled for 20 November 2012).

Why does Solvency II matter for asset management?

Insurers and reinsurers are important institutional investors: European insurers and reinsurers are the largest investors in Europe in absolute terms and the largest debt investors (Fitch 2011). Investment by insurers and reinsurers accounts for 30% of European managers' assets under management (Fitch 2011). Solvency II will affect investment decisions taken by insurers and reinsurers in the following ways:

- firms using a standard formula to calculate their solvency requirement will be required to apply a specified capital charge for the assets they hold. Riskier assets are likely to attract a larger capital charge, making them more "expensive" to hold. Anecdotally, high rated fixed income is likely to be less expensive than equity;
- it seems likely that insurers and reinsurers will no longer be subject to express asset and counterparty concentration requirements (even thought some drafts of national transposition acts want to stick to at least some quantitative restrictions). Insurers and reinsurers will rather be guided by the amount of capital they have to hold against each asset (by way of a capital charge), and by the "prudent person principle". The prudent person principle requires firms to invest only in "assets and instruments whose risks [it] can properly identify, measure, monitor, manage, control and report" and to invest in a manner which ensures the "security, quality, liquidity and profitability of the portfolio as a whole";
- investment by insurers and reinsurers in securitisations is likely to be more costly as a result of higher capital charges imposed in relation to asset-backed securities, and more practically difficult as a result of onerous due diligence requirements proposed to be imposed in relation to such investments; and
- we have seen (and advised on) increased interest in short to medium-term bonds and infrastructure and real estate loans by insurance companies already based on the proposed rules of Solvency II and the draft technical standards and Level 2 measures.

Does Solvency II have any extra-territorial effect?

Solvency II contains a concept of "third country equivalence" which permits entities in non-EEA jurisdictions to be treated favourably in certain respects

(especially in relation to the group solvency requirement). Countries seeking third country equivalence could implement Solvency II-like rules in order to gain equivalence, which might be expected to mean a similar treatment of assets to that set out in Solvency II.

Asset managers from outside the EEA seeking to court investment by EEA insurers will need to be mindful of the regulatory treatment their offering will receive under Solvency II. However, this also holds true with regard to European based asset managers also are already preparing for Solvency II optimised products.

Find out more

We have an international Solvency II information group exchanging Solvency II-optimised structuring ideas for both insurance companies and asset managers. The contacts listed at the end of this report will be able to assist you in contacting our Solvency II experts.

US regulation

COMMODITY EXCHANGE ACT – CPO AND CTA REGISTRATION AND REPORTING REQUIREMENTS

What is the policy?

As a result of recent changes to the Commodity Exchange Act (**CEA**) pursuant to the Dodd-Frank Act, a fund, SPV, trust or similar arrangement (**CP Entity**) that has entered, or will enter, into one or more swaps may be determined to be a commodity pool. This is an addition to the prior definition whereby a CP Entity that trades commodity interests, including futures contracts, forwards, options, forex, swaps or interests in other commodity pools, is regulated as a commodity pool.

A "**commodity pool**" is defined as any investment trust, syndicate or other enterprise operated for the purpose of trading any "**commodity interests**." A "commodity interest" under the CEA includes, among other things, options contracts, foreign exchange contracts and any contract for the purchase or sale of a commodity for future delivery (such as any futures or security futures product). The Dodd-Frank Act amended the definitions to include swaps within the definition of commodity interest.

Any management of or advice in relation to a CP Entity may subject one or more of the relevant parties to regulation by the United States Commodity Futures Trading Commission (**CFTC**) and the National Futures Association (**NFA**) as commodity pool operators (**CPOs**) and/or commodity trading advisors (**CTAs**), even if the party and/or the CP Entity is formed outside of the United States. Although the CFTC previously gave fund managers broad exemptions from CPO and CTA registration, disclosure, reporting, and record-keeping requirements based on an investor sophistication standard that was widely used in the private funds industry, the CFTC eliminated these exemptions from registration. (See CFTC Regulation 4.14(a)(5) and rescinded Regulation 4.13(a)(4).)

When did it come into effect?

The CEA changes will be effective as of 12 October 2012, though the CFTC has provided registration relief until 31 December 2012 for certain entities and may provide further registration relief for securitization vehicles.

Do any exemptions still apply?

CFTC Regulation 4.13(a)(1) continues to provide an exemption for any operator that operates only one privately offered pool for no compensation. CFTC Regulation 4.13(a)(2) provides an extreme de minimis exemption for any operator whose commodity pools have an aggregate subscription of $400,000 or less and less than

15 participants. Finally, CFTC Regulation 4.13(a)(3) gives a two-part test, and satisfying either of the prongs could give an exemption from regulation, provided interests in the commodity pool are exempt from registration under the Securities Act of 1933, and such interests are offered and sold without marketing to the public in the United States: (1) the aggregate initial margin/premium does not exceed 5% of the liquidation value of the CP Entity; or (2) the aggregate net notional value of commodity interest positions does not exceed 100% of the liquidation value of the CP Entity. However, there is uncertainty surrounding the calculation of aggregate initial margin/premium under the first prong of the CFTC Regulation 4.13(a)(3) exemption in the context of swap transactions (in particular because these tests were drafted for traditional commodity interests (ie, exchange-traded futures and options) rather than swaps), and it is unclear how many CP Entities will be able to take advantage of this exemption without further guidance from the CFTC.

What does it mean for your business?

Unless an exemption applies, each such commodity pool must have a CPO that is registered with the CFTC. Each commodity pool may also have a CTA that must be registered with the CFTC. The identity of these entities are factual questions:

- CPO: A CPO is defined as an entity that is engaged in a business that is of the nature of a commodity pool and that solicits, accepts, or receives from others funds, securities, or property for the purpose of trading in commodity interests. The identity of the CPO may be unclear in certain contexts (eg, the securitization context) and it may be necessary to consider this question in detail.

- CTA: A CTA is defined as an entity who, "for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value or the advisability of trading in," or who "for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning" commodity interests (including swaps). The CFTC has interpreted this definition broadly to include a wide range of entities (but does limit the concept to entities earning specific advisory fee for their service).

Registration as a CPO or CTA requires registering both the entity (in the case of a corporate CPO or CTA) and certain individuals or entities that own or are involved in the operation of the commodity pool. In addition, certain individuals will be required to meet CFTC proficiency standards, which may involve completing an examination. Please call or email your usual Allen & Overy contact if you would like more information, including a summary of the registration, disclosure, reporting and record-keeping requirements for CPOs and CTAs.

INVESTMENT ADVISERS ACT OF 1940 – REGISTRATION AND REPORTING REQUIREMENTS

What is the policy?

In 2010, the Dodd-Frank Act eliminated the "private adviser exemption" upon which many advisers or managers (including advisers or managers based outside of the US) had relied in order to avoid registering as an "investment adviser" with the US Securities and Exchange Commission (**SEC**). Instead, the Dodd-Frank Act now provides for three limited exemptions from registration for advisers to "private funds", the most relevant of which are the Foreign Private Adviser Exemption and the Private Fund Adviser Exemption.

The Foreign Private Adviser Exemption is available to any investment adviser that (i) has no place of business in the US, (ii) has, in total, fewer than 15 clients in the US

and/or investors in the US in private funds advised by the investment adviser, (iii) has aggregate assets under management attributable to such U.S. clients and investors of less than US$25 million, and (iv) does not generally hold itself out to the US public as an investment adviser.

The Private Fund Adviser Exemption is available to any investment adviser solely to private funds that have less than US$150 million in assets under management from the US. This exemption would be available to a non-US adviser whose activities in the US are limited solely to managing qualifying private funds, provided that, if the non-US adviser has a place of business in the US, it manages in aggregate less than US$150 million in private fund assets from such US place of business. A non-US adviser may advise non-US clients other than private funds from outside the US. A Private Fund Adviser would be deemed an "**Exempt Reporting Adviser**" and, while not required to register as an investment adviser with the SEC, must comply with certain reporting requirements regarding the private funds they advise and background information on their business operations.

When did it come into effect?

Any "investment adviser" that did not meet one of the three limited exemptions provided for in the Dodd-Frank Act was required to register with the SEC by 30 March 2012. Exempt Reporting Advisers were also required to file their initial reports on Form ADV by 30 March 2012.

What does it mean for your business?

Going forward, European asset managers must determine whether they fall into any of the exemptions from registration provided for in the Dodd-Frank Act, which requires a detailed facts and circumstances analysis. For example, calculating the number of US clients and investors may require looking through private funds to determine who would be an "investor" or a "client" for purposes of the Foreign Private Adviser Exemption. If it is determined that none of the exemptions are available, you must register with the SEC by completing Parts 1, 2A and 2B of Form ADV. In addition, registered investment advisers are required to adopt and implement policies and procedures that are reasonably designed to prevent and detect violations of the Investment Advisers Act of 1940 and other federal securities laws, as well as a written code of ethics. If you are deemed an Exempt Reporting Adviser, you must complete certain sections of Part 1 of Form ADV. Both the full registration and the reporting requirement for Exempt Reporting Advisers can be significant undertakings due to the detailed information requested. Asset managers should also take note that the SEC's Division of Enforcement has indicated that it will be scrutinizing Forms ADV to determine whether investment advisers have filed false or misleading information, and recent SEC enforcement actions have focused on advisers' compliance infrastructure.

Read more

We have prepared a client bulletin that goes into significant detail as to the scope of the registration and reporting requirements:

SEC Adopts New Advisers Act Rules, Pushes Back Filing and Reporting Dates to First Quarter 2012.

SECTION 619 OF THE DODD-FRANK ACT, AKA THE "VOLCKER RULE"

What is the policy?

In January 2010 following consultation with adviser and former regulator Paul Volcker, President Barack Obama proposed a rule (the **Volcker Rule**) aimed at restricting the ability of banks to engage in proprietary trading or own, invest in or sponsor hedge funds or private equity funds for their own profit. The simple principle behind the Volcker Rule was that financial institutions "should not be allowed to run … hedge funds and private equit[y] funds while running a bank backed by the American people". Despite no indication that funds had contributed to the financial crisis (and no attempt to link bank failure to private

funds) the President's administration was determined to protect taxpayers from further bail-outs by limiting fund sponsorship and investment.

When does it come into effect and what is going to happen before it does?

On 21 July 2010 the Dodd-Frank Act, which at section 619 set forth guiding principles for the Volcker Rule, became law. During the autumn of 2011 and the winter of 2012, all of the five federal agencies tasked with implementing the Volcker Rule published for comment their proposed implementing measures. These agencies received thousands of comment letters, and they are expected to issue a final rule by the end of 2012.

Although the Volcker Rule technically became effective on 21 July 2012, financial institutions have a two-year period to comply with its provisions. The compliance grace period ends on 21 July 2014, but after this date a financial institution can apply to the Board of Governors of the Federal Reserve System (the **Board**) for up to three additional one-year extensions to the grace period (potentially extending the period for compliance to 21 July 2017). In seeking to apply these extensions it should be noted that there is no guarantee they will be granted by the Board, which has broad discretion to accept or deny applications. In addition to the three one-year extensions, the Volcker Rule also provides for a five-year "illiquid fund exemption" for financial institutions that had a contractual obligation in respect of an illiquid fund that was in effect on 1 May 2010 (potentially allowing maximum extension of the grace period to 21 July 2022 in respect of illiquid funds). The Board has indicated that it intends to apply the illiquid fund exemption in a restrictive manner, retaining wide discretion to deny applications and adopting a very narrow definition of "illiquid fund".

In April 2012, the Board issued a statement that the conformance period is a period in which a banking entity can wind down, sell, or otherwise conform its activities, investments, and relationships to the requirements of the Volcker Rule. Further, the Board stated that a banking entity should "engage in good faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments … by no later than the end of the conformance period." These statements make clear that banking entities may continue to engage in existing activities and investments during the conformance period, at least until they are required to make good faith efforts to conform such activities and investments. However, no guidance has been provided to indicate when conformance efforts should begin.

How could your asset management business be within its scope?

The Volcker Rule applies to any "banking entity", which is defined to include (i) any insured depository institution, (ii) any company that controls an insured depository institution, (iii) any non-US banking organization with a branch or agency in the US and (iv) any affiliate or subsidiary of any of the foregoing. Because the Volcker Rule defines "banking entity" so broadly, its provisions will apply to the asset management arm of any bank that is subject to oversight by the Board due to a branch or agency in the US.

What will it mean for your business?

For all European banking entities, the Volcker Rule will require one or both of two courses of action:

- The banking entity will have to tailor its funds activities to fit in the Volcker Rule's "foreign funds exemption". We recently described the foreign funds exemption as well as issues surrounding its interpretation and future application in this e-Alert:

  The Volcker Rule and Foreign Banks, Part II: The "Foreign Funds Exemption" and the Outer Limits of Extraterritorial Reach

- If the foreign funds exemption is either not practicable or otherwise not desirable, the European banking entity will have to comply with the restrictions of the Volcker Rule. We give a general outline of these restrictions with interpretation of what they mean here:

  Walking a Narrow Path: The Proposed Volcker Rule and Bank-Affiliated Asset Managers

Read more

Including the items referenced above, we have prepared a number of client bulletins that go into significant detail as to the scope and meaning of the Volcker Rule and the obligations of banking entitites during the conformance period:

Agencies release proposal to implement Volcker Rule and request comment

The Volcker Rule and Foreign Banks Part I

"To Conform or Not to Conform": The Federal Reserve releases guidance on the obligations of banking entities under the Volcker Rule during the conformance period.

DODD-FRANK ACT – DESIGNATION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTIUTIONS (SIFIS)

What is the policy?

Congress created the Financial Stability Oversight Council (the **Council**) as part of the Dodd-Frank Act's efforts to mitigate the threat to US financial markets of systemic risk caused by the failure of a large banking entity or other large financial institution. The Council's task is to identify risks to the stability of the US financial markets. As part of this task, the Council is charged with designating certain large banking institutions and non-bank financial institutions as SIFIs. An institution that is deemed to be a SIFI is subject to enhanced regulation and supervision by the Board, as described below.

What types of companies are SIFIs?

SIFIs include (i) bank holding companies with US$50 billion or more in total consolidated assets (**Bank SIFIs**), and (ii) non-bank domestic or foreign companies that are predominantly engaged in financial activities in the United States (**Non-Bank SIFIs**). Bank SIFIs are easily identified, but the scope of Non-Bank SIFI status is unclear. The Dodd-Frank Act uses an assets and revenue test to determine whether a company is "predominantly engaged in financial activities," but provides the Council with the ability to develop the criteria and processes for determining when a company is a Non-Bank SIFI. On 11 April 2012, the Council issued a final rule setting forth a three-step process (in each step narrowing the universe of companies it is reviewing) and a six-factor framework (based on broad factors for consideration set forth in the Dodd-Frank Act) to determine when a non-bank company should be designated as a Non-Bank SIFI. The six factors the Council intends to use are:

- size;
- interconnectedness with the broader financial system;
- substitutability of the company's goods or services;
- leverage;
- liquidity risk and maturity mismatch; and
- existing regulatory scrutiny.

The Council will examine these categories from a qualitative perspective and, in the case of certain factors, using broadly applied quantitative thresholds. Timothy Geithner, the Secretary of Treasury, has indicated that the Council will make the first Non-Bank SIFI designations during 2012.

What does designation as a SIFI mean for a company?

Companies that are designated Bank SIFIs or Non-Bank SIFIs are subject to enhanced oversight and regulation by the Board. The Dodd-Frank Act requires the Board to adopt certain stringent prudential standards that will apply to SIFIs. In January 2012 the Board proposed a rule setting out these prudential standards. Notably, the proposed rule would

not apply to non-US Bank SIFIs; the Board plans to issue a separate release addressing prudential standards for non-US Bank SIFIs in the near future. As proposed, SIFIs would:

- be required to submit an annual "capital plan" to the Board that describes, among other things, its projected capital holdings and uses of capital for the upcoming nine quarters;
- be required to meet certain capital requirements;
- be required to conduct periodic stress tests to measure liquidity needs and capital holdings under various stressed scenarios;
- be required to limit the SIFI's net credit exposure to any one counterparty;
- be required to create a risk committee of the SIFI's board of directors and designate a Chief Risk Officer;
- if deemed a "grave threat" to US financial stability, maintain a debt-to-equity ratio of no more than 15-to-1; and
- be subject to an escalating four-step early-remediation regime in the event the organization begins to deteriorate and create a "living will" that describes the SIFI's processes and procedures in the event it must wind down.

How could your asset management business be within its scope and what will it mean for our business?

As discussed above, the current rule proposal for regulating SIFIs only applies to domestic SIFI's and non-US Non-Bank SIFIs, but a subsequent rule proposal is expected shortly on regulating non-US Bank SIFIs. At this time our expectation is that the rule proposal for regulating non-US Bank SIFIs will be similar to the rule proposal discussed above. As a result, during the later part of 2012, non-US asset managers should follow the developments concerning the rule proposal for regulating non-US SIFIs.

Read more

We have prepared a client bulletin that goes into significant detail as to the rule proposal for applying enhanced prdential standards to SIFIs:

Only A First Step: The Federal Reserve Board's Proposed Enhanced Prudential Standards For Systemically Important Financial Institutions And Their Potential Implications for Asset Managers

SECURITIES EXCHANGE ACT OF 1934 – LARGE TRADER REPORTING

What is the policy?

In order to enhance its ability to monitor and investigate the impact active market participants have on the securities markets, the SEC adopted new Rule 13h-1, which is likely to impose significant disclosure obligations and other compliance burdens on market participants deemed to be "**Large Traders**". A Large Trader is a US or non-US market participant that directly or indirectly exercises investment discretion over one or more accounts and effects transactions (including the exercise or assignment of certain option contracts) for the purchase or sale of any National Market System (**NMS**) security for or on behalf of such accounts by or through one or more US-registered broker-dealers in an aggregate amount equal to or exceeding: (i) 2 million shares or shares with a fair market value of US$20 million during a calendar day; or (ii) 20 million shares or shares with a fair market value of US$200 million during a calendar month. Once a market participant qualifies as a Large Trader, it must file Form 13H to disclose a fair amount of information, including the types of business the Large Trader or its affiliates engage in, a description of the Large Trader's operations and trading strategies, whether the Large Trader or any of its affiliates is registered with the US Commodity Futures Trading Commission (**CFTC**) or regulated by a

foreign regulator, and an organizational chart illustrating the Large Trader, its parent company (if any), its affiliates that exercise investment discretion over NMS securities (**Securities Affiliates**), and its CFTC-registered affiliates. A parent company can file one Form 13H on behalf of all of its Large Trader subsidiaries as long as it "controls" such subsidiaries.

When did it come into effect?

Rule 13h-1 became effective as of 3 October 2011. Large Traders must identify themselves to the SEC by submitting an initial Form 13H within 10 days of meeting the aggregate thresholds discussed above, and subsequently submit an Annual Filing every year. Large Traders are also required to amend the Form 13H if the information therein becomes inaccurate.

How could your asset management business be within its scope?

If your regular business is to exercise investment discretion over any accounts for which you enter into transactions involving US securities, you may be required to comply with Rule 13h-1. It is important to review your trading activity to determine whether you meet or exceed the aggregate thresholds discussed above.

What does it mean for your business?

If you determine that you meet the Large Trader definition, you will be required to complete and submit the Form 13H, as well as an Annual Filing and amended Form 13H whenever the filing becomes inaccurate for any reason. If your organization is on the borderline of the aggregate thresholds mentioned above, you can elect to either (i) voluntarily file Form 13H or (ii) not file Form 13H and instead monitor your aggregate trading activity to see whether the thresholds are triggered. However, if you follow the latter approach, it is important to remember that once the aggregate thresholds are triggered, you must file the Form 13H within 10 days. We caution that preparing a Form 13H can be a significant undertaking, and would likely take more than 10 days to prepare, especially if you elect to file one Form 13H at the parent company level.

Read more

We have prepared a client bulletin that goes into significant detail as to the scope of the Large Trader reporting requirements:

SEC Adopts New Rule Requiring Disclosure of Trading Activity

Key contacts

If you require advice on any of the matters raised in this document, please call any of our partners listed below or your usual contact at Allen & Overy.

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