K&L Gates Eighth Annual Investment Management Conference

Global Legal and Regulatory Issues for Investment Managers and Funds

2 July 2013

K&L GATES

The Changing Landscape for Derivatives

Sean P. Donovan-Smith, Partner, London
Stephen H. Moller, Partner, London
Philip J. Morgan, Partner, London
Anthony R. G. Nolan, Partner, New York

2 July 2013

DC 9712467 v1

Overview

- MiFID: Market Reform and Exchange Trading of Derivatives

- EMIR: Swaps clearing and reporting
  - Overview of clearing mandate and architecture
  - EMIR timeline
  - Hot topics: segregation and reporting
  - Action points
- Dodd-Frank Title VII: Extraterritorial impact
  - CPO registration
  - Swaps transactional requirements
  - Security-based swaps transactional requirements
- Wrapping up: Emerging Trends

MiFID: Market Reform and Exchange Trading of OTC Derivatives

K&L GATES

EU Objectives

- G20 Pittsburgh 2009:

  "*...all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest*"

- European Commission objectives:
  - To mandate trading of OTC derivatives to take place on multilateral and fully transparent trading venues (such as Regulated Markets, Multilateral Trading Facilities ("MTFs") and Organised Trading Facilities ("OTFs") in line with G20 commitments and to complement EMIR
  - To ensure a level playing field between similar trading practices
  - To have a clear delineation between multilateral and bilateral trading
  - Alignment with Swap Execution Facility in the U.S.
- MiFID II is in the form of a new Markets in Financial Instruments Regulation ("MiFIR"), and a revised Directive

K&L GATES

Key Proposals in Relation to Markets

- Exchange trading of derivatives
- Introduction of Organised Trading Facilities ("OTFs")
- Infrastructure interoperability
- Controls on systematic internalisers
- High-frequency trading
- Consolidated information
- Intervention powers

OTFs and the OTC Market

- All organised trading to be conducted on regulated trading venues, in order to provide greater transparency and effective regulation.
- Introduction of a new category of OTFs
- Article 24 EMIR requires transactions in derivatives that have been declared subject to the trading obligation to be concluded only on regulated markets, MTFs, OTFs or certain third country venues
- ESMA determines which derivatives should be subject to the trading obligation, depending on whether they are assessed to be "sufficiently liquid"
- With the aim of maintaining operator neutrality, Article 20 MiFID requires operators of an OTF to ensure that they have arrangements preventing the execution of client orders on an OTF against the proprietary capital of the operator

K&L GATES

Interoperability

- MiFIR Title VI
  - Non-discriminatory access to a CCP (Article 28)
  - Non-discriminatory access to a trading venue (Article 29)
  - Non-discriminatory access to and obligation to licence benchmarks (Article 30)

K&L GATES

Comprehensive Reform of Markets

- Markets in Financial Instruments Directive (“MiFID II”)
- Markets in Financial Instruments Regulation (“MiFIR”)
- Market Abuse Regulation (“MAR”)
- Criminal Sanctions on Market Abuse Directive (“CSMAD”)

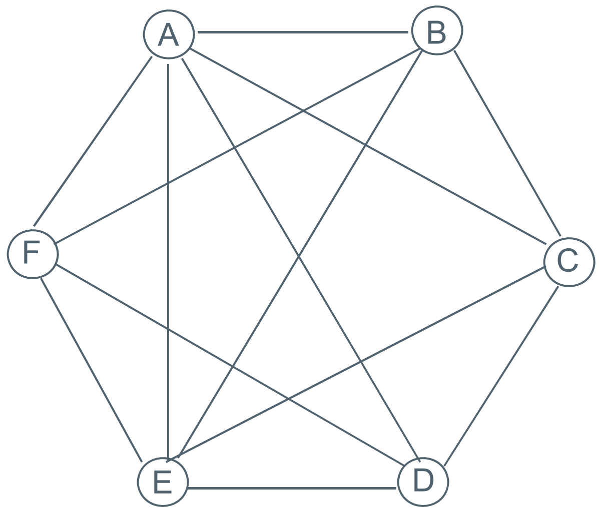
K&L GATES

Expected Timings

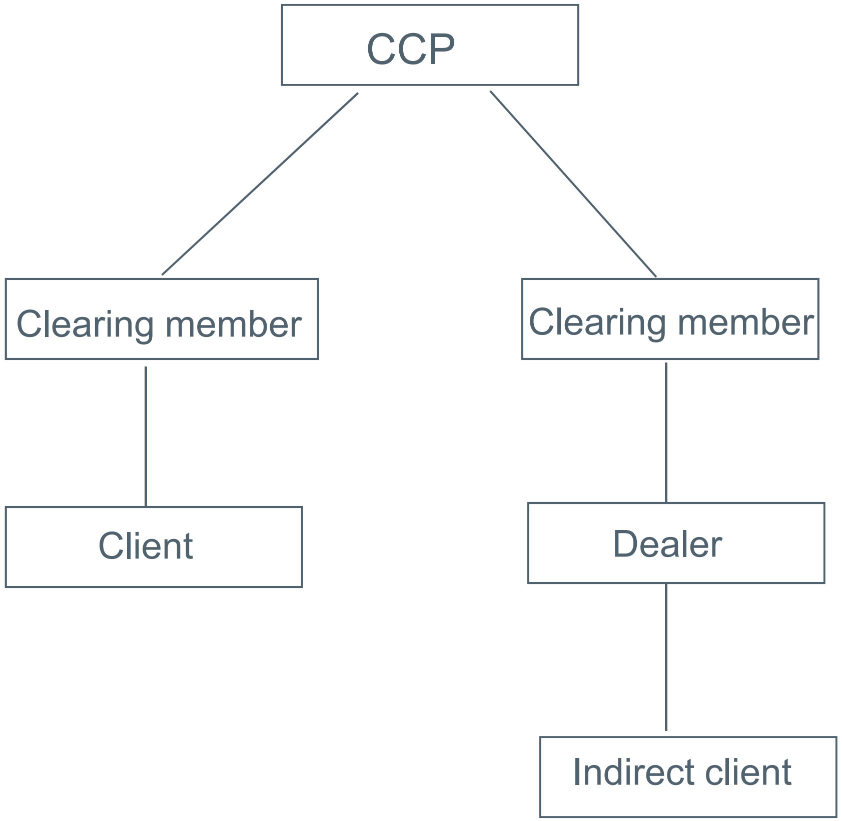
- European Council has just adopted its position
- Trilogue process to commence
- 18 months to develop implementing legislation
  - Development of “Level 2” implementing measures with advice and input from ESMA
  - ESMA to prepare issue "Level 3" guidance to national regulators on how they should interpret Levels 1 and 2, thus ensuring consistent application of across the EU
- Application of all requirements to commence 2015 / 2016

EMIR:
Swaps Clearing and Reporting

EMIR – What is Clearing?



Bilateral Trade



Clearing Trade – (European Principal Model)

K&L GATES

EMIR – Recap #1

- Central counterparty (CCP) and trade repository (TR) requirements
- Trade repository reporting
- Risk mitigation for uncleared trades
- Clearing of standardised OTC derivative contracts

EMIR – Recap #2

A standardised OTC Derivative Contract is subject to clearing if both parties fall within the following categories:

Financial counterparty
NFC +
Third country equivalent

Financial counterparty
NFC +
Third country equivalent

But, a contract between two third country equivalents is exempt unless:

- Direct, substantial and foreseeable effect in the Union
- Necessary or appropriate to prevent evasion of EMIR

EMIR Timeline

August 2012	EMIR in force
March 2013	Technical standards on OTC derivatives, Trade Repositories and requirements for Trade Repositories and CCPs NFC+ notification requirement in force Timely confirmation requirement in force
September 2013	Risk management of non-cleared OTC derivatives
August 2013?	Reporting of credit and interest rate derivatives
January 2014	Reporting of other derivatives
Q2 2014?	Clearing obligation comes into effect
2014	Margin requirements for non-cleared trades come into effect

EMIR – Hot Topics #1: Segregation

Segregation models

- Non-segregated net omnibus account
- Gross omnibus account
- Individual segregation
- Individual segregation/full physical segregation

Legal effect of segregation

EMIR – Hot Topics #2: Reporting

- Information required
  - Type of contract and parties
  - Price and notional value
  - Settlement date and maturity date
- Whose obligation is it?
- Backloading
- Reporting exposures

K&L GATES

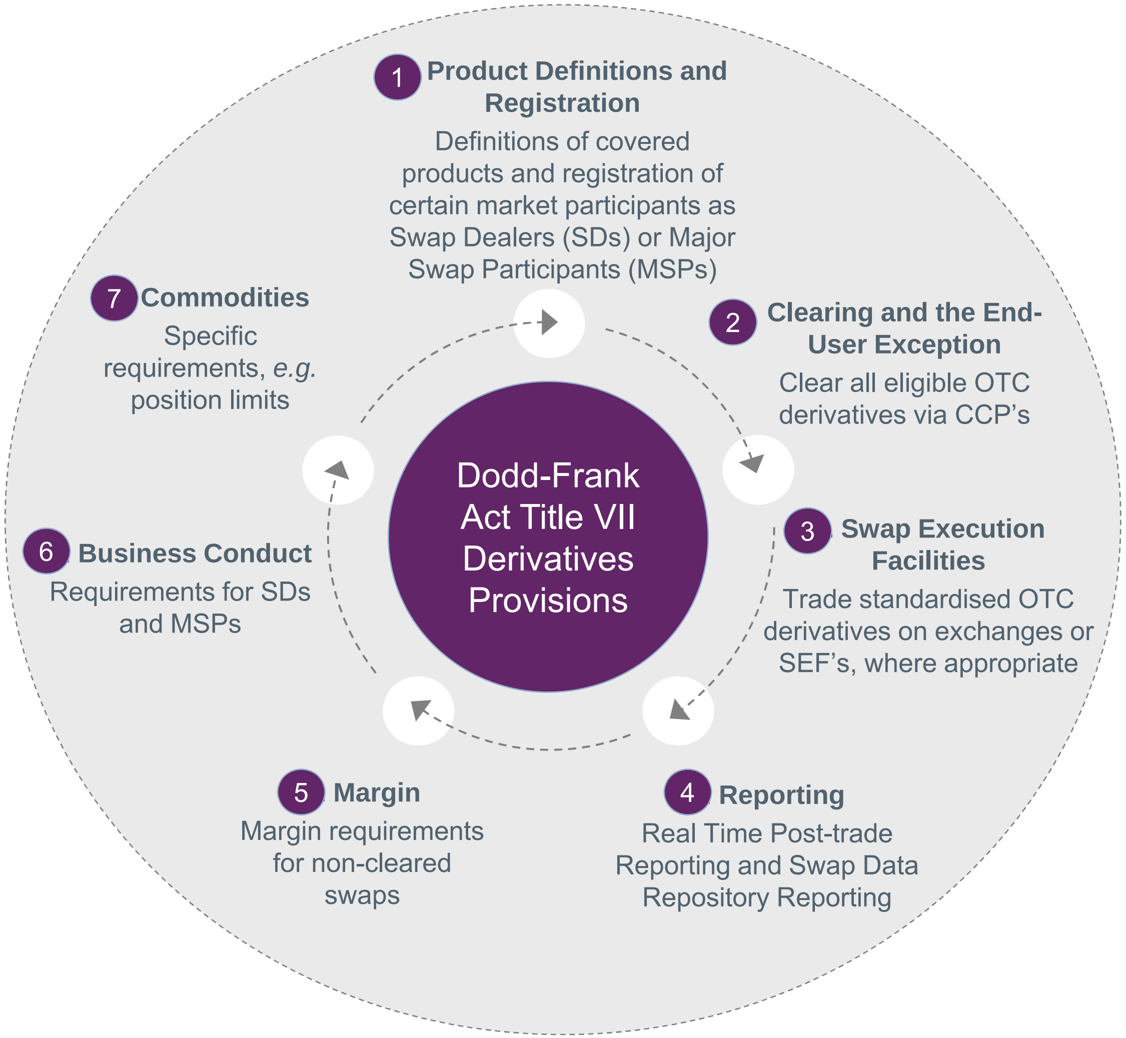
EMIR – What to do?

- Assess status as financial counterparty, NFC+ party or NFC- party
- Prepare for notification requirements
- Prepare for reporting requirements
  - Will need a pre-Legal Entity Identifier
- Segregation and risk mitigation
- Documentation issues
  - ISDA NFC+ protocol
  - Timely Confirmation Agreement
- Anticipate counterparty requirements

Dodd-Frank Title VII:
Extraterritorial Impact on Non-US Funds

K&L GATES

Dodd Frank Act – Key Derivatives Provisions



K&L GATES

Dodd-Frank Product Definitions and Registration Requirements

- Dodd Frank regulations generally cover any transactions done under an ISDA Master Agreement, with limited exclusions

"Swaps" and "Security Based Swaps" defined

- **CFTC** regulates **Swaps**
  - Interest rate swaps
  - FX
    - Covered under Dodd Frank: FX options, swaptions and non-deliverable forwards
    - Not covered under Dodd Frank (except for Business Conduct), subject to final determination by US Treasury Dept.: FX swaps, FX forwards
    - Not covered at all under Dodd-Frank: FX spot; securities transactions
  - Index CDS
  - Index equity derivatives
  - Commodity derivatives
  - Guarantees of swaps are considered to be swaps

- **SEC** regulates **Security Based Swaps**
  - Single name CDS
  - Narrow index CDS (9 names or less)
  - Single name equity swaps
  - Narrow index equity derivatives (9 names or less)
  - Guarantees of security-based swaps are considered to be securities subject to federal securities law regulation

K&L GATES

Dodd-Frank Act Extraterritoriality for End-users

- Overview of regulatory landscape
  - Status of rulemaking process
    - CFTC rulemaking process 2/3 done
    - SEC rulemaking process far behind that of CFTC
  - Extraterritoriality:
    - CFTC Exemptive order (currently in effect until July 12, 2013)
    - CFTC Proposed interpretive guidance
    - SEC proposed extraterritorial rule
    - Swap Jurisdiction Certainty Act (bill – H.R. 3283)

Dodd-Frank Act Extraterritoriality for End-users *(cont'd)*

- Funds that ARE managed by Commodity Pool Operators ("CPOs):
  - Non-US funds that are managed by CPOs are deemed to be US persons for purposes of Dodd-frank Title VII. As such they are fully subject to CFTC swap transactional requirements, regardless of location or identity of the counterparty.
  - Deemed US persons also generally must perform CFTC-mandated reporting obligations in swap transactions with non-US persons.
  - CPO status is <u>not relevant</u> to SEC-regulated security-based swaps.
  - A non-US fund operator is a CPO if (i) the fund has or solicits US investors; (ii) the funds invests in "commodity interests" including swaps and certain FX contracts and (iii) the fund does not fit within the safe harbor provided by CFTC Rule 4.13(a)(3).
  - ***CPO registration will discussed during the 14:45 session.***

Dodd-Frank Act Extraterritoriality for End-users *(cont'd)*

- Funds that ARE NOT managed by CPOs:
  - Swap transactions of non-US funds with US-based swap dealers are fully subject to the Dodd-Frank Title VII transactional requirements.
  - Swap transactions of non-US funds that are booked in the US are fully subject to the Dodd-Frank Title VII transactional requirements.
  - Swap transactions of non-US funds with certain other US persons and with certain non-US persons affiliated with a US person are subject to the Dodd-Frank Title VII transactional requirements, subject to substituted compliance in certain cases.
  - The following tables illustrate the basic extraterritorial application of transactional requirements under:
    - The CFTC Proposed Cross-Border Guidance;
    - The CFTC Exemptive Order; and
    - The SEC Proposed Cross-Border Rule.

K&L GATES

- CFTC Proposed Cross-Border Guidance

	Counterparty / Trade Characteristics	Transaction Level Requirements
	US-based Swap Dealer	Apply.
	Swaps negotiated or solicited by a foreign affiliate, but booked in US	Apply.
	Foreign affiliate of US Person, but not booked in US (affiliate is legal swap counterparty) • whether or not guaranteed by US Person.	Do Not Apply.
	Foreign branch/agency of US-based Swap Dealer	Apply, except (i) external business conduct standards do not apply, and (ii) substituted compliance may apply in certain limited circumstances.
	Non-US-based Swap Dealer, • not booked in US, and • not guaranteed by US Person.	Do Not Apply.
	US Person, Non-Swap Dealer	Apply, except that substituted compliance may apply in certain limited circumstances.
	Non-US Person, Non-Swap Dealer, • Whether guaranteed or not guaranteed by US Person	Do Not Apply.

- CFTC Exemptive Order on Extraterritorial Application of Title VII

	Counterparty / Trade Characteristics	Transaction Level Requirements
	US Person (other than a foreign branch of a US Swap dealer)	Apply, but with limited compliance obligations, such as certain recordkeeping requirements and possibly reporting and mandatory training in clearing requirements.
	Foreign branch of US Swap Dealer	Substituted compliance permitted.
	Non-US Person, Non-Swap Dealer	Do Not Apply.
	Non-US Swap Dealer	Substituted compliance permitted.

- SEC Proposed Cross-Border Rule

	Counterparty / Trade Characteristics	Transaction Level Requirements
	US Person (other than a foreign branch of a US Swap dealer)	Apply, but with limited compliance obligations, such as certain recordkeeping requirements and possibly reporting and mandatory training in clearing requirements.
	Foreign branch of US Swap Dealer	Substituted compliance permitted.
	Non-US Person, Non-Swap Dealer	Do Not Apply.
	Non-US Swap Dealer	Substituted compliance permitted.

Wrapping Up:
Emerging Trends in Derivatives Markets Under the Impetus of Regulation

Questions?

K&L GATES

Addressing EU Restrictions on Remuneration

Sean Donovan-Smith, Partner, London
Cary Meer, Partner, Washington, DC
Philip Morgan, Partner, London

2 July 2013

DC #9711526 v1

K&L GATES

Overview

- Sources of remuneration rules
- Scope
- Possible structuring to fall outside scope
- Timing
- Proportionality
- Bonus caps
- Code staff/Identified staff

Overview *(cont'd)*

- Disclosure requirements
- Remuneration policy content

Sources of Remuneration Rules

- Alternative Investment Fund Managers Directive (AIFMD)
- Undertakings for Collective Investment in Transferable Securities (UCITS) – N.B. UCITS V
- Capital Requirements Directive (CRD) – N.B. CRD IV/CRR
- Markets in Financial Investments Directive (MiFID)
- Many firms may be subject to multiple requirements and ESMA has, to date, made no attempt to try to sort this out. The general thrust of the rules is similar but there are important differences at a level of detail

K&L GATES

Scope

- AIFMD
  - Subject to 1 year transitional relief which may be applied by an EU Member State, AIFMD applies as follows:
    - Remuneration disclosure to investors (separately or in annual report) – Article 22 AIFMD – applies to all EU AIFMs and non-EU AIFMs marketing AIF into the EU (N.B. marketing = offering at own initiative)

Scope *(cont'd)*

- AIFMD
  - Requirements re remuneration policies – Article 13 and Annex II AIFMD – Applies to all EU AIFMs <u>and</u>, according to ESMA guidelines, paragraph 18, entities to whom their portfolio management or risk management activities have been delegated (N.B. also non-EU AIFMs if and when they seek authorisation post – 2015 in order to get EU passport)
  - Delegate to be subject to regulatory requirements on remuneration that are "equally as effective" as those applicable under the ESMA Guidelines

Scope *(cont'd)*

- AIFMD
  - Appropriate contractual arrangements between AIFM and delegates to ensure no "circumvention of the remuneration rules" These need to cover payments made to delegates' identified staff (broadly senior management, risk takers) as compensation for the performance of portfolio or risk management activities on behalf of the AIFM

Scope *(cont'd)*

- AIFMD
  - ESMA Guidelines: True Guidelines or Rules?
    - There are 170 "guidelines"
    - A mixture of time guidelines and seemingly definite rules
    - 18 guidelines as to when the guidelines apply and to what, *e.g.* defining remuneration:
      - All forms of payments or benefits paid by the AIFM, any amount paid by the AIF, including carried interest, or transfer of shares, fringe benefits (even mobile phone)
      - In exchange for *professional services*

Scope *(cont'd)*

- AIFMD
  - ESMA Guidelines: True Guidelines or Rules?
    - AIFM needs to be able to "clearly identify" *pro rata* investment returns/profit shares on investments in the AIFM or AIF made by identified staff vs. remuneration for professional services
    - ESMA thinks that even then investment returns may need to be subject to the guidelines on "risk alignment" implying that shares that are *awarded* should be subject to an accrual period (time horizons), an award process and a payout process. Rules on shares *purchased* are vague

Scope *(cont'd)*

- AIFMD
  - ESMA Guidelines: True Guidelines or Rules?
    - Initial 18 guidelines seem to support the position that some of the guidelines are in fact specific rules, *e.g.*, "A 'retention bonus' is a form of variable remuneration **and can only be allowed** to the extent that risk alignment provisions are properly applied." That is, it is not enough to pay someone for staying with you for 35 years, and since mobile phones are covered, so would be the "gold watch"
    - Even regulators are unsure of the status of ESMA guidelines

K&L GATES

Scope *(cont'd)*

- AIFMD
  - ESMA Guidelines: Timing
    - Not yet translated; when translated will be published as final on ESMA website; effective from 22 July 2013 subject to transitional relief
    - Competent authorities and financial market participants "shall make every effort" to comply; within 2 months of issuance, each competent authority to confirm whether it does or does not intend to comply stating reasons; competent authority complies by incorporating into supervisory practices
    - FCA consultation paper on remuneration not expected until after 22 July 2013; possibly September? Other jurisdictions?

K&L GATES

Scope *(cont'd)*

- UCITS
  - Current draft UCITS V remuneration rules apply to the UCITS management company (*i.e.* in a typical UK structure, the Authorised Corporate Director)
  - No express extension to delegates of the UCITS management company but ESMA to be delegated to produce guidelines and the likelihood is that they will adopt the same approach as for AIFMD

K&L GATES

Scope *(cont'd)*

- UCITS
  - Currently in the UK, the ACD remains fully responsible for discharging all of its obligations under the "regulatory system" if it outsources crucial or important operational functions (including investment management) or any relevant services and activities (FCA COLL 6.6.16 G and SYSC 8.1.6 R)
  - Can have combined AIFM/UCITS manager authorisation in a single entity

Scope *(cont'd)*

- CRD
  - Credit institutions (*i.e.* banks/building societies)
  - Investment firms (*i.e.* most MiFID firms)
  - Remuneration-related rules apply to the global operations of EU-headquartered firms and for non EU-headquartered firms, apply to EU operations

K&L GATES

Scope *(cont'd)*

- MiFID
  - Investment services and activities: dealing; advising portfolio management; executing orders; reception and transmission of orders; operating an MTF etc.
  - Credit institutions when performing investment services
  - UCITS management companies and external AIFMs when providing individual portfolio management or non-core services; can be four-way overlap between AIFMD, UCITS, CRD and MiFID in relation to single entity

K&L GATES

Scope *(cont'd)*

- MiFID
  - Exemptions include only providing services intra-group; only dealing on own account; depositories and managers of funds; dealing in a way that is ancillary to a non-MiFID activity
  - Also exempt – Article 3 firms – only advise and receive and transmit orders to regulated firms and do not hold client assets – *e.g.* typical IFA
  - Large overlap with CRD, however can be CRD-exempt but within MiFID for passporting

K&L GATES

Possible Structuring to Fall Outside Scope?

- AIFMD
  - Avoid being subject to AIFMD – no EU AIFM; no marketing into EU; no portfolio or risk management as delegate of EU AIFM (N.B. can be delegate of non-EU AIFM)
  - Additional layer of delegation – *i.e.* sub-delegation by delegate? Literal understanding of ESMA Guidelines paragraph 18; but AIFM must consent, notify regulator and ensure compliance with the Directive so not clear whether this works

K&L GATES

Possible Structuring to Fall Outside Scope? *(cont'd)*

- AIFMD
  - The non-EU delegate's perspective
    - US advisers operating as delegates are wholly unprepared for the EU rules
    - The concept is entirely unknown in the US and will only apply to advisers with $1 billion in balance sheet capital (*i.e.*, they are a division of a bank or a broker)
    - U.S. advisers' internal control mechanisms rarely involve a compensation committee or board functions: typically designed by a Human Resources or business unit/line manager approach

K&L GATES

Possible Structuring to Fall Outside Scope? *(cont'd)*

- AIFMD
  - The non-EU delegate's perspective
    - Variable compensation tends to be results orientated
    - Retention mechanisms tend to be firm-wide, not business unit-based
    - Use of "shares" in the firm is complicated by US rules on accredited investors
    - Use of shares in the AIF is complicated by US rules on qualified purchasers; also AIFs sold in Europe are typically not suitable investments for US persons from a personal income tax perspective
    - Disclosure is unheard of, outside the context of conflicts of interest disclosure (high level)

Possible Structuring to Fall Outside Scope? *(cont'd)*

- AIFMD
  - The non-EU delegate's perspective
    - US firms ill-prepared to identify "identified staff" or to segregate staff that work on AIFs for AIFMs from those that do not
    - Delegates' contractual arrangements need to be renegotiated, due diligence conducted on remuneration policies and proportionality solutions must be documented
      - Expect push-back on confidentiality
      - Level of detail
      - Arguments that the entirety of remuneration rules should be disapplied

Possible Structuring to Fall Outside Scope? *(cont'd)*

- AIFMD
  - Avoid remuneration paid by the AIFM or AIF in exchange for professional services (ESMA Guidelines paragraph 10) – *e.g.* option with other group companies?
  - Dual employment structure – Restructuring to set up parallel entities to isolate AIFMD-affected remuneration from other remuneration

K&L GATES

Possible Structuring to Fall Outside Scope? *(cont'd)*

- UCITS V
  - Avoid being UCITS management company BUT if, as seems likely, the rules are extended to delegates of the UCITS management company, avoidance may not be possible for UCITS portfolio managers, *e.g.* non-EU managers acting as sub-advisors to UCITS
  - Position should become clearer when ESMA produced UCITS V remuneration technical standards and local regulators implement

K&L GATES

Possible Structuring to Fall Outside Scope? *(cont'd)*

- CRD
  - Become/remain CRD-exempt
  - *e.g.* firms who are advisers and arrangers but do not do discretionary management, and are not within MiFID Article 3 exemption – *e.g.* because of opt-in to MiFID to use passport or because of transmission of orders to persons not listed in the Article 3 exemption

Possible Structuring to Fall Outside Scope? *(cont'd)*

- MiFID
  - Groups exemption?
  - Own-account dealing exemption?
  - Ancillary activities exemption?
  - Article 3 exemption?
  - For non-EU firms: UK overseas persons exemption

Timing

- AIFMD
  - Non-EU AIFMs marketing into EU – Disclosure requirements generally effective 22 July 2013 or 22 July 2014 depending on whether transitional relief applied in EU Member State into which AIF marketed; 22 July 2014 in the UK
  - EU AIFMs – 22 July 2013 or 22 July 2014 depending on application of transitional relief in relevant EU Member State

Timing *(cont'd)*

- AIFMD
  - Delegates of EU AIFM – same as EU AIFM; subject to approach to ESMA Guidelines in EU AIFM's Home Member State
  - Uncertainty in relation to EU Member States late in implementation (incl. UK given FCA approach to AIFMD remuneration rules and ESMA Guidelines likely to be settled after 22 July 2013)

K&L GATES

Timing *(cont'd)*

- UCITS V
  - Directive proposed by Commission in July 2012
  - ECON voted on report on proposals in March 2013
  - EU Parliament expected to vote in plenary on 3 July 2013; unclear whether this will be passed as draft still being altered
  - Level 1 text expected to be finalised in second half of 2013

K&L GATES

Timing *(cont'd)*

- UCITS V
  - FCA Consultation paper on implementation of UCITS V – expected Q3 or Q4 2013
  - ESMA technical advice and guidelines – expected Q4 2013
  - Implementation date at Member State level – possibly end 2015

Timing *(cont'd)*

- CRD IV
  - Texts agreed by Council and Parliament in March 2013
  - April 2013 – Parliament approved text in plenary
  - Council formally adopted the legislation on 20 June 2013
    - To be published in Official Journal before 1 July 2013
    - Required to be implemented locally and effective by 1 January 2014

K&L GATES

Timing *(cont'd)*

- CRD IV
  - Institutions shall apply provisions relating to bonus caps (Article 94(1)(g) CRD) to remuneration awarded for services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after the implementation of CRD IV (Article 162(3) CRD)

Timing *(cont'd)*

- MiFID
  - Directive in force currently
  - ESMA Guidelines on remuneration apply from 60 calendar days after the date by which national regulators are required to have notified ESMA whether they comply or do not intend to comply with all or any of the Guidelines (the "reporting requirement date")
  - The reporting requirement date is two months after the publication of the translated versions of the Guidelines on ESMA's website
  - Thus likely applicability towards end of 2013

Proportionality

- AIFMD
  - Disclosure
    - No generally applicable proportionality concept; but proportionality applied re requirement to disclose enough about remuneration policies to allow investors to assess incentives for identified staff (Level 2, Article 107(4))
  - Remuneration Policies
    - AIFMs to comply "in a way and to an extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities"

K&L GATES

Proportionality *(cont'd)*

- AIFMD
  - Only large and/or complex AIFMs require a remuneration committee (Annex II, paragraph 3)
- Proportionality may lead, on an exceptional basis and taking into account specific facts, to the disapplication of some requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the AIFM and the AIFs it manages and within the limits set by the ESMA Guidelines (ESMA Guidelines, paragraph 25)
- Possible disapplication not automatic but always on a case-by-case basis and must be explained by AIFM to regulator

Proportionality *(cont'd)*

- AIFMD
  - Only requirements that may be disapplied (in relation to specific numerical criteria, only in their entirety – may not lower percentage)
    - Variable remuneration in instruments
    - Retention
    - Deferral
    - Ex post incorporation of risk for variable remuneration
    - Remuneration committee requirement
  - FCA approach key to understanding how this will be applied in practice in the UK; other jurisdictions also need to be monitored as there may be different approaches to this issue

Proportionality *(cont'd)*

- UCITS V
  - Disclosure
    - No generally applicable proportionality concept; but proportionality applied re "Giegold" proposal to disclose information about remuneration practices to all 'stakeholders'
  - Remuneration policies
    - The UCITS management company shall comply "in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities"
    - Only large and/or complex management companies require a remuneration committee

Proportionality *(cont'd)*

- CRD IV
  - Disclosure
    - Institutions shall comply with the disclosure requirements in Article 450 (CRR) in a manner that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities
  - Remuneration policies (including variable remuneration)
    - Institutions to comply "in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities"
    - Only large and/or complex institutions require a remuneration committee

Proportionality *(cont'd)*

- MiFID
  - No such concept here

Bonus Caps

- AIFMD
  - None, yet, but possibility of “mission creep” from UCITS etc
  - UCITS cap not finalised and may yet fail to pass the EU Parliament

K&L GATES

Bonus Caps *(cont'd)*

- UCITS V
  - Current "Giegold proposal" anticipates variable component of total remuneration not exceeding fixed component of total remuneration – *i.e.* 100% bonus cap, subject to proportionality (either in totally or out?)

K&L GATES

Bonus Caps *(cont'd)*

- CRD IV
  - Variable component of remuneration shall not exceed 100% of the fixed component of total remuneration for each individual, subject to proportionality (either in totally or out?)
  - Shareholders of the institution may approve a higher ratio between fixed and variable components of remuneration provided overall level of the variable component shall not exceed 200% of the fixed component of the total remuneration for each individual

Bonus Caps *(cont'd)*

- CRD IV
  - If a quorum of 50% of voting rights is reached 66% or more must vote in favour. If such quorum is not reached 75% must vote in favour

Bonus Caps *(cont'd)*

- MiFID
  - There are none but most MiFID firms subject to CRD

K&L GATES

Code Staff/Identified Staff

- AIFMD
  - Staff whose professional activities have a material impact on the AIFM's risk profile or the risk profile of the AIF that it manages, and may include senior management, risk takers, control functions (risk management, compliance, internal audit and similar functions) and any employee receiving total remuneration that takes them into the same remuneration bracket, subject in each case to the risk-based criteria

Code Staff/Identified Staff *(cont'd)*

- AIFMD
  - Includes heads of portfolio management, administration, marketing and HR
  - Not necessarily highly paid people
  - Dividends or similar distributions received by partners (including members of LLPs) as owners of an AIFM <u>not</u> covered by remuneration restrictions UNLESS "the material outcome of the payment of such dividends results in a circumvention of the relevant remuneration rules, any intention to circumvent such rules being irrelevant for such purpose." (ESMA Guidelines, paragraph 17)

K&L GATES

Code Staff/Identified Staff *(cont'd)*

- UCITS V
  - The management company's remuneration policies and practices shall apply to staff including senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers and whose professional activities have a material impact on the risk profile of the management company or the risk profile of the UCITS they manage
  - Current "Giegold" proposal applies remuneration policies and practices on categories of staff who are fund managers and other persons who take investment decisions that affect the risk position of the UCITS
  - Current position on delegation unclear

Code Staff/Identified Staff *(cont'd)*

- CRD IV
  - "Identified Staff" include senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers whose professional activities have a material impact on the institution's risk profile

Code Staff/Identified Staff *(cont'd)*

- CRD IV
  - European Banking Authority (EBA), published Consultation Paper, Draft Regulatory Technical Standards, "on criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile" in May 2013
  - Identification process based upon:
    - Internal criteria

      use of internally developed criteria based on the institution's individual risk profiles
    - Qualitative Criteria

      identifies staff within the management body. Senior management and other staff with key functions or managerial responsibilities over other risk takers within institutions

Code Staff/Identified Staff *(cont'd)*

- CRD IV
  - Quantitative criteria
  - Identifies staff using the following criteria
    - Staff with a total remuneration of over EUR 500,000
    - Staff within the 0.3% of staff who received the highest total gross remuneration
    - Staff whose total remuneration falls within the remuneration bracket of senior management and other risk takers
    - Staff whose variable remuneration exceeds 75% of the fixed component of remuneration and EUR 75,000

K&L GATES

Code Staff/Identified Staff *(cont'd)*

- CRD IV
  - Under the EBA's proposal, a staff member will be characterised as "identified staff" if at least one of the above criteria is met
  - However, if staff are identified under criteria based on the payment bracket or variable remuneration only, institutions would be able to exclude staff from the group of identified staff if the staff member has no material impact on the institution's risk profile
- MiFID
  - No such concept

Disclosure Requirements

- AIFMD
  - Total remuneration paid by AIFM to staff, split into fixed and variable and number of beneficiaries and including carried Interest (paid out of AIF as compensation for management) – may be of entire staff, just staff involved with the AIF or a proportion of remuneration of all staff attributable to the AIF; needs to be broken down by senior management and risk takers re AIF
  - Financial and non-financial criteria of remuneration policies for risk takers and the way remuneration policies are determined (N.B: proportionality)

Disclosure Requirements *(cont'd)*

- UCITS V
  - Current Article 69(3) amended for annual report to contain:
    - Total amount of remuneration for financial year, split into fixed and variable remuneration paid by the management company and by the investment company (*i.e.* the UCITS fund itself) to its staff, and the number of beneficiaries (and carried interest paid by the UCITS) [in fact most remuneration not paid by UCITS management company or fund]

Disclosure Requirements *(cont'd)*

- UCITS V
  - The aggregate amount of remuneration broken down by senior management and members of staff of the management company and, where relevant, of the investment company, whose actions have a material impact on the risk profile of the UCITS
- Giegold proposal introduces "comprehensive", accurate and timely disclosure of information about remuneration practices to all "stakeholders"

Disclosure Requirements *(cont'd)*

- CRD IV

Institutions shall, on a proportionate basis, disclose at least the following information regarding the remuneration policy and practices of the institution for those categories of staff whose professional activities have a material impact on its risk profile (Article 450, CRR):

  - Information concerning the decision making process used for determining the remuneration policy, including information about the composition and the mandate of a remuneration committee
  - Information on link between pay and performance

Disclosure Requirements *(cont 'd)*

- CRD IV
  - The ratios between fixed and variable remuneration
  - Aggregate quantitative information on remuneration broken down by business area
  - Information on the performance criteria on which the entitlement to shares, options or variable remuneration is based
  - Main parameters and rationale for any variable component scheme and any other non-cash benefits

Disclosure Requirements *(cont'd)*

- CRD IV
  - Aggregate quantitative information on remuneration broken down by senior management and members of staff whose actions have a material impact on the risk profile of the institution, indicating the following:
    - The amount of remuneration for the financial year, split into fixed and variable remuneration, and the number of beneficiaries
    - The amounts and forms of variable remuneration, split into cash, shares, share-linked instruments and other types
    - The amounts of outstanding deferred remuneration
    - Amounts of deferred remuneration awarded during the financial year
    - New sign-on and severance payments made during the financial year
    - Amount of severance payments awarded during financial year

K&L GATES

Disclosure Requirements *(cont'd)*

- CRD IV
  - The number of individuals being remunerated EUR 1 million or more per financial year
  - Upon demand from Member States or competent authority, the total remuneration for each member of the management body or senior management
- For large and complex institutions, the quantitative information required to be disclosed in relation to management body members shall be made available to the public
- Currently unclear under Article 450 (ERR) to whom exactly disclosures should be made

K&L GATES

Disclosure Requirements *(cont'd)*

- MiFID
  - No mention of disclosure requirements in ESMA Guidelines (June 2013)
  - Guidance states that firms should have written remuneration policies, which should be periodically reviewed

Remuneration Policy Content

- AIFMD
  - Remuneration policy promotes sound and effective risk management
  - Specific restrictions for identified staff
  - At least 50% of any variable remuneration shall consist of units or shares of the AIF concerned, or share linked instruments etc
  - A substantial portion being over 40% of variable remuneration component must be deferred for at least three to five years (or shorter if the life cycle of the AIF is shorter); vesting no faster than pro rata; 60% required to be deferred in the case of large bonuses

Remuneration Policy Content *(cont'd)*

- AIFMD
  - Requirement for remuneration committee (or not!)
  - Staff engaged in control functions (*e.g.* risk, compliance) to be compensated in accordance with the achievement of objectives linked to their function, independent of the business areas they control
  - Guaranteed bonuses "exceptional" and only for first year
  - Payment/vesting of deferred compensation adjusted depending on the future financial situation of the AIFM, the AIF and the individual

K&L GATES

Remuneration Policy Content *(cont'd)*

- UCITS
  - Remuneration policy promotes sound and effective risk management
  - Remuneration policy is in line with the business strategy, objectives, values and interests of the management company and the UCITS it manages and the investors of such UCITS
  - Specific restrictions for identified staff
  - At least 50% of any variable remuneration shall consist of units or shares of the UCITS concerned, or share linked instruments etc

K&L GATES

Remuneration Policy Content *(cont'd)*

- UCITS
  - A substantial portion being over 25% (under current Giegold proposal) of variable remuneration component must be deferred for three to five years (or shorter if the life cycle of the UCITS is shorter); vesting no faster than pro rata; 60% required to be deferred in the case of larger bonuses
  - Requirement for remuneration committee if applicable
  - 100% Bonus Cap (under current Giegold proposal)
  - Performance fee paid from the UCITS investment company to the management company should vary only in proportion to the size of the fund or to the value of the assets under management, unless the UCITS is exclusively distributed to professional clients
  - Where a UCITS fund is not exclusively distributed to professional clients, certain requirements must be fulfilled before a performance fee could be paid by the fund to the management company

Remuneration Policy Content *(cont'd)*

- UCITS
  - Staff engaged in control functions (*e.g.* risk, compliance) to be compensated in accordance with the achievement of objectives linked to their function, independent of the business areas they control
  - Guaranteed bonuses "exceptional" and only for first year
  - Payment/vesting of deferred compensation adjusted depending on the future financial situation of the management company, the UCITS or the individual

Remuneration Policy Content *(cont'd)*

- CRD IV
  - Remuneration policy promotes sound and effective risk management
  - Staff engaged in control functions (*e.g.* risk, compliance) to be compensated in accordance with the achievement of objectives linked to their function, independent of the business areas they control
  - Remuneration policy makes a clear distinction between criteria for setting basic fixed remuneration and variable remuneration
  - Guaranteed variable remuneration is "exceptional" and is limited to the first year of employment

K&L GATES

Remuneration Policy Content *(cont'd)*

- CRD IV
  - Payment/vesting of deferred compensation adjusted depending on the future financial situation of the institution as a whole, the business unit and the individual
  - 100% bonus cap (can be increased to 200% with shareholder approval)
  - 25% of variable remuneration can be discounted for the purposes of calculating variable remuneration provided it is paid in instruments that are deferred for a period of not less than five years

K&L GATES

Remuneration Policy Content *(cont'd)*

- CRD IV
  - At least 50% of any variable remuneration shall consist of shares or equivalent ownership interests in the institution concerned, or share limited instruments etc
  - A substantial portion being over 40% of variable remuneration component must be deferred for at least three to five years; vesting no faster than pro rata; 60% required to be deferred in the case of large bonuses

Remuneration Policy Content *(cont'd)*

- CRD IV
  - Up to 100% of total variable remuneration shall be subject to malus or clawback provisions
  - Variable remuneration is not paid through vehicles or methods that facilitate non-compliance with CRD IV
  - Requirement to establish a remuneration committee if applicable

Remuneration Policy Content *(cont'd)*

- MiFID
  - No specific rules, tied to conflicts of interest requirements and conduct of business rules; need to ensure clients' interests not impaired by remuneration policies
  - Commission relating to sale of particular investment unlikely to be compliant
  - Ensure appropriate ratio between fixed and variable compensation
  - Importance of qualitative criteria encouraging the person to act in the client's best interests

Remuneration Policy Content *(cont'd)*

- MiFID
  - Firms should have written remuneration policies
  - Deferral of bonuses taking into account long-term results "good practice"
  - Compliance department role in remuneration policy design, and should be remunerated without reference to the performance of the business units they control

K&L GATES

LEGAL AND REGULATORY UPDATE FOR MANAGERS OF US REGISTERED FUNDS

Clifford J. Alexander, Partner, Washington, DC
Cary J. Meer, Partner, Washington, DC
2 July 2013

DC #9708433v8

Presentation Overview

- SEC Action Against Umbrella Mutual Fund Platform: *Northern Lights* Funds Settlement Order
- *Morgan Keegan* Funds Settlement Order
- SEC Staff Meetings with Independent Directors
- Impact on Sponsors and Sub-Advisers to US Registered Funds
  - When CPO/CTA Registration with CFTC is Necessary
  - Harmonization of CFTC and SEC Rules
- Suits Against Advisers Who Employ Sub-Advisers
- Money Market Funds Reform

SEC Action Against Umbrella Mutual Fund Platform: *Northern Lights* Funds Settlement Order

K&L GATES

Northern Lights Funds Settlement Order

- The complex operated as an umbrella fund administration business where the administrator/sponsor is not the adviser
- The SEC Settlement Order indicates that the Northern Lights Trust had unusual facts:
  - There were 71 different portfolios
  - More than half had different advisers and sub-advisers
  - During the relevant 24-month period, the Board held 15 meetings and approved 113 advisory agreements and 32 subadvisory agreements (an average of 15.5 per meeting)

Northern Lights Funds Settlement Order (*cont'd*)

- Summary of Sanctions Agreed to by Parties:
  - The Settlement Order described 5 violations of the compliance and recordkeeping rules under the Investment Company Act of 1940 ("Investment Company Act") and its rules
  - All parties, including the Trustees, agreed to accept a "cease and desist" order not to violate the law in the future
  - The Administrator and compliance companies each agreed to pay a $50,000 fine and hire an independent compliance consultant to do a review of the funds' compliance program
  - There was no indication of whether the CCO referred to in the Wells Notice, or any adviser or any other parties, might still be the subject of investigations

Northern Lights Funds Settlement Order (cont'd)

- The Trustees were separately charged with "causing violations" of the Recordkeeping Rule relating to inaccurate minutes of meetings because they approved minutes of meetings that were not accurate
- The Trustees also were charged with "causing violations" of the Shareholder Report Rule relating to inaccurate contract renewals disclosure because:
  - The shareholder report disclosure stated that the Board considered peer group data on comparable fees and services that the Trustees allegedly did not get
  - The shareholder report disclosure stated fees were in line with the industry peer group when they allegedly were double the peer group average

Northern Lights Funds Settlement Order *(cont'd)*

- The Trustees and the Compliance Company were charged with violating the Compliance Rule (Investment Company Act Rule 38a-1) because they did not review either a copy of the compliance policies and procedures of every adviser or a summary
- The Administrator was charged with violating the Recordkeeping Rule because:
  - On 4 occasions, the Administrator allegedly did not retain peer group data the Board considered; for most of the 2 years, the Administrator allegedly did not keep 15(c) summaries prepared by outside counsel
  - The Administrator, in some cases, allegedly failed to make sure that the contract renewal disclosure was included in the next annual and semi-annual shareholder report

Morgan Keegan Funds Settlement Order

K&L GATES

Valuation

- Section 2(a)(41)(B) of the Investment Company Act states that mutual fund boards of trustees are to determine in good faith the fair value of securities and assets for which market quotations are not readily available
- Boards may delegate some aspects, but not all, of their fair valuation duties to others
- Clarification of what this means must await long-delayed guidance from the SEC

Morgan Keegan Settlement Order

- The period was a time of unprecedented turmoil in the market for these securities, and the pricing of mortgage-backed securities in general, and subprime mortgage-backed securities in particular, was exceptionally difficult
- Based on stipulated facts (that the former directors did not admit or deny)
- The SEC found that, during this "relevant period," the Morgan Keegan funds did not have adequate written policies and procedures as to valuation, which the SEC found constituted a violation of Investment Company Act Rule 38a-1
- The Morgan Keegan case involved both open- and closed-end income funds holding a significant proportion of their assets in mortgage- and other asset-backed securities that had to be fair valued

Morgan Keegan Settlement Order *(cont'd)*

- Paragraph 41 of the order possibly offers some insight into what the SEC staff believes the responsibilities and level of involvement of directors should be. It states:

  "In connection with determining fair values, the Directors did not calculate the valuations themselves, and neither established clear and specific valuation methodologies nor followed up their general guidance to review and approve the actual methodologies used and the resulting valuations. Instead, they approved policies generally describing the factors to be considered but failed to determine what was actually being done to implement those policies"

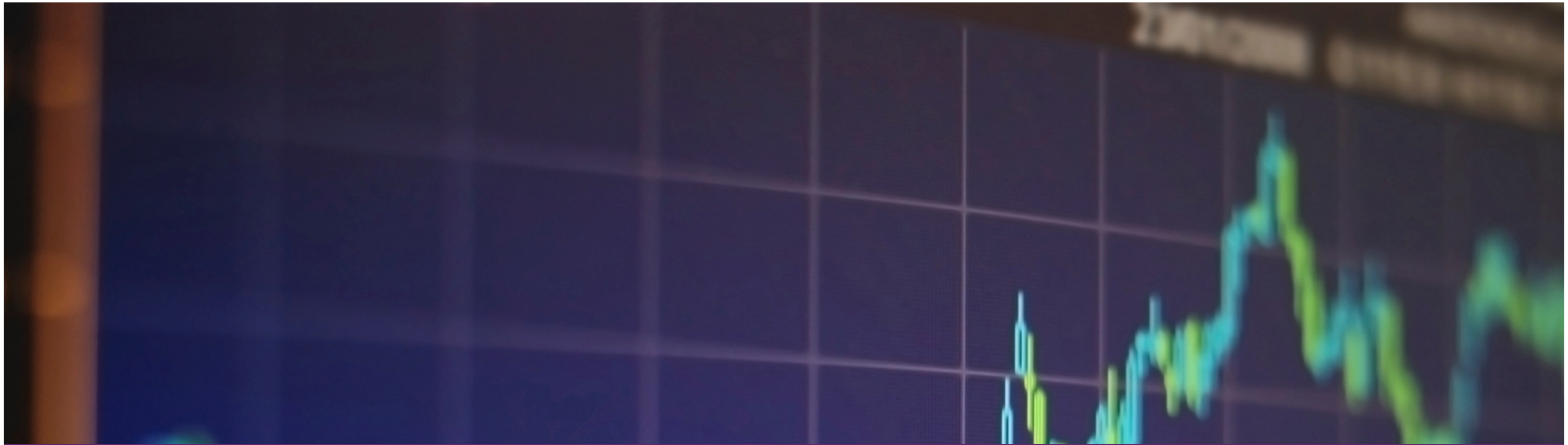
K&L GATES

Morgan Keegan Settlement Order *(cont'd)*

- Apparently building off the Investment Company Act section providing that "fair value" is to be determined "in good faith" by a fund's board, the SEC appears for the first time to have adopted the staff's view that, where a board delegates valuation authority, it must be pursuant to detailed and prescriptive valuation procedures setting out methodologies as part of the package of required fund compliance procedures

Morgan Keegan Settlement Order *(cont'd)*

- The order does not provide guidance on the appropriate methodologies for valuing securities or on the degree of "follow up" involvement or oversight
- The order, particularly when read with the recent order in the *Northern Lights* case, reveals the SEC's willingness to use Rule 38*a*-1, which imposes obligations on funds to establish compliance programs, as a tool to hold directors responsible for what the SEC perceives as flaws in a fund's compliance with any aspect of the Investment Company Act



SEC Staff Meetings with Independent Directors

K&L GATES

SEC Staff Meetings with Independent Directors

- The new Director of the Division of Investment Management and SEC staff are reaching out to fund board members for input regarding how fund boards operate and the challenges directors face
- Because of *Morgan Keegan* and *Northern Lights*, directors are wary of informal meetings with SEC staff
- SEC staff's focus on having these meetings seems to be adding to directors' responsibilities
  - Make them "ears and eyes" of regulators
  - Information gleaned from informal meetings could result in enforcement proceedings

Impact on Sponsors and Sub-Advisers to US Registered Funds

K&L GATES

CPO/CTA Registration with CFTC

Advisers to registered investment companies ("RICs") had relied on exclusion from definition of CPO contained in CFTC Regulation 4.5, and so expected to be regulated principally by the SEC, even if their funds traded commodity interests

- Last year, however, CFTC amended its regulations to narrow this exclusion by reinstituting limits on the trading of commodity interests and imposing marketing restrictions
  - Those advisers to RICs that could not meet the new standards were required to register as commodity pool operators ("CPOs") as of December 31, 2012

CPO/CTA Registration with CFTC *(cont'd)*

- The Investment Company Institute ("ICI") and US Chamber of Commerce filed a lawsuit challenging CFTC Regulation 4.5 amendments
  - Argued that revised regulation imposes unnecessary, overlapping, and burdensome regulations on RICs, their advisers and, ultimately, RIC shareholders
  - Outcome not looking good for ICI and Chamber
  - Decision on appeal expected by September 2013
  - Significantly, effectiveness of the regulation amendments not stayed during litigation

CPO/CTA Registration with CFTC *(cont'd)*

- Swaps now included as "commodity interests"
  - Thus, operators of collective investment vehicles that previously traded swaps but no other commodity interests, and thus were not considered to be operating commodity pools, now must register as CPOs (or claim exemption or exclusion)
- Treasury Determination excludes foreign exchange forwards and foreign exchange swaps from "swaps" definition
  - Non-deliverable forwards not yet excluded but ICI and other parties petitioning for exclusion

CPO/CTA Registration with CFTC *(cont'd)*

- Funds of funds ("FOFs")
  - FOF can be a commodity pool even if the FOF does not trade commodity interests directly
  - FOF CPO registration deferred under a no-action letter
- Interests in certain securitization vehicles, real estate investment trusts, and business development companies now treated as interests in commodity pools

K&L GATES

Harmonization of CFTC and SEC Rules

- Registered CPOs are required to comply with certain disclosure, reporting, and recordkeeping requirements under the CFTC's rules
- Investment advisers to RICs are subject to regulation by the SEC under the Investment Advisers Act of 1940 ("Advisers Act"), and the RICs they manage are subject to regulation under the Investment Company Act
- Investment advisers to RICs concerned about different, and sometimes conflicting, requirements imposed by the SEC, the CFTC, the NFA and FINRA
- To address this, the CFTC has proposed a separate rulemaking to "harmonize" the compliance obligations that will apply to operators of RICs subject to the SEC and the CFTC

Harmonization of CFTC and SEC Rules *(cont'd)*

- CFTC intends to provide harmonization in the following areas, at a minimum:
  - Delivery of disclosure documents and periodic reports
  - Content and timing of disclosure documents and
  - Timing and certification of periodic reports
- CFTC staff is considering harmonization efforts in other areas as well

Harmonization of CFTC and SEC Rules *(cont'd)*

- Reporting that is delayed until after final harmonization rule is released:
  - Form CPO-PQR for RICs (CFTC Regulation 4.27 requires registered CPOs to file Form CPO-PQR)
  - NFA Form PQR for RICs (NFA Compliance Rule 2-46 requires registered CPOs to file Form PQR)
- NFA Compliance Rules relating to books and records, disclosure document requirements, promotional materials, commodity trading advisor ("CTA") performance reports and disclosures by sub-advisers, and contents and delivery of disclosure documents are also deferred

Harmonization of CFTC and SEC Rules *(cont'd)*

- Note: Reporting on CFCs is not deferred
  - NFA confirmed CPO of RIC that consolidates CFC with RIC for financial reporting purposes may defer reporting obligations under Rule 2-46 for the CFC
  - CFTC has not yet confirmed deferral for CFCs, but it is in process
- Reporting changes after final harmonization rule is released:
  - CPO that reports a RIC on SEC Form PF need not complete Schedules B and C of Form CPO-PQR for that RIC (other than schedule of investments)

Actions Against Advisers Who Employ Sub-Advisers

Actions Against Advisers Who Employ Sub-Advisers

- Claymore Advisors, LLC (Dec. 2012)
  - SEC staff alleged that adviser failed to reasonably supervise sub-adviser to prevent sub-adviser's violations of federal securities laws
- AXA Equitable Life Insurance Company (Aug. 2011)
  - Plaintiff has alleged that AXA charged certain funds it manages excessive fees because it retained a substantial amount of management fees while the sub-advisers, who allegedly did most of the work, received considerably less
  - Case is ongoing

K&L GATES

Actions Against Advisers Who Employ Sub-Advisers *(cont'd)*

- Hartford Investment Financial Services, LLC (Dec. 2012)
  - Plaintiff has alleged that Hartford charged certain funds it manages excessive fees because it charges, on average, 3x the amount it pays its sub-advisers for similar services
  - Case is ongoing

Money Market Funds Reform

Money Market Funds (“MMFs”) Reform

- In 2010, SEC adopted series of reforms to increase resiliency of MMFs to runs
- The SEC stated that these reforms were only a first step and that the SEC intends to also address stable value pricing of institutional prime funds and methods to stop MMF runs

SEC Proposal on MMF Reform

- Proposed SEC rule contains two alternative reforms that could be adopted separately or combined:
- First Proposal: Floating NAV
  - Would require all institutional prime MMFs to operate with a floating NAV
    - Institutional funds could no longer value their entire portfolio at amortized cost and could not round share prices to the nearest penny
  - Retail and government MMFs would be exempt as they generally have not been susceptible to runs

SEC Proposal on MMF Reform *(cont'd)*

- Second Proposal: Redemption Fees & Gates
  - This proposal seeks to directly address potentially harmful redemption behavior during times of stress
  - Prime (non-government) MMFs would be required to impose a 2% liquidity fee if the MMF's level of weekly liquid assets fell below 15% of its total assets, unless the fund board determined it was not in the MMF's best interest
  - After falling below 15%, board would also be able to temporarily suspend redemptions for up to 30 days (close the MMF's redemption "gate")

SEC Proposal on MMF Reform *(cont'd)*

- Other SEC staff recommendations in proposed rule:
  - Tighten diversification requirements
  - Require more timely disclosure of holdings
  - Strengthen stress testing
  - Require reporting when an MMF's weekly liquid assets fall below 15%

K&L GATES

Australian Institutional Investors: Superannuation Funds

Jim Bulling, Partner, Melbourne

2 July 2013

DC #9711533v1

Australian Institutional Investors: Superannuation Funds

- Overview of superannuation market in Australia
- Some significant regulatory reforms
- Introduction of MySuper no frills product
- Some new issues for investment managers and advisers
- Impact of regulatory reforms
- Super fund investment in infrastructure
- Self Managed Super Funds (SMSFs)

K&L GATES

Fast Facts on Australian Superannuation

- Total assets – $1.5tr
- 300 funds hold $1.0tr (biggest $45 billion)
- SMSFs hold $0.5tr
- Annual contributions $120 billion – payments of $70 billion
- Asset allocation (excluding SMSFs) at June 2012:
  - 23% cash and fixed interest
  - 28% Australian shares
  - 23% overseas shares
  - 10% property
  - 16% other

K&L GATES

Fast Facts on Australian Superannuation *(cont'd)*

- Unprecedented level of regulatory reform
- 1 July 2013 is kick off date for most of the reforms
- Reforms will reshape industry
  - Some known impacts, some unknown
- Reforms include:
  - MySuper no frills product
  - 12 new prudential standards introduced by Australian Prudential Regulation Authority (APRA)
  - Superstream data protocols and account consolidation
  - Tax subsidies for superannuation under review

K&L GATES

MySuper

- Review of system showed:
  - Significant tax subsidies
  - Costs too high for members with low balances
  - Significant proportion of members disengaged (>40%)
  - Many members paying for unwanted functionality
  - Too many accounts
- MySuper product features
  - Limited options (no frills)
  - Low cost
  - Conservative investment profile (life cycle)
  - Is compulsory for default employer contributions

K&L GATES

MySuper *(cont'd)*

- Could be 30%+ of $1.0tr invested in MySuper
- Significant volatility amongst funds in next 2-3 years
- Superannuation will be split into 3 segments:
  - MySuper
  - Choice
  - SMSFs
- MySuper focussed on "balanced" and life cycle investments
- Choice provides opportunities for other strategies and member directed

K&L GATES

Introduction of New Prudential Standards

- Black letter law with civil penalties for breach
- Several new prudential standards relevant to investment management
  - Investment governance
  - Risk management
  - Outsourcing
  - Account consolidation (more volatility as contributions and balances move)

Investment Governance Standard

- Significant uplift for trustees in mandated due diligence, risk management monitoring and ongoing management of investment portfolios
- Investment managers and advisers will be asked to assist trustees demonstrate compliance with new requirements
  - Many requests of trustees will look familiar
  - But detail may require managers and advisers to revisit their own processes, data and capabilities

K&L GATES

Investment Governance Standard *(cont'd)*

- Investment objectives for funds must include return and risk objectives for each option provided by the manager
- Manager must provide data to enable trustee to monitor whether objectives being met
- Must identify risk factors associated with each source of return
- Must identify how sources of return interact in different market conditions
- Must examine impact of these interactions on the overall diversification of the portfolio

Investment Governance Standard *(cont'd)*

- Demonstrate due diligence for individual investments including:
  - Current market environment
  - Valuation methodologies
  - Projected performance
- Undertake stress testing for each investment strategy demonstrating how asset allocation may:
  - Perform under certain stress scenarios (staying true to label?)
  - Be appropriate in terms of probability of meeting objectives
  - Impact on liquidity during extreme market volatility

Investment Governance Standard *(cont'd)*

- Having set asset allocation targets and ranges for a particular strategy
  - Need a policy for ensuring allocation stays within ranges
  - Identify trigger points for commencement of a review of an investment strategy
  - Identify trigger points for initiating changes in strategy

Investment Governance Standard *(cont'd)*

- Trustee must demonstrate assessment of liquidity risk arising from
  - Relative ease of saleability of assets
  - Possible market events affecting liquidity of assets
  - Cash flow needs for managing hedging
- Need to undertake liquidity stress testing under normal and extreme circumstances

K&L GATES

Investment Governance Standard *(cont'd)*

- Trustee must consider availability of reliable valuation information in respect of assets, having regard to:
  - Type of asset
  - Whether investment is direct, pooled or fund of funds
  - Independence, timeliness, reliability and frequency of valuations
  - Robustness of valuation methodologies
- May be problematic for certain asset classes, *e.g.* private equity, infrastructure

Outsourcing Standard

- Standard applies to outsourcing of “material business activities”
  - *e.g.* administration, custody, investment management
- Outsourcing Agreement must contain minimum terms
  - *e.g.* service levels, termination, liability and indemnity
- Trustee must conduct tender process and due diligence reviews
- Regulator must be notified before outsourcing to a service provider outside Australia

New Restriction on Performance Fees

- Restrictions for investment managers within MySuper
- Performance fee can only be charged if:
  - Base fee is reduced because of performance fee
  - Performance is measured against appropriate benchmark on after costs/tax basis
- For all funds, trustee must understand:
  - Performance fee structure
  - Impact on return objectives
  - Impact of various market cycles

Reporting and Portfolio Disclosures

- From 31 December 2013, trustees required to disclose portfolio holdings at asset level
  - Disclosure to be made publically available
  - Required every 6 months on 3 month delay
- Disclose list of all financial products/property held
  - Include indirect holdings (*e.g.* through a fund of funds)
  - Uncertainty where fund of funds is outside Australia
  - Concern re disclosure of trade secrets
- Trustees likely to seek information from investment managers, managed investments and fund of funds

Impact of Regulatory Reform

- 300 funds under pressure on costs and fees
- M&A activity amongst 300 funds
  - To access economies of scale
  - Enhance compliance and risk capabilities
  - Compete with the banks, each other and SMSFs
  - Provide viable MySuper offering
- Fewer but larger funds (internal funds management capability?)
- All funds looking to take costs out of the system

Investment in Infrastructure

- Australian super funds underweight (6%) infrastructure compared with global peers, *e.g.* Canada
- Variety of factors making infrastructure investment unattractive for Australian super funds
  - Lack of pipeline of provable projects in Australia
  - Poor experience during GFC
  - Tax settings do not encourage investment by super funds

Investment in Infrastructure *(cont'd)*

- State and local government regulatory risk still a work in progress but it is improving
- Some aspects of recent regulatory reforms mitigate against infrastructure as an asset class

- Some recent successes
- Australian super funds continue to look offshore for infrastructure opportunities

Fast Facts on SMSFs

- $500bn from 500k funds with average balance of $1.0m
- Mum and Dad are trustees and members
- Not regulated by the prudential regulator but by the Australian Tax Office (ATO)
- Growth in SMSFs driven by:
  - Desire to take control
  - Perception that fund managers charged too much and did not perform
- Overweight cash and Australian shares
- Sector is bigger than anyone imagined

K&L GATES

Current Trends in SMSFs

- SMSF features
  - Tax advantages (pension tax free)
  - Members approaching retirement
  - Gearing permitted
- Banks, fund managers and advisers now targeting SMSFs
- Growing realisation that SMSFs need to diversify portfolios, but they are conservative

K&L GATES

Current Trends in SMSFs *(cont'd)*

- Slew of product releases in recent years directed at SMSFs which were very successful:
  - Bank sponsored
  - Fixed interest/quasi-equity
  - Yield focus
- Number of structured product offerings:
  - Gearing permitted
  - Capital protected
  - ASX 50 corporations

Current Trends in SMSFs *(cont'd)*

- Distribution channels emerging from disaggregated market
  - Advisers and accountants
  - Direct via other relationships
  - Web based aggregators, *e.g.* platforms

K&L GATES

K&L Gates Clients in Superannuation

- Superannuation fund trustees
- Custodians
- Administrators
- Fund managers
- Investment advisers
- Financial planners
- Platform providers
- SMSFs

K&L GATES

Opportunities In Asia

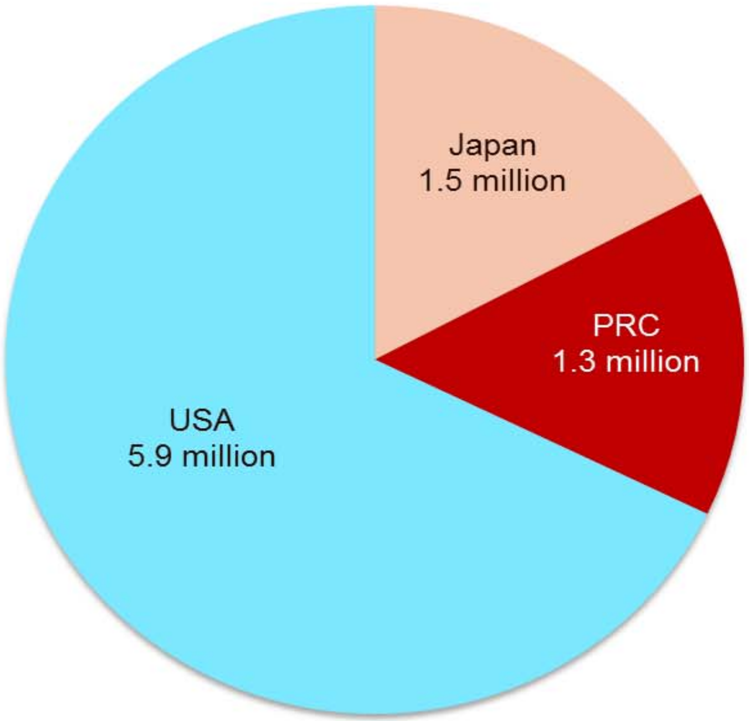
Choo Lye Tan, Partner, Hong Kong

2 July 2013

DC #9712710

Asia Private Wealth

APAC set to overtake North America in 4 years.

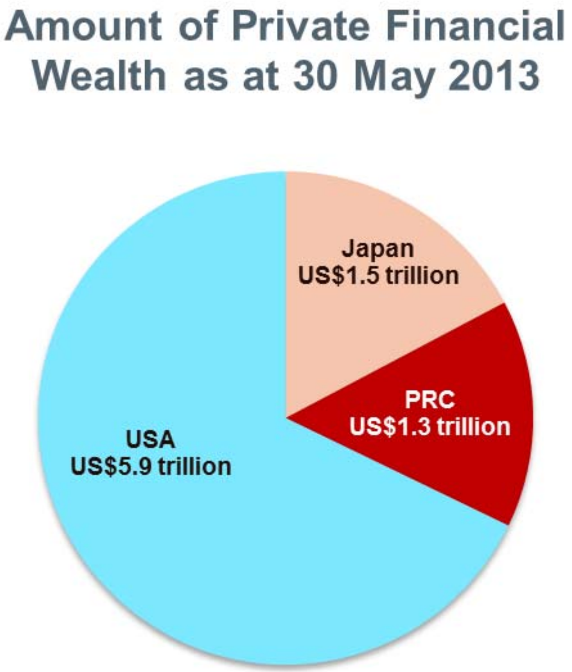


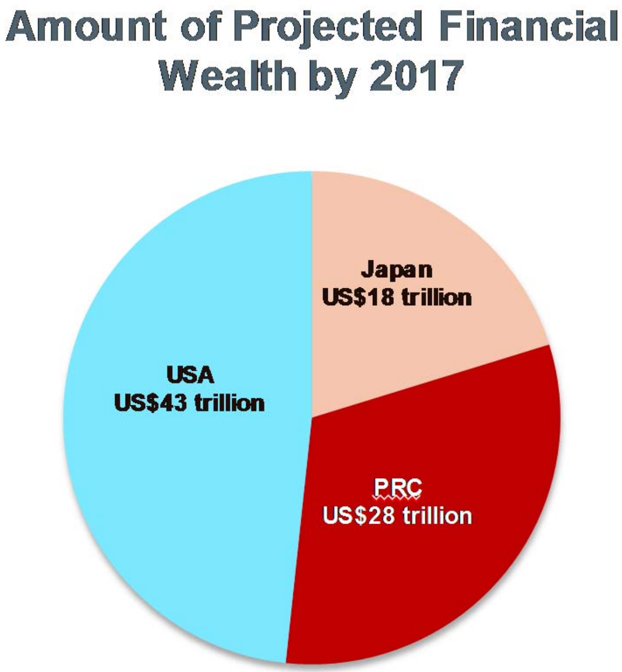
Number of Millionaire Households as at 30 May 2013

Source: Boston Consultating Group

Asia Private Wealth *(cont'd)*

- As of 30 May 2013:
  - Asia Pacific ex-Japan is projected to inch past North America by year-end 2017 in terms of regional wealth, with an estimated US$48.1 trillion, versus US$48.0 trillion for North America.



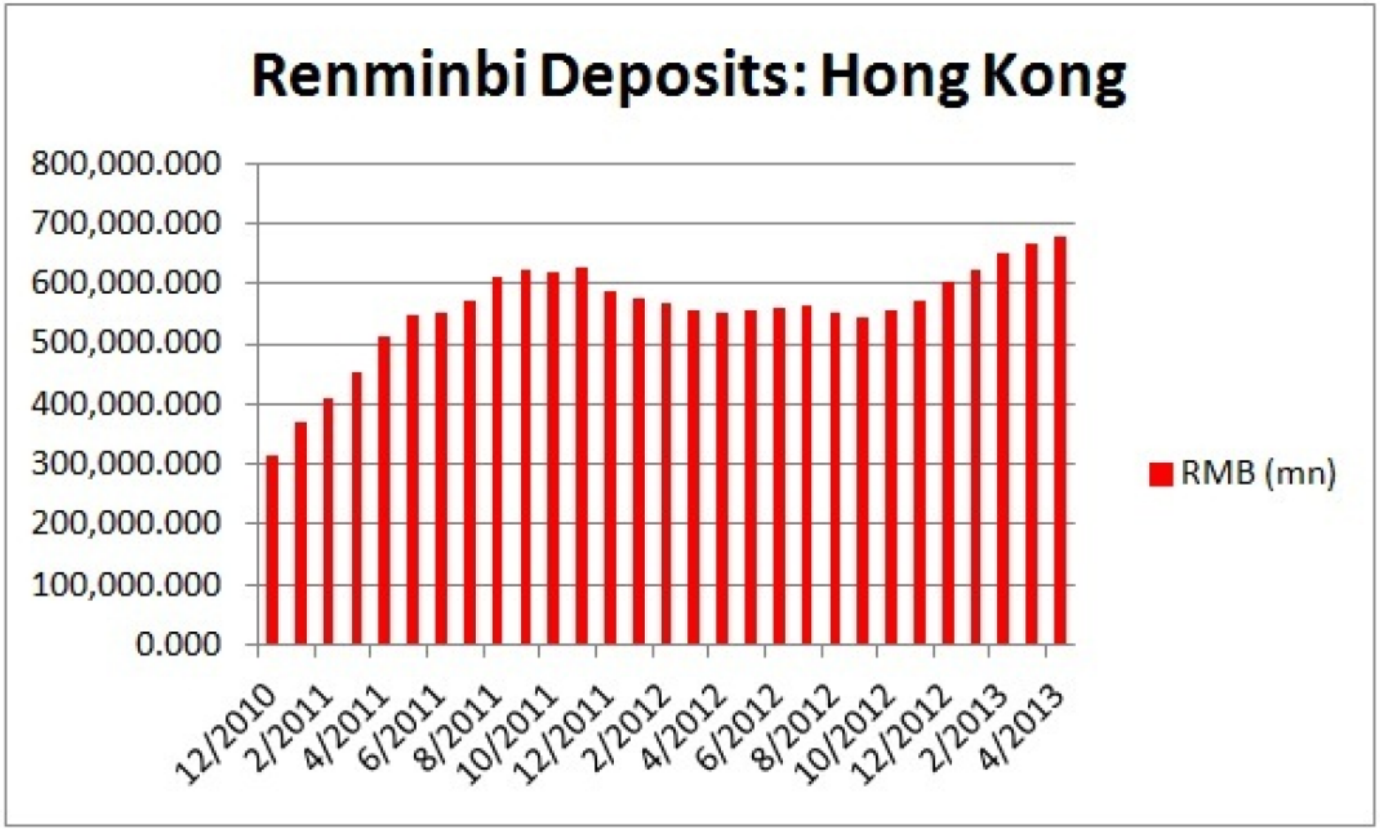


Source: Boston Consulting Group

Asia Private Wealth *(cont'd)*

- Rising value/stability of Asian currencies
  - RMB has appreciated 1.6% against the US dollar since the beginning of the year
- Popularity of RMB
  - Amount of RMB deposits in Hong Kong at end-2012 was almost **RMB700 billion**
  - Taiwan RMB deposits estimated to hit **RMB150 billion** by end-2013
  - Increased use of RMB for trade
- High savings rate

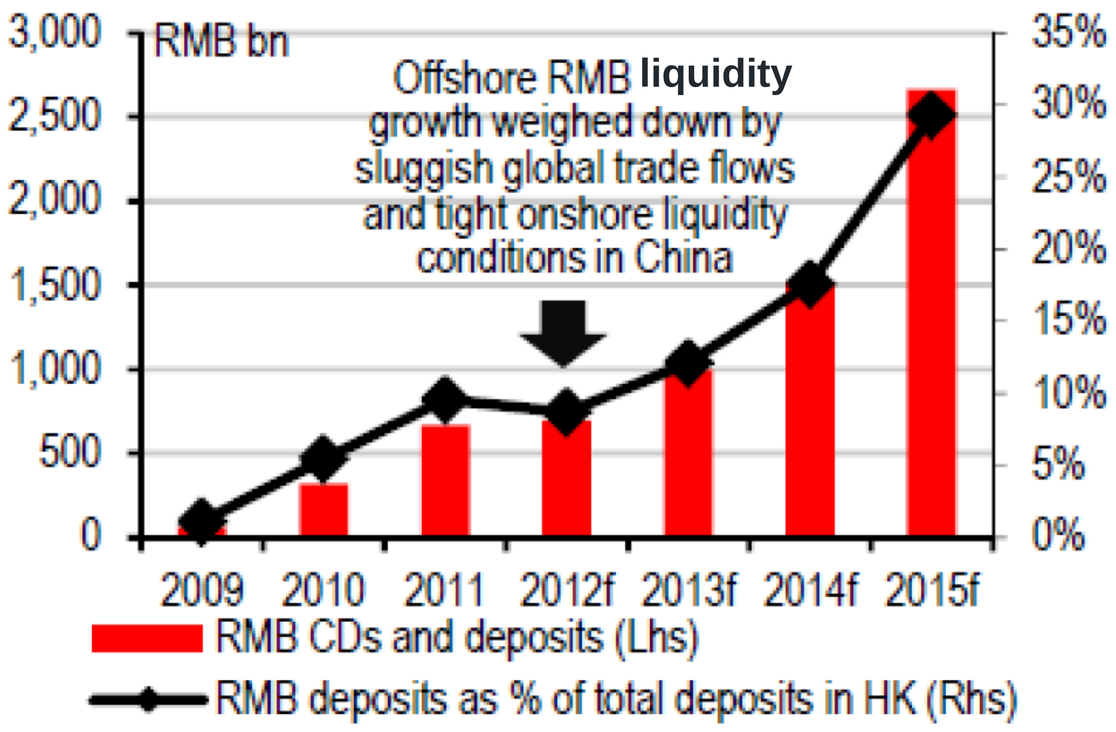
Asia Private Wealth *(cont'd)*



Source: HKMA, CEIC. Last updated: June 5, 2013

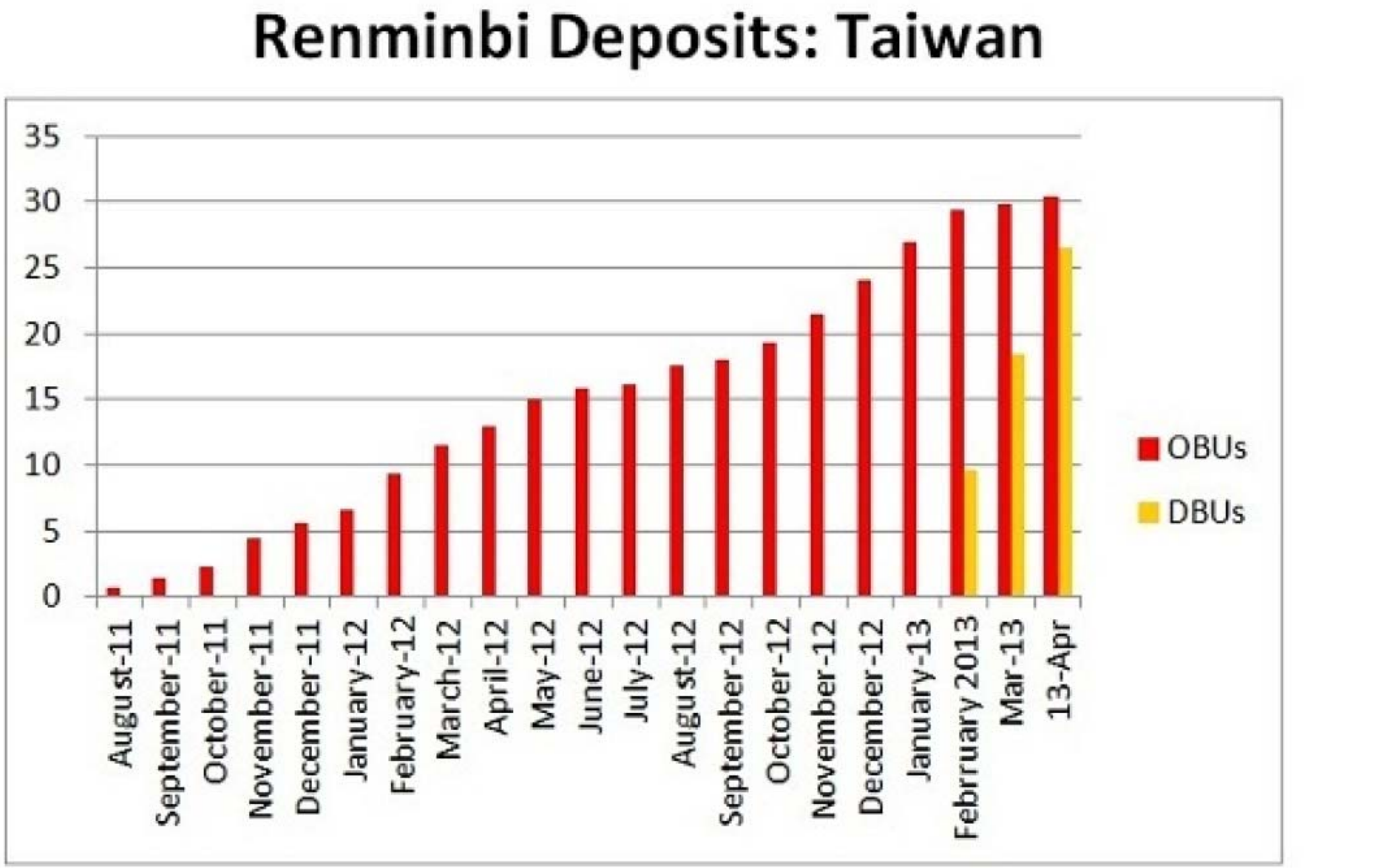
Asia Private Wealth *(cont'd)*

Chart 4. We expect Hong Kong's offshore RMB liquidity to top RMB2.6trn by end 2015



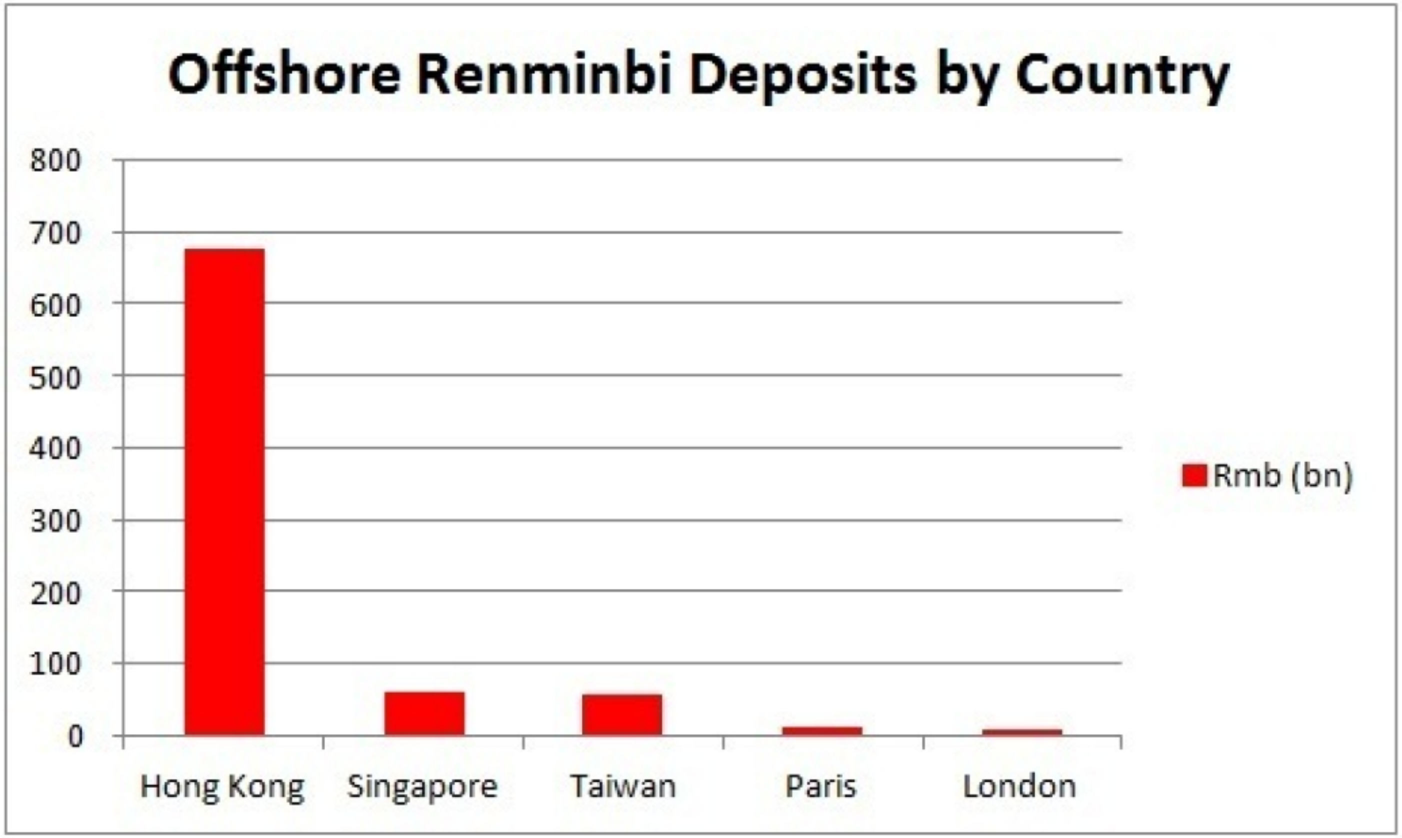
Source: HKMA, CEIC, HSBC estimates

Asia Private Wealth *(cont'd)*



OBU = overseas banking unit DBU = domestic banking unit. Source: CBC, Asiamoney. Last updated May 30, 2013

Asia Private Wealth *(cont'd)*



Source: Asiamoney, CBC, City of London, HKMA, Last updated June 5, 2013

OFFSHORE RMB PRODUCTS

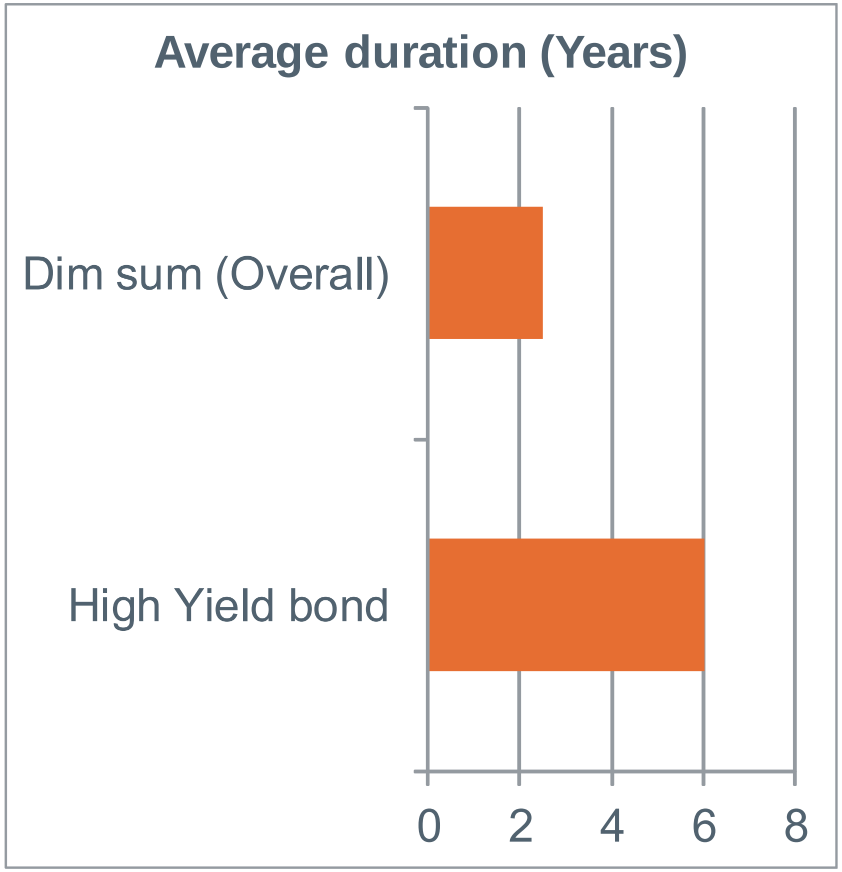
RMB BONDS
High Yield Bonds as compared to RMB Bonds

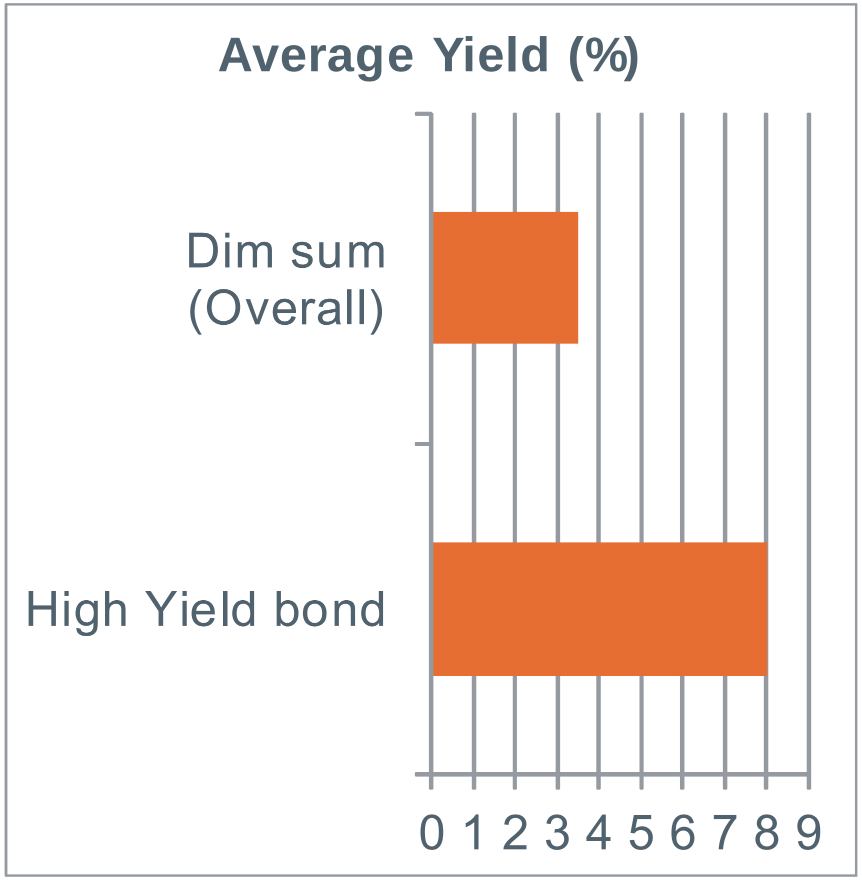
- Generally longer tenor than dim sum bonds
- Decent yields
- Dominated by PRC issuers

Issues

- Unpredictable market
- Quality of issuer
- Legal structure of issuer
- Market euphoria

HIGH YIELD BOND ISSUES BY ASIAN ISSUERS
Dim sum bond vs High Yield bond





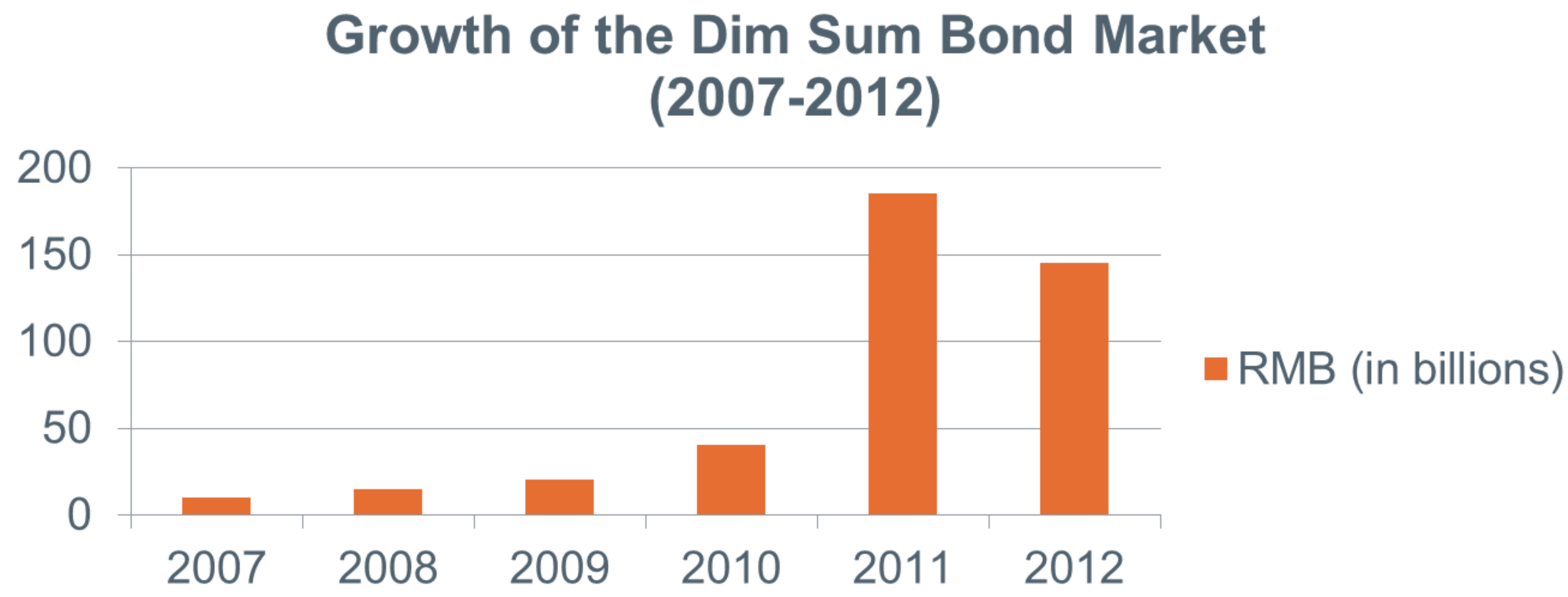
Sources: Reuters; HSBC

K&L GATES

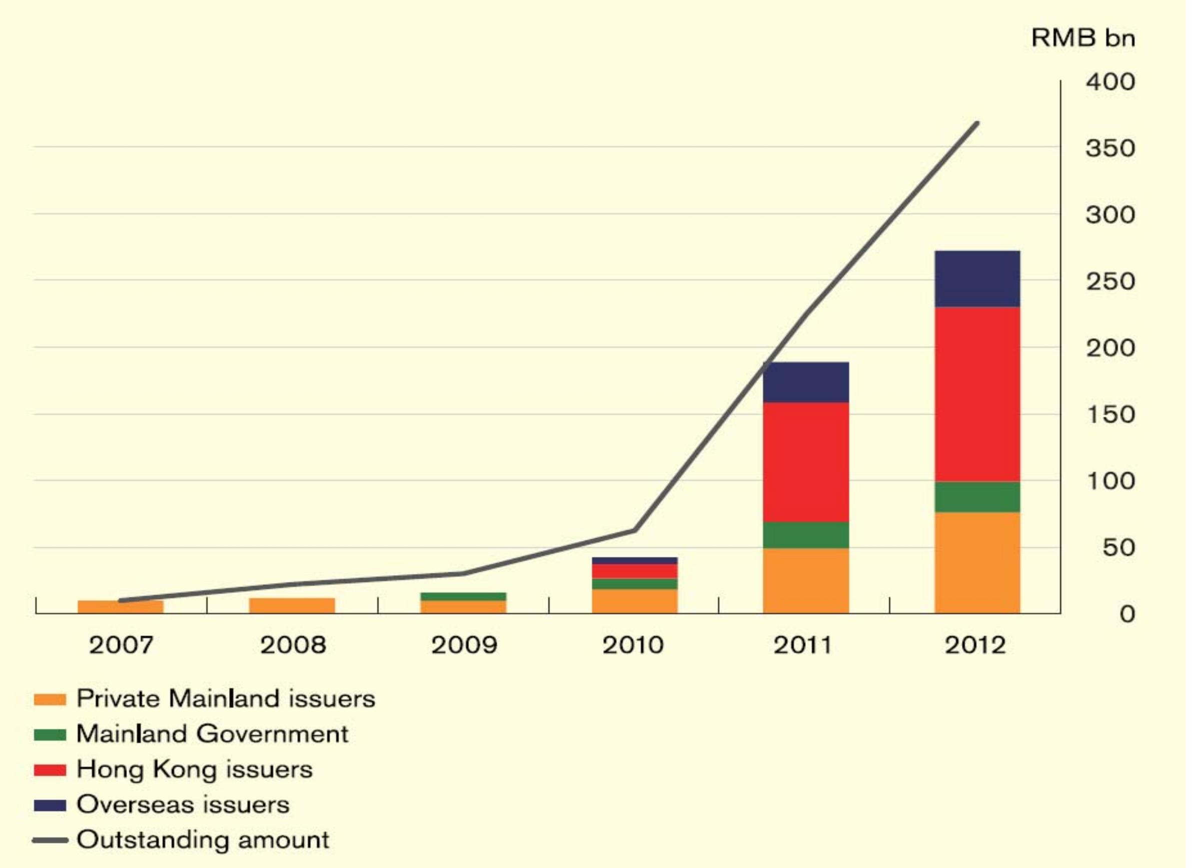
OFFSHORE RMB PRODUCTS

RMB bonds and bond funds

- RMB bonds more popularly known as dim sum bonds (HK)



OFFSHORE BOND ISSUES



Sources: Newswires and HKMA staff estimates.

K&L GATES

OFFSHORE BOND ISSUES

Table 1: Number, Amount, Average Coupon, and Average Tenor of Dim Sum Bonds by Issue Date July 2007-December 15, 2012*

Year	Number of Issues	Amount CNY (Mln)	Average Amt CNY (Mln)	Average Coupon (%)	Average Coupon (Exclude zeros and FRN) (%)	Average Tenor (years)
2007	5	10,000.00	2,000.00	3.15	3.15	2.40
2008	5	12,000.00	2,400.00	3.31	3.31	2.40
2009	8	16,000.00	2,000.00	2.68	3.21	2.50
2010	28	35,680.00	1,274.29	2.52	2.58	2.68
2011	290	152,011.50	524.18	2.19	2.15	2.16
2012*	444	171,206.70	385.60	3.24	3.14	1.83
Overall	**780**	**396,898.20**	**508.84**	**2.81**	**2.76**	**2.00**

Source: Bloomberg

- Offshore RMB bonds – denomination (principal), coupon (interest) and price are denominated in RMB

OFFSHORE BOND ISSUES

Why RMB Offshore bonds and bond funds?

- Appreciating RMB
- Substantial amounts of offshore uninvested RMB
- Growing investor base
- Quality of issuers and perception of dim sum bonds has improved
- Most international offshore product today due to offshore RMB centres in London, Singapore, Taiwan and Hong Kong
- Alternative to riskier equities

OFFSHORE BOND ISSUES *(cont'd)*

Why RMB Offshore bonds and bond funds?

- Hybrid nature
- Shorter-term alternative to conventional bonds – tenor of between one to three years
- Investment grade bonds with returns of 3 to 5%; high yield bonds with returns of at least 6%

OFFSHORE RMB PRODUCTS
HK ETF bond fund

- Fund that tracks a basket of dim sum bonds on an index
- iShares RMB Bond Index ETF offered by BlackRock
  - Provides investors with access to dim sum bonds that are issued and settled in renminbi outside China with a minimum maturity date of one year and a minimum size outstanding of RMB1 billion (US$162.98 million), including fixed-rate securities issued by governments, government sponsored agencies, supranationals and corporations
  - As of May 20, the Citi RMB Bond Capped Index had 92 constituent bonds, with a total market value of RMB158.5 billion (US$25.83 billion). About 70% of those bonds are investment-grade, 7% are high-yield and about 23% are not rated.

OFFSHORE RMB PRODUCTS *(cont'd)*
HK ETF bond fund

- Listed :
  - Greater liquidity than RMB bonds
  - More transparency
- Lower minimum entry size than RMB bonds
- Lower management fees
- Not UCITS-compliant unlike many RMB bonds
- Passive as opposed to most RMB bond funds which are active

K&L GATES

OFFSHORE RMB PRODUCTS *(cont'd)*

Dim Sum Bond Variants

- Lion City bonds
- Taiwan RMB bonds – Bao Dao & Formosa
- London RMB bonds

Combined with RQFII, issues as to repatriation of proceeds to PRC lessened

ONSHORE RMB PRODUCTS

ONSHORE RMB PRODUCTS

RQFII

- RMB qualified foreign institutional investor
- Enables onshore investments in the PRC by non-PRC entities using offshore RMB
- Original RQFII announced on 16 December 2011 followed by two further amendments known as RQFII 2 and RQFII 3

ONSHORE RMB PRODUCTS *(cont'd)*

- **RQFII 1**
  - Announced on 16 December 2011
  - Granted only to Hong Kong subsidiaries of qualified PRC asset management and securities firms
  - May only invest directly in PRC securities, of which at least 80% must be in onshore RMB bonds and bond funds and not more than 20% may be in China A-shares and other permitted PRC equity instruments
- **RQFII 2**
  - Enabled individual investors from Taiwan, Hong Kong, and Macau who are resident or working in the mainland to open brokerage accounts in the mainland to buy A-shares from 1 April 2013.

K&L GATES

ONSHORE RMB PRODUCTS *(cont'd)*

- **RQFII 3**
  - CSRC released "Measures for Securities Investment of Pilot Renminbi Qualified Foreign Institution Investors" on 6 March 2013
  - Removal of investment restrictions as to asset mix
  - Investment in index futures specifically permitted
  - Hong Kong subsidiaries of mainland banks and insurance companies and **Hong-Kong domiciled and authorised** asset management firms may now apply for RQFII licences.
  - RMB funds raised outside of Hong Kong may be used
  - Any single foreign entity cannot own more than 10% of a Chinese company's stock, and total combined foreign ownership remains capped at 30%.

ONSHORE RMB PRODUCTS *(cont'd)*

- **RQFII Funds & RQFII A-Share ETFs**
  - Entities with RQFII quotas can establish RQFII funds denominated in RMB in which non-PRC investors can invest
  - Subscriptions and redemptions of units in RQFII funds must be settled in RMB
  - Must be authorised by the SFC and therefore, subject to the SFC's Code of Unit Trusts and Mutual Funds.

ONSHORE RMB PRODUCTS *(cont'd)*

- Key requirements
  - Must have a mainland parent OR at least one (1) key personnel with at least two (2) years' physical A-share ETF portfolio management experience
  - ETF must adopt a full physical replication strategy
  - Must retain a "reputable" mainland, HK or international firm "acceptable to the SFC" as its investment advisor for at least a year after listing
    - Investment advisor must :-
      - Have at least three (3) years of "solid experience"
      - A good "track record" in managing ETFs in the mainland, HK or other ETF markets
      - Must provide administrative support to the ETF

K&L GATES

ONSHORE RMB PRODUCTS *(cont'd)*

- Key requirements
  - SFC has absolute discretion to grant exemptions to the requirements

	RQFII A-share ETFs	RQFII retail funds
RQFII quota requirement	√	√
Listing on SEHK	√	X
Underlying investment	A-shares traded in the Mainland markets	At least 80% in renminbi bonds and bond funds issued in mainland China, not more than 20% in China A-shares and other equity investments

K&L GATES

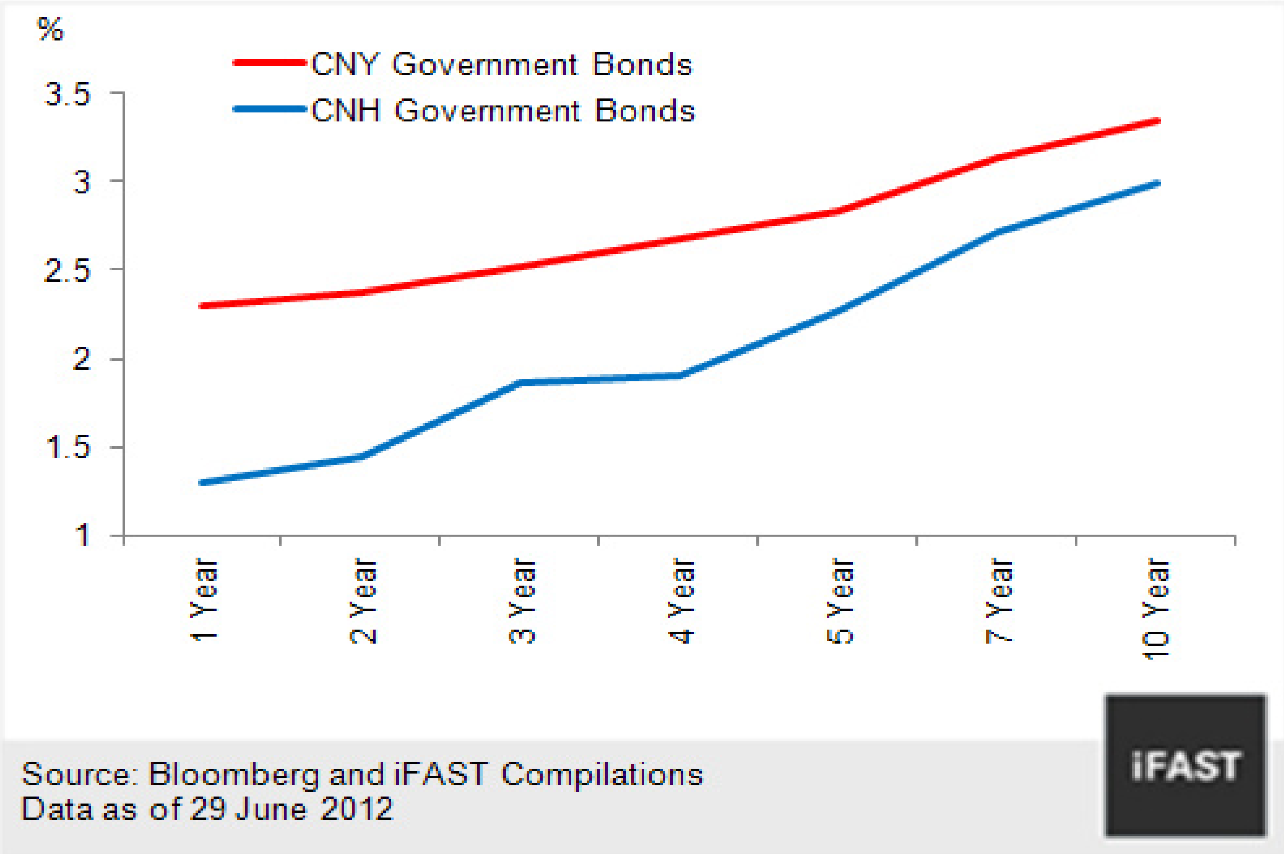
ONSHORE RMB PRODUCTS *(cont'd)*

Why?

- Hedging
- Greater variety of RMB products, such as RQFII retail funds and ETFs
- Greater access to the retail market

ONSHORE RMB PRODUCTS *(cont'd)*

- Direct access to PRC Securities



ONSHORE RMB PRODUCTS *(cont'd)*

The future for RQFII

- Taiwan may be the next beneficiary of the RQFII program

HK-PRC MUTUAL RECOGNITION OF FUNDS

HK-PRC MUTUAL RECOGNITION OF FUNDS

- Announced on 23 January 2013 that “SFC and CSRC were in negotiations for the mutual recognition of mutual funds and units trusts from each others’ jurisdictions to be allowed to be sold to retail investors in each other’s markets”
- Passporting between Hong Kong and the PRC
- Mutual recognition of unit trusts and mutual funds domiciled and authorised in the PRC and Hong Kong

HK-PRC MUTUAL RECOGNITION OF FUNDS *(cont'd)*

- Key features:
  - Only applicable to those funds that are domiciled and SFC-authorised in Hong Kong.
  - "Domiciled in Hong Kong" means funds set up by a Hong Kong-licenced fund management business,using a Hong Kong trustee and in effect, having its primary place of business in Hong Kong.
  - Management of assets, however, is not restricted to Hong Kong – SFC guidelines allow Hong Kong authorised funds to be set up as fund-of-funds
  - No automatic entry as Hong Kong authorised fund into PRC and vice versa - the key condition is recognised fund status.

K&L GATES

HK-PRC MUTUAL RECOGNITION OF FUNDS *(cont'd)*

- What's the big deal?

SFC – authorised unit trusts and mutual funds – by origin

	As at 30.9.2012	As at 31.3.2012	Change (%)
Hong Kong	**296**	261	13.4
Luxembourg	**1,048**	1,070	-2.1
Ireland	**280**	282	-0.7
Guernsey	**1**	3	-66.7
United Kingdom	**53**	53	-
Other Europe	**2**	2	-
Bermuda	**7**	22	-68.2
British Virgin Islands	**5**	5	-
Cayman Islands	**150**	157	-4.5
Others	**8**	8	-
Total	**1,850**	1,863	-0.7

HK-PRC MUTUAL RECOGNITION OF FUNDS *(cont'd)*

- Hong Kong domiciled funds may be the start, but it signals loosening of policy
- Access to the PRC retail market
  - Mutual fund industry in PRC is less than 15 years old but in that time, total assets in funds, trust company products and insurance savings have grown to exceed US$2 trillion in size
  - Current market capitalization of China-listed securities exceeds US$4 trillion. More than 2500 listed securities
  - Average savings rate in PRC exceeds 50% of GDP – or about US$4 trillion per annum

HK-PRC MUTUAL RECOGNITION OF FUNDS *(cont'd)*

- Huge opportunity for service providers
  - If all 1,850 authorised funds in Hong Kong were locally domiciled, an additional US$3.5 billion in domestic fund administration and support service fees would be injected into Hong Kong's asset management industry.
  - For every US$1 of assets under management (AUM) in a fund, 25 basis points would go to service providers
  - For any one full-time employee working directly in the asset management industry for a locally domiciled fund, there are 4.6 jobs in the industry for servicing the fund structure
  - In Hong Kong, there are almost 4,000 direct jobs in the asset management industry, according to a recent SFC survey

HK-PRC MUTUAL RECOGNITION OF FUNDS *(cont'd)*

- Avoidance of UCITS, AIFMD, MiFID II, RDR regulations
- Lower Costs
- Mandatory Provident Fund Use in HK
- QDII may only invest in jurisdictions which have signed agreements with CSRC

HK-PRC MUTUAL RECOGNITION OF FUNDS *(cont'd)*

- Where are we now?
  - As at 6 June 2013 – still trying to get "a consensus of the minds"


HK ETFS FOR DOMESTIC PRC RESIDENTS

HK ETFS FOR DOMESTIC PRC RESIDENTS

- Pilot program for ETFs tracking Hong Kong stocks and the RMB Qualified Foreign Institutional Investors (RQFII) in Shenzhen approved on 6 June 2013
- Will offer mainland investors access to offshore securities market
- Success depends on market conditions, valuations, sophistication of investors
- May face same issues as QDII

REITS

REITS

Table 1

Asian REIT performance: post-GFC

Country	Average annual return		Risk		Risk-adjusted returns	
	REITs	Stocks	REITs	Stocks	REITs	Stocks
Japan	8.4%	3.7%	21.0%	19.9%	0.40	0.18
Singapore	28.5%	24.6%	18.5%	21.8%	1.52	1.11
Hong Kong	30.2%	19.5%	14.2%	24.6%	2.11	0.79
Malaysia	23.3%	25.6%	9.2%	13.5%	2.25	1.71
Thailand	20.9%	44.5%	6.3%	20.6%	3.00	2.06
Taiwan	25.2%	17.0%	13.7%	23.7%	1.80	0.70
South Korea	0.2%	19.3%	23.0%	21.6%	-0.10	0.78

Source: Professor Newell's analysis

REITS (cont'd)

	REIT markets	Total returns (Apr 06 to Feb 13)	Volatility
1	Singapore REITs - SGD UBS Singapore REIT Total Return Index	82.1%	24.6%
2	Hong Kong REITs - HKD GPR 250 REIT Hong Kong REIT Index	195.8%	21.4%
3	Japan REITs - JPY Tokyo Stock Exchange REIT Index	9.8%	21.0%
4	Asian REITs - USD Bloomberg Asia REIT Index	91.1%	19.6%
5	Australia REITs - AUD S&P/ASX 300 AREIT Accumulation Index	(17.1%)	22.2%
6	Asia Pacific REITs - USD FTSE EPRA/NAREIT Asia REITs Total Return Index	44.5%	24.0%
7	US REITs - USD FTSE NAREIT All REITs Total Return Index	37.7%	30.3%
8	Global REITs - USD FTSE EPRA/NAREIT Developed Total Return Index	28.4%	26.3%

Source: Bloomberg, monthly data from April 2006 - February 2013 in local currency terms with dividends reinvested into the index NB: The EPRA/NAREIT Asia REITs Index is in fact an Asia Pacific REITs index, which includes the sizeable and mature Australian REIT market and plays a large part in explaining the index's mediocre performance over the last 7 years. While EPRA/NAREIT does not have regional sub indexes, using other reliable providers included in the table breaks down the performance of major REIT markets in Asia.

REITS *(cont'd)*
Hong Kong

- Fairly young – since 2003 when Code on REITs introduced
- First REIT was the LINK REIT in November 2005
- Regulations
  - Code on Real Estate Investment Trust
  - Securities and Futures Ordinance
  - The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited
  - General trust and taxation laws, common laws

REITS *(cont'd)*
Hong Kong (2)

- Structure
  - Must be trusts
  - Domiciled in Hong Kong
  - Listed on HKEX
- Over the past 3 years: prices rose an average of 89% vs. Hang Seng Index, which dropped ~6.5%
- 2007 to 2010: increase of value of 49%
- Recent Development: Hui Xian REIT (2011) – first RMB-denominated REIT

REITS *(cont'd)*
Singapore

- First REIT regulations introduced in 1999
- First REIT to list in Singapore – CAPITAL Mall Trust in 2002
- Regulations/Regulator
  - Code of Collective Investment Schemes
  - Securities and Futures Act
  - Monetary Authority of Singapore
  - General trust and taxation laws, common laws

REITS *(cont'd)*
Singapore (2)

- Structure
  - May be trust or corporation
  - No domicile restrictions
  - Listing on SGX not mandatory but customary – every REIT in Singapore is listed
- 2012: best performing REITs in the world (average return of 37% – twice the gains in the US, UK, and Japan)
- Average dividend yield of approx. 6.47% (vs. HK = 4.97%)

REITS *(cont'd)*

Singapore (3)

- Earnings growth (distribution per unit) all-time high between 2006-2008 (13% growth rate). Estimated to slow to ~4% up to 2014.
- Recent Development: Mapletree Greater China Commercial Trust – US$1.3 billion IPO on SGX (institutional investors oversubscribed 37x). Closed March 11, 2013 15% above IPO price of S$0.93/unit

K&L GATES

REITS *(cont'd)*
Malaysia

- Long history of property trusts going back to 1989 with Amanah Harta Tanah PNB (AHT) the first property trust to list on Bursa Malaysia
- The first REIT in Malaysia, in the currently-recognised form, listed on Bursa Malaysia in 2004 – the AXIS REIT

REITS *(cont'd)*
Malaysia (2)

- Regulations/Regulator
  - Securities Commission Act 1993
  - Capital Market Services Act 2007
  - Guidelines for Real Estate Investment Trusts 2008
  - Guidelines for Islamic Real Estate Investment Trusts 2005
  - Securities Commission Malaysia
  - General trust and taxation laws, common laws

REITS *(cont'd)*
Malaysia (3)

- Structure
  - Trust
  - Local ownership and bumiputera ownership requirements
  - Listing on Bursa Malaysia
- Average gross dividend yield of approximately 6.4%, net 4.4%
- KLCC Property Real Estate Investment Trust, Malaysia's biggest REIT, rose as much as 6.3 percent in its relisting on 9 May 2013, trading at RM7.71 to its index price of RM7.25
- Islamic REITS

WHAT ARE THE ISSUES?

HOT SPOTS

- Asset Bubble (Bonds)
- Maturing market (defaults)
- Enforcement
  - By regulators
  - Of documents
- Market environment
- Currency risks
- Rapidly-changing regulatory framework

K&L GATES

WHERE SHOULD WE BE?

- Taiwan
  - Specialised products
- Singapore
  - REITs
- Hong Kong
  - Everything else


THE END
THANK YOU

K&L GATES

Marketing Funds and Investment Services in the Middle East

Natalie Boyd, Partner, Dubai

2 July 2013

DC #9711854v1

Agenda

- Overview of the GCC countries
- Opportunities and challenges for foreign firms seeking to invest in the GCC
- Issues to consider when marketing funds and investment services in each GCC country
- Broader legal and geopolitical considerations

The Gulf Co-operation Council Countries (GCC)

GCC Facts

- Establishment: Abu Dhabi, 25 May 1981
- Political and economic union. Members are:
  - Saudi Arabia: Largest and capital of the GCC countries: 20% world's proven oil reserves
  - United Arab Emirates: Location of the region's largest SWF: $627bn assets[1]
  - Oman: Dwindling oil reserves. Heavily reliant on tourism
  - Kuwait: 9% world's proven oil reserves
  - Bahrain: Reputation as commercial hub and population dwindled due to Arab Spring
  - Qatar: Richest country in the world. Over 25 billion barrels of proven oil reserves. 14% world's national gas reserves. Smallest per capita GCC country
- Population: 42,100,000
- GDP (nominal):
  - Total: $1.386 trillion
  - Per capita: $33,005
- No economic monetary union

1 Based on Global Finance 2013

Opportunities for Foreign Firms Seeking to Invest in the GCC

- GCC is home to some of the world's largest SWFs: 35.6% of world SWF allocation[1]
  - ADIA: $627bn[2]
  - SAMA Foreign Holdings: $533bn
  - Kuwait Investment Authority: $296bn
  - Qatar Investment Authority: $100bn
  - Investment Corporation of Dubai: $70bn
  - International Petroleum Investment Company: $50bn
- Reduced business opportunities in the US and Europe are attracting firms to the GCC on a fly-in/fly-out (tolerated practice) model
- Regional wealth continues to rise despite global economic difficulties: 9.1% 2013[3]
- Funds sector is not as highly regulated in Europe, US, Asia

1 Based on Sovereign Wealth Fund Institute 2012 Allocation Report

2 Based on Global Finance 2012 figures

3 Boston Consulting Group 2013

K&L GATES

Challenges for Foreign Firms Seeking to Invest in the GCC

- Disparity between regulatory and legal regimes across the GCC
- Perceived lack of transparency and clarity of regulations and laws; lack of passporting across the GCC
- Regional regulation of financial services activities is evolving in line with the tightening of US and European regulation resulting from the global economic crisis
- Tolerated practice model is being increasingly observed by GCC regulators and regulation is developing to restrict or prohibit it
- Non-licensed firms are not immune from sanction by GCC regulators

The Dubai International Financial Centre (DIFC)

- An offshore free-zone jurisdiction within the UAE and the GCC commercial hub
- Regulated by the DFSA
- Permitted financial service activities are limited by the category of DFSA licence
- DFSA licence does not permit a DIFC firm to carry on licensable activities in onshore UAE which requires a UAE onshore licence
- No plans for onshore passporting of DFSA licences
- Potential competition from QFC and Abu Dhabi free zones
- Domestic DIFC Funds Regime
- Exempt Funds Regime
  - Principles
  - External Fund Managers
  - Specialist Funds

K&L GATES

The UAE (outside the DIFC)

- An onshore jurisdiction housing some of the world's largest sovereign wealth funds (ADIA, ICD, IPIC)
- Regulated by the UAE Central Bank and ESCA
- "Doing business" in the UAE is not permitted without a licence – no definition of doing business
- Obtaining an onshore licence is costly and likely to be prolonged
- Many non-licensed firms acted on a cross-border basis in reliance on accepted guidelines for tolerated practice
- Specific restriction of marketing on foreign funds now imposed by the UAE Investment Funds Regulation 2012
  - Approval by ESCA
  - Role of local promoter
  - Grace period for existing funds
- Limited exemption provided by 2013 amendment to UAE Investment Funds Regulation

The Qatar Financial Centre (QFC)

- An onshore commercial hub within Qatar with free zone benefits
- Regulated by the QFRCA
- Unlike DIFC, QFRCA licence permits a QFC firm to carry on activities permitted by its licence outside the QFC
- QFRCA is incentivising foreign firms to set up in the QFC through offers of seed capital
- Foreign firms tend to conduct business on a tolerated practice basis
- Two types of funds: Registered Funds and Foreign Funds
  - Registered fund is a QFC fund established under Collective Investment Scheme Rules 2010
  - Foreign Fund is a collective investment fund not established in the QFC
- Private placement regime
- Payments to foreign entities are subject to withholding tax: Income Tax Law No. 21 of 2009

Qatar (outside the QFC)

- Distinct regulatory regime from the QFC – financial services activities are regulated and licensed by the QCB and QFMA
- “Doing business” in Qatar is not permitted without a licence – no definition of doing business
- Onshore licences are not often issued to non-Qatari firms
- Foreign firms tend to act on a tolerated practice basis
- Foreign funds are required to be registered in Qatar
- Public offerings are limited to QCB licensed entities
- Withholding tax considerations same as in QFC
- Potential restrictions on foreign funding by Law No. 13 of 2012

Saudi Arabia

- Foreign entity must be licensed by CMA as an "authorised person" (AP) or act through an AP
- Obtaining a CMA licence takes at least a year
- No concept of tolerated practice or reverse solicitation
- Foreign funds must be registered and distributed by an AP
- Foreign funds can not be offered to the public
- Private placement exemption for certain securities activities; but not for funds activities
- CMA has issued a warning to foreign firms carrying on financial services activities without a licence

Kuwait/Oman

- Financial services activities regulated and licensed by the CMA
- Kuwaiti CMA will only issue licences to Kuwaiti firms; foreign firms are encouraged to act through locally licensed intermediary
- Kuwaiti CMA requires a licence to be issued for <u>each</u> offering
- Non-licensed firms act on cross-border basis in reliance on accepted guidelines for tolerated practice
- No requirement to register foreign funds offered on a cross-border basis; local intermediary will be obliged to register funds offered in Kuwait
- No private placement exemptions
- Tax implications in Kuwait and Oman
- Currency restrictions on transfer of Omani rial to non-residents holding of offshore rial accounts

Bahrain

- Foreign entity must be licensed by Ministry of Industry & Commerce and Central Bank (CBB) or act through a licensed intermediary
- Foreign funds characterised as Collective Investment Undertakings must be registered with and approved by the CBB
- Non-licensed firms act on a cross border basis in reliance on accepted guidelines for tolerated practice
- Private Placement regime – minimum subscription amount; must be approved by CBB and made only to Accredited Investors
- Central Bank of Bahrain is paying closer attention to fly-in/ fly-out model adopted by non-licensed firms

Broader GCC Considerations

- Public sector/sovereign immunity issues
- Significance of governing law and dispute resolution clauses
- Litigation vs. arbitration
  - ICC
  - Dubai is seat of choice for MENA
  - DIAC
  - DIFC – LCIA

THANK YOU

QUESTIONS?

K&L GATES

Current Issues for Compliance Officers

Clifford J. Alexander, Partner, Washington, DC
Robert Hadley, Partner, London
Cary J. Meer, Partner, Washington, DC
Elizabeth Robertson, Partner, London

2 July 2013

DC #9707083v8

Presentation Overview

- Identification and Valuation of Illiquid Securities
- CPO and CTA Registration for Fund-of-Funds Managers
- Forms PF, CPO-PQR and NFA-PQR
- Broker-Dealer Issues
- Status of JOBS Act
- Protection of Client Information (Red Flags Rules)
- Alternative Investments Issues
- Inadvertent Custody
- Recent SEC and FCA Enforcement Actions and Litigation

Identification and Valuation of Illiquid Securities

Identification and Valuation of Illiquid Securities

- Possible Controls
  - Daily variance to an index (3%)
  - Weekly variance to an independent pricing source
  - Daily back testing for fixed income securities
  - Stale (unchanged) prices for five days
- Impact of Inaccurate Valuations
  - Performance
  - Fees
  - Records

K&L GATES

Identification and Valuation of Illiquid Securities *(cont'd)*

- Securities with a Potential for Issues
  - Private placements
  - High yield securities
  - Tax-exempt securities
  - Bank loan participations
  - Defaulted bonds
  - Bankrupt issuers
  - Stopped trading
  - Closed exchanges
  - Foreign securities
  - Corporate actions
  - New bond issues

CPO and CTA Registration for Fund-of-Funds Managers

Funds-of-Funds (“FOFs”)

- What is a FOF for CFTC purposes?
  - A FOF can be a commodity pool even if the investing fund does not trade commodity interests directly
  - Mortgage real estate investment trusts (“mortgage REITs”), securitisation vehicles, business development companies (“BDCs”)
- CFTC Amendments to Part 4 Regulations
  - Exemptions from registration in CFTC Regulation 4.13(a)(4) rescinded for commodity pool operators (“CPOs”), and in Regulation 4.14(a)(8) for commodity trading advisors (“CTAs”)
  - FOF operators can continue to rely on rescinded guidance for operators of FOFs until new guidance is issued

Funds-of-Funds *(cont'd)*

- Current No-Action Relief (No-Action Letter 12-38)
  - CPO registration relief for:
    - Operators of newly formed funds, preexisting funds
    - Operators of mortgage real estate investment trusts, certain "plain vanilla" securitisation vehicles, and business development companies that meet specified conditions
  - Note: not available to sub-advisers
- CFTC staff guidance still under development

Forms PF, CPO-PQR and NFA-PQR

Form PF

Form PF must be filed by <u>all</u> advisers that:

- Are registered or required to be registered under the Investment Advisers Act of 1940
- Advise one or more “private funds” – issuers exempt from registration under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940
- Manage at least $150 million “regulatory assets under management” attributable to private funds as of end of most recent fiscal year

K&L GATES

Form PF *(cont'd)*

Form PF requires:

- Section 1: Aggregate information regarding adviser's identity and AUM, and information about each managed private fund and adviser's hedge funds
- Section 2: Aggregate information about each managed hedge fund and additional information on large hedge funds
- Section 3: Information about each large liquidity fund
- Section 4: Information about each large private equity fund

Form PF *(cont'd)*

Filing deadlines:

- If adviser had $5 billion in private fund assets under management, first filing was with respect to June 30, 2012 – number of days depends on type of filer as set forth below (large hedge fund, large liquidity fund or large private equity fund adviser)
- All others – first filing was with respect to December 31, 2012
- Large hedge fund advisers ($1.5 billion attributable to hedge funds) must file quarterly within 60 days of end of adviser's fiscal quarter
- Large liquidity fund advisers ($1 billion attributable to liquidity funds) must file quarterly within 15 days of end of adviser's fiscal quarter
- Large private equity and smaller private fund advisers must file annually within 120 days of end of adviser's fiscal year

Form CPO-PQR

CFTC adopted CFTC Regulation 4.27(d), which establishes new reporting requirements with respect to private funds

- Requires CPOs to report certain information to the CFTC on Form CPO-PQR:
  - Schedule A seeks basic identifying information about the CPO
  - Schedule B requires information on each non-exempt pool operated by a CPO
  - Schedule C requires that "Large CPOs" (at least $1.5 billion AUM) report information on an aggregate basis as well as on an individual pool basis for each "Large Pool," *i.e.*, any pool that has a net asset value individually, or in combination with any parallel pool structure, of at least $500 million

Form CPO-PQR *(cont'd)*

Filing Requirements:

- CPOs dually registered with the SEC and CFTC that file Sections 1 and 2 of Form PF, as applicable, must generally file only Schedule A of Form CPO-PQR
- Non-dually registered CPOs must file all relevant sections of Form CPO-PQR based on certain reporting thresholds
- Even if a dually registered CPO files Form PF with the SEC, it may still need to file Schedules B and/or C of Form CPO-PQR if it has pools that were not captured on Form PF
- Must be filed via NFA's EasyFile System

K&L GATES

NFA Form PQR

NFA Compliance Rule 2-46:

- Requires each CPO NFA Member to file NFA Form PQR quarterly for each pool it operates and for which it has any reporting requirement under CFTC Regulation 4.27
  - Do not generally need to include pools for which the CPO can rely on Regulation 4.13(a)(3) exemption
- Provides that each CPO NFA Member that is required to file Form CPO-PQR quarterly does not need to file NFA Form PQR
  - If CPO only has annual reporting requirement with CFTC, must still file NFA Form PQR quarterly

NFA Form PQR *(cont'd)*

Filing Requirements:

- CPO Members required to file NFA Form PQR must file quarterly with the NFA within 60 days of end of first 3 quarters as well as year-end report within 60 or 90 days, depending on size of CPO
- Even if only have Schedule A reporting requirement (*e.g.*, because CPO also files Form PF), must file/update Schedule of Investments <u>quarterly</u> under NFA-PQR reporting requirements
  - Requires categorisation of investments into cash, equities, alternative investments, fixed income, derivatives, options and funds
  - Once categorised (and, in some cases, sub-categorised), if dollar value of any investment equals or exceeds 5% of pool's net asset value (NAV), must itemise investments in sub-category

Broker-Dealer Issues

Broker-Dealer Issues

- While working as an independent consultant for Ranieri Partners LLC ("Ranieri"), Stephens actively solicited investors on behalf of private funds managed by Ranieri's affiliates and received transaction-based compensation totaling approximately $2.4 million (1% of capital commitments of investors introduced by Stephens)
  - Stephens' solicitation efforts included:
    - Sending PPMs, subscription documents, and due diligence materials to potential investors
    - Urging at least one investor to consider adjusting its portfolio allocations to accommodate an investment in Ranieri funds
    - Providing potential investors with his analysis of Ranieri's funds' strategy and performance track record
    - Providing potential investors with confidential information relating to the identity of other investors and their capital commitments

K&L GATES

Broker-Dealer Issues *(cont'd)*

- By his actions, Stephens engaged in the business of effecting transactions in securities without first being registered as a broker or dealer or associated with a registered broker or dealer
- Ranieri and Donald W. Phillips, then Senior Managing Partner, provided Stephens with key documents and information related to Ranieri's private equity funds and did not take adequate steps to prevent Stephens from having substantive contacts with potential investors
- Ranieri, Phillips and Stephens penalised by SEC

Status of JOBS Act

K&L GATES

JOBS Act – General Solicitation Rule

In April 2012, President Obama signed into law the Jumpstarting Our Business Startups Act (“JOBS Act”)

- Section 201 of JOBS Act requires certain amendments to private placement provisions of Rule 506 of Regulation D under the Securities Act of 1933, which must be implemented by an SEC rule
- In August 2012, the SEC proposed a rule that permits general solicitation if the issuer can objectively determine if the purchaser of an offered security is an “accredited investor” under Rule 506
  - This is proposed as a “facts and circumstances” test
    - Depends on factors such as type of purchaser accredited investor claims to be, amount and type of information an issuer has about a purchaser, and nature of offering

JOBS Act – General Solicitation Rule *(cont'd)*

- Proposed rule met with considerable backlash
  - Senator Carl Levin and consumer advocacy groups urged the SEC to repropose the rule
  - SEC criticised for failing to meet 90-day deadline for finalising proposed rule as required under JOBS Act
- As of this date, the SEC has not indicated whether the proposed rule will be reproposed or if it will be finalised based on the current proposal

JOBS Act – General Solicitation Rule *(cont'd)*

- SEC Chairman Mary Jo White announced that completing the outstanding rulemakings under the JOBS Act and the Dodd-Frank Act is a "top priority," but no timeline has been given for completion of the General Solicitation/Advertising Prohibition Rule
  - Speculation that SEC Chairman White may take the step of issuing an interim final rule to implement the General Solicitation/Advertising Prohibition in its current form, rather than issuing a final rule with additional consumer protection
- As long as private funds comply with amended Rule 506, they may engage in general solicitation or advertising without losing their exemptions under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act

JOBS Act – General Solicitation Rule *(cont'd)*

- JOBS Act does not eliminate all regulatory considerations regarding general advertising and solicitation for private placements
  - SEC-registered investment advisers still must comply with Investment Advisers Act rules relating to advertising to extent applicable
  - Broker-dealers that are FINRA members acting as placement agents or intermediaries that engage in general solicitation or advertising on behalf of issuers, including private funds or their managers, must comply with FINRA advertising and public communication rules

JOBS Act – General Solicitation Rule *(cont'd)*

- Note that JOBS Act did not amend Commodity Exchange Act
  - Unclear whether an issuer can engage in general solicitation if it is offering a fund where it is relying on CFTC Regulations 4.13(a)(3) or 4.7(b), which also require that the fund interests be offered "without marketing to the public"
    - CFTC staff has indicated that they are aware of this issue and will consider amending the rules to harmonise them with the SEC's rule amendments once they are finalised

Protection of Client Information

(Red Flags Rules)

K&L GATES

SEC and CFTC Red Flags Rules

- Dodd-Frank Act transferred identity theft rulemaking responsibility and enforcement authority to SEC and CFTC with respect to SEC and CFTC regulated entities
- Formerly was in hands of Federal Trade Commission ("FTC")
- SEC and CFTC jointly adopted rules and guidelines that require certain regulated entities that are subject to their enforcement authority to establish programs to address risks of identity theft

SEC and CFTC Red Flags Rules *(cont'd)*

- SEC/CFTC rules are substantially similar to FTC's rules, but include examples and minor language changes more tailored to SEC and CFTC regulated businesses
  - Main change for existing programs is to update rule references
- Rules require certain SEC or CFTC regulated entities to develop and implement written program designed to detect, prevent, and mitigate identity theft in connection with certain accounts
- Rules operate the same for all covered entities, regardless of size

K&L GATES

SEC and CFTC Red Flags Rules *(cont'd)*

- Written identity theft program must have policies and procedures designed to:
  - Identify relevant types of identity theft red flags
  - Detect occurrence of those red flags
  - Respond appropriately to detected red flags
  - Provide for administration of program, including staff training and oversight of service providers
  - Periodically update program
- Rules include guidelines and examples of red flags but do not single out specific red flags or require specific policies and procedures to identify them

K&L GATES

SEC and CFTC Red Flags Rules *(cont'd)*

- Rules apply to SEC and CFTC regulated financial institutions and creditors that offer or maintain covered accounts
  - Entities likely to qualify include registered brokers, dealers, investment companies, investment advisers, futures commission merchants, retail forex dealers, CTAs, CPOs, introducing brokers, swap dealers and major swap participants
- Compliance with new rules is required by 20 November 2013

SEC and CFTC Red Flags Rules *(cont'd)*

- To the extent broker-dealer or fund has a red flags program, the program needs to be coordinated with its anti-money laundering program, especially in the areas of account opening, due diligence, activity monitoring and suspicious activity reporting

SEC and CFTC Red Flags Rules *(cont'd)*

Exception:

- If an adviser does not lend money, short term or long term, and it cannot direct transfers/payments from accounts belonging to individuals to third parties upon the individuals' instructions (*i.e.*, the money going out of the account goes back to the account that the money came from), then the adviser does not maintain a "transaction account" and would not be required to maintain a red flags program
  - Prudent to implement some type of monitoring system to identify changes in practice, because, if adviser were to permit a client to direct money elsewhere, then issue of whether a red flags program is required would need to be reexamined
- Important to note that determination regarding whether a red flags program is required is very <u>*fact specific*</u>

Alternative Investments Issues

K&L GATES

Alternative Investments Issues

- Many advisers are looking at alternative investments as a way to achieve non-correlated alpha, which can involve private equity-type investments
- CCO issues:
  - Due diligence
  - Documents
  - Valuation
  - Tax issues
  - Form of organisation (corporation, limited liability partnership, limited liability company, master limited partnership, business trust)

Inadvertent Custody

K&L GATES

Inadvertent Custody

- Advisers who have "custody" must comply with certain requirements designed to protect client assets
- The SEC Office of Compliance Inspections and Examinations issued a Risk Alert in March reporting that 1/3 of the advisers it examined had "serious deficiencies" in Custody Rule compliance
  - Failure to recognise they had custody
  - Failure to comply with the qualified custodian requirement
  - Failure to comply with the surprise audit and quarterly account statement requirements
  - Failure of hedge fund advisers to comply with the audit exception to the surprise audit and quarterly account statement requirements

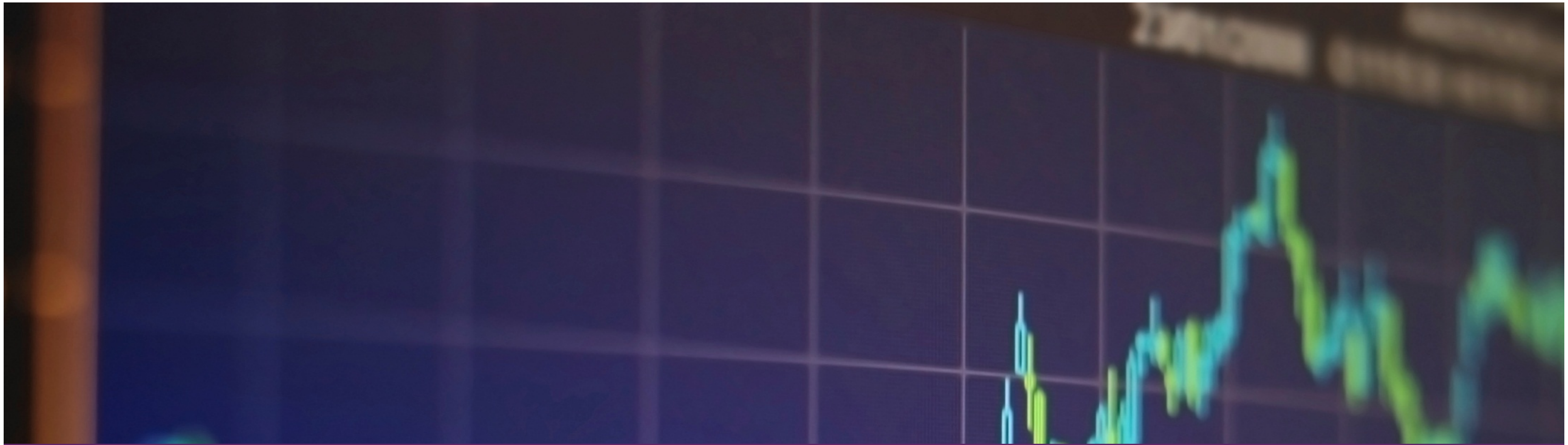
K&L GATES

Inadvertent Custody *(cont'd)*

- The concept of custody is broad and can include the following:
  - Receipt of securities or funds
  - Power of attorney
  - Serving as the general partner or managing member of a private fund
  - Authority to withdraw from an account
  - Authority to pay client bills
  - Trustee relationship
  - An affiliate has custody

Inadvertent Custody *(cont'd)*

- Custody triggers a number of requirements, including an annual surprise examination of client accounts and statements by an independent public accountant
- SEC staff has tried to make accounting firms deputy examination staff by requiring a report to be filed with the SEC if the accountants find a "material discrepancy"



Recent SEC and FCA Enforcement Actions and Litigation

SEC Enforcement Actions and Litigation

Note: Most of the SEC proceedings involved decisions based on voluntary settlements in which the respondents expressly stated that they neither admitted nor denied the findings contained in the SEC Order

K&L GATES

US Enforcement and Litigation

- US Supreme Court Agrees to Hear Fidelity Whistleblower Case
  - US Supreme Court agreed to hear an appeal of *Lawson v. FMR LLC,* in which two former employees alleged that Fidelity violated the whistleblower protections of the Sarbanes-Oxley Act of 2002 when it retaliated against them after they reported potential securities laws violations to their superiors
    - Fidelity is a private company
    - The former Fidelity employees have argued that they were contractors of public companies, like mutual funds, and were covered by the whistleblower protections

US Enforcement and Litigation *(cont'd)*

- "Fraud Discovery Rule" Does Not Apply to SEC Enforcement Actions Seeking Civil Penalties
  - US Supreme Court unanimously rejected SEC's position that the "fraud discovery rule" applies to SEC enforcement actions seeking civil penalties
  - In April 2008, SEC sued two Gabelli executives for allegedly allowing a fund client to engage in market-timing from 1999 to 2002
  - Federal law requires that the SEC initiate a case within five years, which traditionally has been measured from the time the alleged wrongful conduct occurred
  - Supreme Court's decision does not apply to disgorgement of illegal profits or situations where a defendant endeavors to actively conceal its fraudulent conduct

US Enforcement and Litigation *(cont'd)*

- "Admit or Deny" Settlements
  - Years ago, the SEC allowed a person to settle an enforcement case but deny he did anything wrong
  - In response to criticism, the SEC has made a number of changes over the years
    - The SEC has prohibited persons from denying guilt
    - Now the SEC will insist on admissions of guilt in some cases
- Benefits to the SEC of the Policy
  - Easier to bring a "message case"
  - Fewer settlements
- Detriments to the SEC of the Policy
  - Longer delays before victims get compensated
  - Greater money and resources cost to the SEC

FSA Enforcement

- Credible Deterrence
  - Market Abuse Insider Dealing
  - Criminal Prosecution
  - Higher Fines
  - More Prohibitions
  - Senior Management "Continuing Focus"

FCA Enforcement

"Credible deterrence will remain central to our enforcement approach"

- Bringing more enforcement cases and pressing for tough penalties for infringements of rules to reset conduct standards
- Pursuing more cases against individuals and holding members of senior management accountable for their actions
- Pursuing criminal prosecutions, including for insider dealing and market manipulation
- Taking action to tackle unauthorised business
- Continuing to prioritise compensation for consumers

FCA Enforcement *(cont'd)*

- Enforcement will focus on:
  - Reinforcing proper standards of market conduct
  - Ensuring firms put consumers at the heart of their businesses
- FCA will pursue a strategy of:
  - Credible deterrence
  - Taking tough and meaningful action against firms and individuals who break rules
  - "We will continue to use the full range of our criminal, civil, and regulatory powers to support our priority of securing better results for consumers and reinforcing our commitment to ensuring markets function well."
    - Business Plan 2013/14

FCA Business Plan 2013/14

- Highlighted Issues Relevant to Funds and Investment Managers:
  - Segregation of Client Assets
  - Fund Fee Structures
  - AIFMD
  - Conflicts of Interest Review 2013/14
  - Product Intervention

Higher Fines

- £377 million
- £160 million
- £150 million
- £16 million
- £9.5 million
- £29.7 million

K&L GATES

LIBOR

- Principles 3 and 5 breached

- 27 June 2012 Barclays - £85 million
  - (reduced to £59.5 million after 30% discount)

- 19 December 2012 UBS - £200 million
  - (reduced to £160 million after 20% discount)

- 6 February 2013 RBS - £125 million
  - (reduced to £87.5 million after 30% discount)

Insider Dealing – Criminal Prosecutions

Richard Joseph

- Former futures trader
- Investment bank print room manager passing inside information on which Joseph traded
- £591,117 profit September 2007 to July 2008
- Four years
- Linked to Project Saturn – seven convictions in July 2012

Insider Dealing – Criminal Prosecutions *(cont'd)*

Thomas Ammann

- Mizuho International plc
- Advising Canon on acquisition of Océ NV, passed information to two associates, who returned half of their profits to him
- Associates acquitted
- Two years eight months

Insider Dealing – Criminal Prosecutions *(cont'd)*

Paul Milsom

- Senior Equities Trader disclosing inside information about investment manager's transactions
- £245,000 confiscation
- Two years
- Plea Agreement – second

K&L GATES

Market Abuse: Market Manipulation

- Stefan Chaligné, Patrick Sejean, Cheickh Tidiane Diallo
  - Cayman OEIC/BVI Investment Manager
  - Chaligné ordered Sejean and Diallo to buy shares
  - Large trades before the close; 31 December Year End NAV
  - Real Trades

Market Abuse: Market Manipulation *(cont'd)*

- Stefan Chaligné, Patrick Sejean, Cheickh Tidiane Diallo
  - Mr. Chaligné €362,950 disgorgement of benefit
  - £900,000 fine, prohibition order
  - Mr. Sejean fined £600,000, prohibition order
  - Mr. Diallo given prohibition order; no fine due to hardship

K&L GATES

Market Abuse: Market Manipulation *(cont'd)*

- Stefan Chaligné, Patrick Sejean, Cheickh Tidiane Diallo
  - Mr. Chaligné not aiming to increase fees – but still "dishonest"
  - Mr. Sejean's penalty increased at Tribunal – despite claimed financial hardship
  - "Removal from the market must be expected by those who are caught"

Market Abuse: Market Manipulation *(cont'd)*

Swift Trade

- Layering

Argued in Tribunal

- No jurisdiction
- CFDs
- Not me Guv
- No investor loss
- Abuse because settled with Canadian Regulator
- £8 million

Publicity

- FCA plans to publish information about warning notices CP13/8
- Starting point will be to publish
  - Assume the subject will be identifiable
- Circumstances where publication will not occur
  - Detrimental to consumers/financial system stability
  - “Unfair”
    - Health
    - Disproportionate loss of livelihood
    - Prejudice to criminal process
    - “Some other equal degree of harm”
- Appeal procedure against publication decision - RDC

K&L GATES

Publicity *(cont'd)*

Decision Notices Under Appeal

- Swift Trade
- Arch Financial Products LLP/Farrell/Addison
  - Serious reputational damage to firm and individuals
  - Prejudice in civil proceedings
- Angela Burns
  - "Destruction of livelihood"

K&L GATES

Prudential

1 March 2010

- Prudential announces intention to acquire AIA from AIG for US$35.5 billion – rights issue US$14.5 billion

June 2010

- Prudential announces it is not pursuing the transaction

Prudential *(cont'd)*

<u>2009/10 Timeline</u>

Late 2009

- AIG intention to dispose of AIA

October 2009

- Prudential informs AIG of bid intention

January 2010

- Prudential begins due diligence

12 January 2010

- Confidentiality agreement signed

31 January 2010

- Prudential board meets Credit Suisse to be briefed on transaction

12 February 2010

- Prudential/FSA annual supervisor meeting

K&L GATES

Prudential *(cont'd)*

15 February 2010

- AIG sends draft SPA to Prudential

27 February 2010

- Rumours of the deal appear in the media

27 February 2010

- Prudential informs FSA/UKLA

28 February 2010

- AIG board approves Prudential bid

1 March 2010

- Prudential announces intention to acquire AIA

Prudential *(cont'd)*

- Prudential Assurance Company Limited
  - Principle 11
  - £16 million
- Prudential plc
  - Listing Principle 6
  - £14 million
- Cheick Tidjane Thiam
  - Knowingly concerned in PAC breach of Principle 11
  - Public Censure

Prudential *(cont'd)*

- The "leak" risk
- No actual effect on markets
  - Significant risk of wrong regulatory decisions
  - "Timely and pro-active communication with the FSA is of fundamental importance to the functioning of the regulatory system"
  - "Transformative" transaction
  - Overseas regulators

Senior Management

Mr. Thiam

- Group Chief Executive and Chairman of PAC
- Approved CF1
- Pottage/RBS Report not FSA policy guidance
- FSA accepts must be personally culpable

Senior Management *(cont'd)*

Peter Cummings – Chief Executive of the Corporate division of HBOS

- Statement of Principle 6
- "Knowingly concerned" in HBOS's contravention of Principle 3 (Systems and Controls)
- Three failures highlighted by FSA:
  - Failure to mitigate risks
  - Pursuing aggressive strategy despite risk
  - Failure to exercise reasonable care
- 12 September 2012, £500,000 fine, prohibition order

Client Money/CASS

Xcap Securities PLC – 31 May 2013

- Failure to segregate funds/maintain accurate records in respect of client money and safe custody assets held
- Failure to have in place adequate organisational arrangements, policies and procedures to detect and manage client money and safe custody assets risks
- Principle 3 (systems and controls)/Principle 10 (Client Assets)/CASS Rules
- £151,136 reduced to £120,900 with 20% discount

K&L GATES

Anti-Money Laundering

EFG Private Bank Limited – 28 March 2013

- Ineffective systems and controls re: higher risk customers
- Thematic review
- Principle 3 (Systems and Controls)/SYSC 6.1.1R/6.3.1R
- £6 million reduced to £4.2 million with 30% discount
- HSBC Bank plc

K&L GATES

Suitability

JP Morgan International Bank Limited – 10 May 2013

- Failure to take reasonable care in investment advice and portfolio investment services with adequate risk management systems
- Inadequate processes and training on the assessment of suitability
- Failure to ensure front office staff obtained and properly recorded sufficient KYC and suitability information from clients per procedures

Suitability *(cont'd)*

JP Morgan International Bank Limited – 10 May 2013

- Inadequate compliance monitoring and oversight; no internal audit May 2008-November 2011
- Skilled Person's Report
- Principle 3 (Systems and Controls)/SYSC 9.1.1R
- £4,394,695 reduced to £3,076,200 with 30% discount
- Reviewed 1,416 cases
- 1

Brave New World

- Look forward not back
- Approved Persons/CEO engagement
- Product intervention
- Plus ça change

K&L GATES

EU Fund Developments: UCITS and AIFMD

Dr. Christian Büche, Partner, Frankfurt
Sean P. Donovan-Smith, Partner, London
Cary Meer, Partner, Washington, DC
Philip J. Morgan, Partner, London

2 July 2013

DC #9711733v1

K&L GATES

Overview

- Update on UCITS funds
  - UCITS IV-VI
  - ESMA Guidelines on ETFs and other UCITS issues
- Update on AIFMD developments
  - EU Implementation: Focus on Germany
  - Developments in Switzerland
  - Regulatory reporting
  - Co-operation agreements
  - Developments in the UK

Update on UCITS Funds

K&L GATES

UCITS IV (revisited)

- From July 2011
- Improved cross-border registration
- Use of Key Investor Information Disclosure (“KIID”) documents
- Formal cross-border merger options
- Master/Feeder structures introduced

UCITS V

- Depositaries
  - Delegation
  - Liability
  - Functions
- Enforcement and sanctions
- Data access
- Remuneration

K&L GATES

UCITS VI

- Consultation announced July 2012
- Eligible assets and the use of derivatives
- Money Market Funds
- Depositary passport
- Improvements to UCITS IV

ESMA Guidelines on ETFs and other UCITS issues (December 2012)

- Effective from February 18, 2013
- Efficient portfolio management
- Use of indices
  - Financial index futures (exchange traded or otherwise) must comply with the guidelines on disclosure and rebalancing frequency
  - Prospectus should include a clear description of the indices including information on their underlying components
  - Indices which rebalance on a intra-day or daily basis are not eligible for investment by a UCITS fund
- ETFs
  - UCITS that fall within the definition of an UCITS ETF will have to carry the designation “UCITS ETF”
  - UCITS ETFs will have to ensure appropriate redemption conditions for secondary market investors by opening the fund for direct redemptions when there is a lack of liquidity in the secondary market

Update on AIFMD Developments

Marketing EU-AIF and Non-EU-AIF into Germany

Overview

- Transposition of AIFMD in Germany
- Transitional Provisions
- What is “Marketing”?
- Preconditions to marketing EU-AIF and non-EU-AIF into Germany after 21 July 2013

Transposition of AIFMD in Germany

K&L GATES

Transposition of AIFMD in Germany

- Vermögensanlagengesetz (Investment Act) 2012
  - closed-ended funds are considered financial instruments within the meaning of MiFID
  - private placements of closed-ended funds require a license in Germany since 1 January 2013
- Kapitalanlagegesetzbuch (AIFMD Transposition Act) 2013
  - 20/07/2012 – discussion draft published by Ministry of Finance, call for consultations
  - 12/12/2012 – draft law approved by Cabinet
  - 17/05/2013 – law adopted by Federal Parliament
  - 07/06/2013 – no objections by Federal Council
  - ??/07/2013 – law published in Federal Gazette

K&L GATES

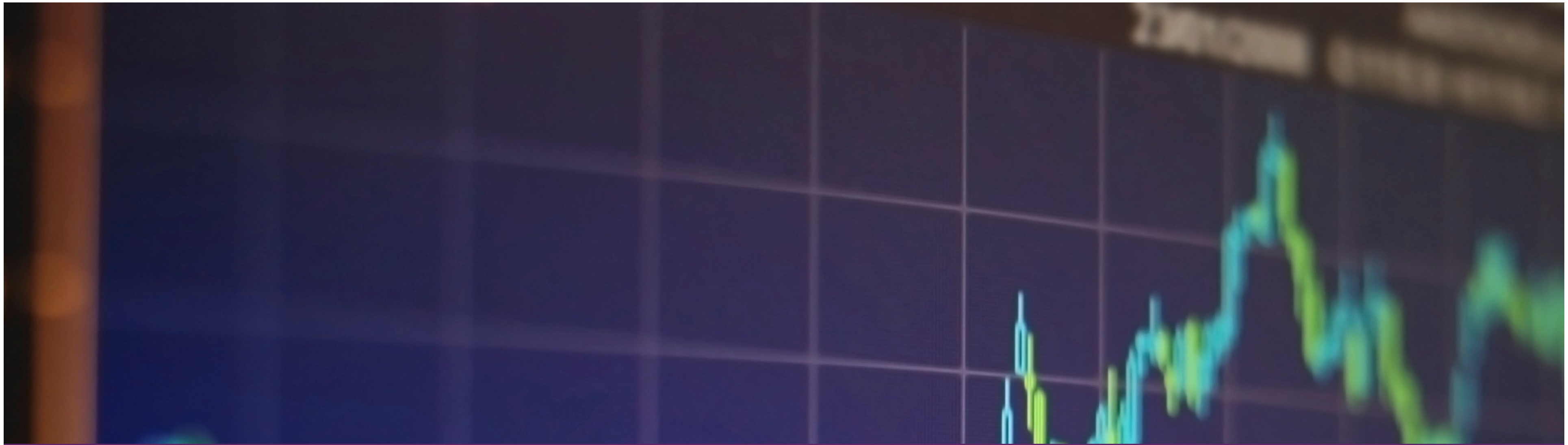
Transposition of AIFMD in Germany *(cont'd)*

- Stability of Financial Markets vs. Investor Protection
- Goldplating
  - Specific requirements for legal forms of German AIFs
  - Restrictions on investments for German AIFs
  - Current ability to make private placements ends as of 22 July 2013; but replaced by AIFMD-compliant regime
  - Retail clients

Transitional Provisions

Transitional Provisions

- Non-German AIFM may continue marketing AIF in Germany, if:
  - Subscription period for AIF has not expired prior to 22 July 2013
  - AIF is a closed-ended EU-AIF or non-EU-AIF or open-ended non-UCITS like EU-AIF or non-EU-AIF
  - Marketing of AIF started prior to 22 July 2013
  - Marketing of AIF was permitted in Germany prior to 22 July 2013
  - Not entirely clear: whether it is necessary to submit marketing notification as precondition to enjoy transitional relief
- Until the earlier of completion of notification procedures and 21 July 2014
- In accordance with legal provisions applicable prior to 22 July 2013



What Is “Marketing”?

What is “Marketing”?

- Active vs. passive marketing:
  - Direct or indirect offering or placement **at the initiative of the AIFM or on its behalf** of units or shares of an AIF **to investors domiciled or with a registered office in the EEA** (cf. A1(1)(x))
- Marketing to professional and semi-professional clients vs. marketing to retail clients
- Broad interpretation of “active” marketing
  - Offer, placement, advertising or similar acts
  - Assisting third parties in marketing by participating in person, by providing human or material resources

K&L GATES

What is “Marketing”? *(cont’d)*

- “Reverse solicitation” as passive marketing remains permissible
- Guidelines on marketing by BaFin are still expected prior to 22 July 2013
- Marketing to German investors outside Germany?
- Marketing to non-EEA investors in Germany?

Preconditions to Marketing AIF into Germany

Preconditions to Marketing AIF into Germany

- EU-AIFM markets EU-AIF (A32)
- EU-AIFM markets non-EU-AIF (A36)
- Non-EU-AIFM markets EU-AIF or non-EU-AIF (A42)

Preconditions to Marketing AIF into Germany *(cont'd)*

- EU-AIFM markets EU-AIF (A32)
  - Notification procedure in home Member State is completed in accordance with A32.2
  - Marketing is permitted as of the date of the notification by competent authority in home Member State in accordance with A32.4
  - However, arrangements established to prevent units or shares of the AIF from being marketed to retail investors will be reviewed by BaFin
  - <u>For EU-AIFM exempted pursuant to A3.2:</u>
    - Registration in home Member State
    - Reciprocity

Preconditions to Marketing AIF into Germany *(cont'd)*

- EU-AIFM markets non-EU-AIF (A36)
  - Germany allows marketing in accordance with A36 until passporting becomes applicable, presumably by end of 2015
    - Requirements pursuant to A36.1
      - Compliance with AIFMD except A21, but A21.7, 8, 9 apply (depositary functions)
      - Appropriate cooperation agreement in place with supervisory authorities of third country
      - Third country is not a Non-Cooperative Country and Territory
    - Appropriate arrangements to prevent marketing to retail clients
    - <u>If to semi-professional investors:</u> non-EU-AIFM and management of non-EU-AIF must be fully compliant with requirements under AIFMD Transposition Act

Preconditions to Marketing AIF into Germany *(cont'd)*

- Notification Procedure with BaFin
  - Filing either in German or **English** language
  - Documentation
    - Documents and information set out in A31.2 / Annex III
    - Confirmation by competent authority of home Member State that (i) EU-AIFM and management of non-EU-AIF comply with requirements set out in AIFMD and (ii) cooperation agreement is in place with third country
    - Undertaking to provide information to BaFin, *e.g.* annual reports, material changes, business activity in general
    - Evidence that fees have been paid to BaFin
  - Decision will be taken within **20 business days** upon receipt of complete notification file

Preconditions to Marketing AIF into Germany *(cont'd)*

- Non-EU-AIFM markets EU-AIF or non-EU-AIF (A42)
  - Germany allows marketing in accordance with A42 until passporting will become applicable, presumably by end of 2015
    - Requirements pursuant to A42.1
      - Compliance with A22 (Annual Report), A23 (Disclosure to Investors), A24 (Reporting Obligations to Competent Authorities), A26 (Control over Non-Listed Companies)
      - Appropriate cooperation agreement in place with supervisory authorities of third country
      - Third country is not a Non-Cooperative Country and Territory
    - Stricter requirement pursuant to A42.2:
      - Depositary function as described in exception pursuant to A36.1(a)
    - Appropriate arrangements to prevent marketing to retail clients
    - <u>If to semi-professional investors:</u> non-EU-AIFM and management of non-EU-AIF must be fully compliant with requirements under AIFMD Transposition Act

Preconditions to Marketing AIF into Germany *(cont'd)*

- Notification Procedure with BaFin
  - Filing either in German or **English** language
  - Documentation
    - Documents and information set out in A31.2 / Annex III
    - Information on AIFM and depositary
    - Undertaking to provide information to BaFin, *e.g.* annual reports, material changes, business activity in general
    - <u>For marketing to semi-professional investors:</u> further documents and information as are required to obtain license as AIFM in Germany, similar to those described in A8(1)(b), A7.2(a)-(e)
    - Evidence that fees have been paid to BaFin
  - Decision will be taken within **two months**, or if marketing to semi-professional investors, **four months** upon receipt of complete notification file

Developments in Switzerland

Developments in Switzerland

- Revised Collective Investment Schemes Act (“CISA”) came into force on 1 March 2013 – subject to a two year transitional period
- Until 28 February 2015, non-Swiss funds can continue to be offered to all “qualified investors”:
  - “Regulated qualified investors” (regulated financial intermediaries, regulated insurance institutions)
  - “Unregulated qualified investors” (public entities/pension funds/companies with professional treasury management, high net worth individuals and their personal holding vehicles, investors who have entered into a written discretionary asset management agreement)
  - High net worth individuals are either (i) those whose net wealth amounts to a minimum of CHF 5,000,000 in eligible assets, or (ii) those with technical competencies in the financial field with net wealth amounting to a minimum of CHF 500,000 in eligible assets

Developments in Switzerland *(cont'd)*

- From 1 March 2015, funds offering to unregulated qualified investors must appoint a Swiss representative and paying agent (one institution may act as both)
- No requirement if offering to regulated qualified investors
- Any high net worth individual targeted must first "opt-in" to being classified as a qualified investor

Regulatory Reporting

AIFMD : Annex IV Reporting

- Timing/frequency
  - €100M – €1bn AUM : half yearly (<u>all</u> AUM of AIFM)
  - > €1bn AUM : quarterly
  - Individual AIF with AUM (incl through leverage) > €500M : quarterly
  - Unleveraged P/E fund : annual
  - Within 1 month of end of relevant period (add 15 days for fund of funds)
  - Draft ESMA Guidelines (24th May 2013) propose:
    - Reporting periods based on calendar year
    - First reporting by 31 January 2014 (15 February 2014 for fund of funds) covering 23 July 2013 to 31 December 2013
    - Then frequency as described above
    - A lot of guidance on switching between frequencies – generally report at end of first full period except for Q4

AIFMD : Annex IV Reporting *(cont'd)*

- Recipient(s) of Report
  - EU AIFM – home Member State (location of registered office)
  - Non-EU AIFM – <u>every</u> EU Member State where funds offered (query whether need to complete form differently for different Member States?)
- Approach to Reporting (Draft ESMA Guidelines)
  - Feeder AIFs – each feeder of a single master should be reported individually (rather than aggregated)
  - Where non-EU feeder AIF is marketed into the EU, need to provide fund information per AIFMD Article 24(2) regarding Master AIF as well, even where that AIF is not marketed into the EU
  - Umbrella AIF with sub-funds or compartments – AIF-specific information to be reported at the level of the sub-fund

AIFMD : Annex IV Reporting *(cont'd)*

- Approach to Reporting
  - Non-EU AIFMs subject to Article 24 reporting only with regard to AIFs marketed into the EU
  - ESMA has offered a lot of guidance on exactly how the form is to be completed and the abbreviations/codes to be used
  - Value of AUM to be calculated per Article 2 and 10 of Level 2 Regulation; value in Euro should always be indicated using ECB conversion rate; information reported as of the last business day of the reporting period

AIFMD : Annex IV Reporting *(cont'd)*

- Approach of Reporting
  - Principal exposures – ESMA says need to disclose whether short positions are covered or uncovered
  - Much of the form to be completed in the "base currency" of the AIF
  - Reporting risk profile – various measures to be used: DV01, CS01, Net Equity Delta, Net FX Delta, Net Commodity Delta, Vega exposure at current market levels with market 10% lower and 10% higher, and VAR (indicating type of VAR – Monte Carlo or historical simulation)
  - We understand that it is expected that many administrators will provide the completion of this form as part of their services

Status of Co-operation Agreements

Status of Co-operation Agreements

- 34 agreements announced on May 30, 2013
- Based on the IOSCO Memorandum of Understanding
- Include information sharing, assistance with enforcement and other regulatory co-operation provisions
- Will eventually be made publically available
- Individual members states must now arrange to sign
- Required before marketing under a private placement exemption

Developments in the UK

Developments in the UK

- Final AIFMD Regulations published
  - Include interaction with the new EU Venture Capital and Social enterprise regimes
- Use of transitional provisions
- Extension to non-EU AIFs / AIFMs
- Use of reverse solicitations


Q & A

K&L GATES