Funds Quarterly Legal and Regulatory Update

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FUNDS QUARTERLY LEGAL AND REGULATORY UPDATE

UCITS, Non-UCITS & Hedge Funds

(i) Draft of UCITS V Directive released

A draft of the UCITS V Directive was unofficially released in April 2012, ("UCITS V"). This is a further revision to the regime for Undertakings for Collective Investment in Transferable Securities ("UCITS") and is intended to enhance certain measures within the UCITS framework, particularly in relation to investor protection.

The European Commission (the "Commission") has stated that the purpose UCITS V is to bring the UCITS regime into line with the Alternative Investment Fund Managers Directive ("AIFMD").

UCITS V covers three key elements, namely the Depositary role (covering eligibility criteria, liability, delegation and oversight function relating to cash), Manager remuneration and Regulatory sanctions.

- Depositary role

  Eligibility

  The proposed wording of UCITS V prescribes an exhaustive list of entities that are eligible to act as a depository to a UCITS; (i) authorised credit institutions, (ii) MiFID authorised investment firms which also provide the ancillary service of safe-keeping and administration of financial instruments and (iii) all existing UCITS depositary institutions (which at the point the new requirements come into effect, engage a non-compliant depositary) who chose to avail of a grandfathering mechanism.

  UCITS V does not refer to the third broader category of eligible entity contained in AIFMD namely, entities subject to prudential supervision and ongoing supervision. The relevant provision in AIFMD cross refers to the UCITS IV Directive that is being amended, and this may mean that UCITS V will restrict the scope of eligible depositaries for both UCITS and for non-UCITS.

  Liability

  UCITS V proposes to extend the circumstances in which a depository may be liable if a UCITS fund suffers a loss as a result of the depository's negligence or intentional failure to perform its duties. A depository of a UCITS will be liable for (i) any losses suffered by the UCITS or its investors unless "it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary" and (ii) all losses suffered as a result of the depository's negligent or intentional failure to properly fulfil its obligations.

Depositories will be obliged to return the identical financial instruments or a corresponding amount of assets (where they are capable of substitution, e.g. cash) to the UCITS without delay.

UCITS V also proposes to give new rights to all UCITS investors so that they are able to directly or indirectly sue the UCITS depository.

In this way UCITS V proposes to align the standard of liability of a depository with the standard contained in AIFMD.

Delegation

UCITS V provides that a depository may delegate all or part of its safekeeping tasks to a sub-custodian. UCITS V also elaborates on the conditions applicable to the delegation of a depository's activities, inter alia, requiring the depository to demonstrate that there is an objective reason for the delegation. UCITS V clarifies that a depository when delegating must exercise "*all due skill, care and diligence in the selection and the appointment of any third party to whom it wants to delegate parts of its tasks, and keeps exercising all due skill, care and diligence in the periodic review and ongoing monitoring of any third party to whom it has delegated parts of its tasks and of the arrangements of the third party in respect of the matters delegated to it.*"

The new conditions introduced by UCITS V in relation to the delegation by a depository are very similar to the requirements contained in AIFMD.

Oversight function relating to cash

UCITS V introduces a depositary oversight function relating to cash that is not present in the current UCITS regime. UCITS V imposes an obligation on a depository to monitor cash flows of the UCITS and in particular imposes an obligation on a depository to ensure that subscription monies are properly received by the UCITS.

- Manager remuneration

UCITS V proposes to apply new rules relating to remuneration of UCITS management companies. The new requirements are consistent with those requirements which are already contained in the Capital Requirements Directive and with the proposals contained in AIFMD. Remuneration policies should be designed to promote sound and effective risk management and should discourage disproportionate risk-taking by the UCITS. In particular the remuneration policy should contain rules for guaranteed variable remuneration and contain criteria for calculating compensation for different categories of staff.

The new requirements would apply to persons whose professional activities have a material impact on the risk profile of the UCITS and in particular to senior management including the board of directors, those in supervisory functions, risk management functions and other employees in the same pay bracket as senior management.

The board of directors of the management company should adopt the general principles of the remuneration policy and be responsible for its implementation and periodic review. The compliance function would also be charged with an annual review of the remuneration policy and to ensure that it is being implemented in the organisation.

These measures are similar to measures contained in AIFMD.

- Regulatory sanctions

UCITS V creates a requirement that all EU Member States give wide-ranging investigative powers and administrative sanctions capabilities to their competent authorities for a wide range of breaches of regulatory requirements. These measures expand on the broad principles in the UCITS IV Directive and are similar to measures contained in AIFMD.

It is expected that UCITS V will be formally published this summer, and national implementation could be required by mid- 2014.

(ii) The IFIA publish a response to the draft UCITS V text

In May 2012 the Irish Funds Industry Association ("IFIA"') UCITS V taskforce published their key comments in relation to the draft UCITS V text. The comments set out in the response represent the initial thoughts of the Taskforce and are intended to highlight issues which may be raised by the IFIA with the Central Bank and the Department Finance and in turn with the Commission.

(iii) New Irish Fund Structure to Facilitate U.S Investment

The Irish Minister for Finance has announced that he has approved the development of legislative proposals for a new corporate structure for the Irish funds industry (the "SICAV"). This new SICAV structure will sit alongside the existing public limited company ("PLC") structure.

One of the main advantages of the SICAV is that it will provide for a corporate entity that can elect its classification under the U.S. "check-the-box" taxation rules. If the SICAV elects to "check-the box" to be treated as a partnership for US tax purposes, it will avoid certain adverse tax consequences for U.S. taxable investors which would arise if the structure is deemed to be a 'passive foreign investment company' (PFIC) for US federal income tax purposes. In addition, the SICAV structure will remove the need for compliance with certain requirements under Irish company law resulting in reduced administrative burden and costs.

The new SICAV structure will complement the current fund structures available in Ireland. These structures (namely, the existing PLC structure, the unit trust, the common contractual fund and the investment limited partnership) will continue to be available to promoters who wish to use them. For existing PLC structures, there will be an option to convert to the new SICAV structure.

The new SICAV development reflects the Irish Government's commitment to ensure that Ireland remains a leading domicile for investment funds.

(iv) Industry Guidance on Global Exposure Disclosure in Annual Reports

The updated UCITS Notices issued by the Central Bank of Ireland (the "Central Bank") in December 2011 provide that a UCITS fund must disclose in its annual report the method used to calculated global exposure. The IFIA in its annual report has issued a technical paper on "Annual Financial Reporting requirements around the disclosure of Global Exposure under UCITS IV." The paper gives practical guidance relating to the preparation of these disclosures, and in particular contains guidance on whether information regarding global exposure should be disclosed as part of the FRS 29 note.

The paper is available in the members' area of the IFIA website – www.irishfunds.ie

(v) Central Bank Consultation Paper on proposed changes to the regulatory reporting requirements of Irish authorised collective investment schemes

The Central Bank published a consultation paper on proposed changes to the regulatory reporting requirements of Irish authorised collective investment schemes ("CIS") on the 28th May 2012, ("CP 59"). CP59 sets out the Central Bank's proposals for a number of changes to the existing regulatory reporting regime for CISs whereby reports will now be submitted through an online reporting system.

The Central Bank currently requires CIS to file annual and interim financial statements within 4 and 2 months, respectively, of the relevant reporting periods. These financial statements are currently filed in hardcopy via post or soft copy via e-mail. It is proposed that the submission of financial statements will now be made online in PDF format using an online reporting system. In addition, the CIS auditor will be required to separately file online the annual statutory duty confirmation return and any additional reports relating to the annual financial statements.

It is further proposed that the annual financial derivatives instrument report filed on completion of the annual financial statements will be submitted separately online.

In addition the Central Bank is introducing two new structured online returns, which will require CIS to submit data in a pre-specified format. These returns are entitled (i) Sub-Fund Profile Questionnaire and (ii) Regulatory Report (suspensions form part of this report and must also be filed online).

Finally, it is proposed by the Central Bank that the annual update to the Key Investor Information Document ("KIID") will now be filed online.

It is noted that it will be necessary to amend the provisions of the Central Bank's UCITS and Non-UCITS Notices to reflect any proposed changes. It is likely that any proposed amendments to these documents will be the subject of a separate industry consultation.

The consultation period for CP 59 closed on the 25th June 2012.

(vi) IFIA publish response to Central Bank Consultation Paper on proposed changes to the regulatory reporting requirements of the Irish authorised collective investment schemes

On the 26th June 2012 the IFIA published a response to CP 59. They highlighted the negative impact they believed the changes proposed in CP 59 would have on competitiveness in the Irish funds industry. The response also details the IFIA's opinion on operational concerns, specific reports and finally proposes responses to specific questions posed in CP 59.

(vii) KIID Deadline

All UCITS must have their KIID in place by the 30th June 2012.

Articles 78 to 82 of the UCITS IV Directive outline the provisions on the KIID and in particular Article 78(2) provides: "Key investor information should include appropriate information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis."

This requirement is imposing significant challenges for the majority of UCITS funds which are in transition from the simplified prospectus regime.

(viii) Letter from the Central Bank of Ireland regarding KIID's

On the 8th June, 2012 the Central Bank issued a letter addressed to the IFIA regarding the KIID, in particular in relation to the provision of the KIID to investors making a subsequent subscription. The letter provides that existing investors have to be provided with an up-to-date KIID when making a subsequent subscription. Accordingly, it seems that where an investor has previously been provided with a KIID and they are making a subsequent subscription, the KIID must only be provided to investors if the KIID has been updated since the version previously provided to investors. To meet this requirement a fund would need to have a system in place to track which version of the KIID was issued to the relevant investor(s).

It should be noted that the Central Bank letter does not refer to the requirements relating to the provision of a KIID on a website as set down by Article 38 of the Commission Regulation 583/2010 (which, as it is an EU Regulation, is directly effective and does not need to be transposed into local law). By way of reminder, Article 38 requires investors to specifically consent to accessing the KIID or the Prospectus on a website, however there are numerous practical difficulties associated with this.

Separately, we expect ESMA to issue a Q&A Document in relation to this matter, however, we are not currently aware of when this Q&A is expected to be published.

(ix) Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act ("FATCA") was enacted in 2010 and is a new US reporting and withholding regime, the aim of which is to ensure tax compliance among US persons who hold offshore accounts.

Following the issue of the Joint Statement by the U.S. and a number of EU countries, a spokesperson for the Irish Revenue Commissioners has confirmed that they are in contact with the US Treasury in relation to exploring a common approach to FATCA. It was confirmed that any agreed approach would be based on domestic tax reporting legislation and automatic exchange of information under existing bilateral tax treaties.

It is understood that the approach being explored is to develop a model global agreement, which will be adopted under relevant bilateral tax treaties/exchange of information agreements. Ireland is one of a number of countries with which discussions in relation to a model agreement are ongoing. The model agreement will not alter or amend the obligation to identify or report certain information under FATCA, but will outline an alternative pathway for reporting FATCA information. The model agreement was expected by the 30th June 2012.

(x) Irish Funds Industry Association Taskforce publishes two papers on the area of Money Market Funds

The IFIA established a Taskforce to focus on the position the Irish funds industry should be taking to influence policy in the area of Money Market Funds ("MMF") and to lead the industry response on MMF regulation or market practice. On the 15th of June 2012 the IFIA published two papers.

The first paper was published in response to the Commission's Green Paper on Shadow Banking Consultation Report which issued on the 19th March 2012. The paper sets out some specific commentary on the elements of the Shadow Banking discussion which are pertinent to the Irish funds industry. In particular, the IFIA argues that MMFs and Exchange Traded Funds ("ETFs) should not be included as part of an umbrella category of entities referred to as "Shadow Banking" and further argues that MMFs should not be required to adopt a variable net asset value.

The second paper was published in response to IOSCO's Consultation Paper which was issued on the 27th April 2012 on "Money Market Fund Systemic Risk Analysis and Reform Options", (the "Consultation Paper"). The IFIA's response contains an overview of their opinion relating to individual elements of MMF reform such as the comparison of MMFs with banks and possible changes relating to fund pricing and certain recommendations to adopt variable net asset value. The paper sets out detailed responses to questions raised in the Consultation Paper.

AIFMD

(i) AIFMD Update

AIFMD came into force on the 21st July 2011, and must be transposed into the national law of EU Member States by 22nd July 2013. Its aim is to create a comprehensive and effective regulatory and supervisory framework for alternative investment fund managers within the EU. AIFMD also introduces a passport for the marketing of alternative investment funds within the EU.

AIFMD is subject to a legislative process involving (i) the adoption of the framework Directive by the European Council of Ministers and European Parliament ("Level 1"), which has already entered into force, (ii) technical implementing measures adopted by the Commission and approved by the European Securities Committee, in consultation with the European Parliament, on the basis of advice from ESMA ("Level 2") and (iii) recommendations from ESMA on interpretation to ensure consistent implementation and application ("Level 3").

The Commission released its draft Level 2 Regulation on AIFMD to a restricted circle in late March 2012. The Commission did not adopt ESMA's advice (which was provided to the Commission on the 16th November 2011 by ESMA) on a variety of areas and this has led to a considerable level of commentary which has been released into the public domain. It is likely that the official Level 2 Regulation will be published by the Commission in July 2012.

The Alternative Investment Management Association has published an analysis of the differences it has identified between the Commission's draft Level 2 Regulation implementing AIFMD and the technical advice provided to the Commission last November by ESMA. The note analyses important policy divergences from the ESMA guidance and highlights a number of "unintended consequences" of the changes proposed by the

Commission. It is clear that the divergences do not arise as a result of the restatement of technical recommendations into legal language. The note also provides that the differences between the Commission's draft regulation and the ESMA advice seems to be "significant and wide-ranging" in effect.

It is interesting to note that the Commission has chosen to implement its Level 2 measures as a Regulation which has direct effect, as opposed to a Directive which would require implementing legislation. The Commission has indicated that this is necessary to ensure a single set of rules applicable throughout the EU without delay.

(ii) ESMA has published a consultation paper on proposed Guidelines on remuneration of alternative investment fund managers (AIFMs)

On the 28th of June 2012, ESMA published a consultation paper on proposed guidelines on remuneration of alternative investment fund managers. The proposed guidelines will apply to managers managing alternative investment funds including hedge funds, private equity funds and real estate funds. These funds will be asked to introduce sound and prudent remuneration policies and structures with the aim of increasing investor protection and avoiding conflicts of interest that may lead to excessive risk taking. ESMA invites comments on the proposals put forward in the paper by the 27 September 2012. Comments should be submitted online at; www.esma.europa.eu under the heading 'Your input –'Consultations'.

MiFID II

In our Legislative Update for Quarter 2 of 2012, we referred to the publishing of legislative proposals by the Commission in October 2011 to amend the Markets in Financial Instruments Directive (2004/39/EC) and its implementing legislation ("MiFID"). The proposals (MIFID II) consist of a Directive and a Regulation. We also summarized the key proposals contained in MIFID II.

The text of MiFID II is now with the European Parliament and the Council of the European Union for discussion. A final agreement between the legislative bodies on the Level I proposals is expected by the end of 2012. Once the Level 1 text has been adopted the Commission will prepare more detailed Level 2 implementing measures, which will supplement the Level 1 framework legislation. It is expected that Level 2 measures will be agreed in early 2014.

The Level 3 Committees (which consist of representatives of national supervisory authorities) will prepare joint interpretation recommendations and guidelines. The Commission will conduct extensive consultations with ESMA, the European Banking Authority (the "EBA") and European Insurance and Occupational Pensions Authority ("EIOPA") and providers/users of financial services before the Commission will issue its advices. The Commission ensures compliance by Member States with legislation and where required, pursues enforcement action.

Implementation of the new measures is not expected until at least 2015.

Regulation on over-the-counter Derivatives (OTC), Central Counterparties and Trade Repositories

In September 2009, at the G-20 Pittsburgh Summit, the leaders of the 19 biggest economies in the world and the European Union agreed that *"all standard 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."* Furthermore, they acknowledged that *"OTC derivative contracts should be reported to trade repositories and that non-centrally cleared contracts should be subject to higher capital requirements".* On the 15th June 2012, the Council of the European Union published the revised text of the Regulation on over-the-counter derivatives (OTC), central counterparties and trade repositories ("EMIR") which reconciles the EMIR texts as adopted by the European Parliament on the 29th March 2012 and by the Council on the 11th April 2012. EMIR will implement the G20 commitments on OTC derivatives markets. Both the US (Dodd Frank Act) and Japan have passed OTC derivatives legislation earlier this year.

EMIR aims to improve the functioning of OTC derivative markets in the EU by (i) reducing counterparty risks, (ii) increasing transparency via trade repositories and (iii) ensuring safe and resilient central counterparties.

(i) Reducing Counterparty Risks

EMIR provides that certain OTC derivative contracts must be cleared through a central counterparty ("CCP"), this obligation will apply to financial firms and to non-financial firms that have large positions in OTC derivatives. This mandatory clearing obligation will apply to "financial counterparties" as defined in EMIR.

(ii) Increased Transparency

Detailed information on each OTC derivative contract traded by a financial or a non-financial firm with large positions in the OTC market will need to be reported to trade repositories. EMIR further provides that certain of this information must be made available by the trade repositories to the relevant authorities. EMIR also sets out the information to be provided to ESMA for the authorization and supervision of trade repositories.

(iii) Ensuring Safe and Resilient CCP's

EMIR proposes to impose prudential and conduct of business rules on CCP's. EMIR also contains requirements which aim to ensure better protection of client positions and collateral on clearing member default.

ESMA published a consultation paper concerning the technical standards that it is required to produce under the Regulation on over-the-counter derivatives (OTC), central counterparties and trade repositories ("EMIR") on the 25th June 2012. The deadline for responding to the Consultation Paper is 5 August 2012 and comments should be submitted online at www.esma.europa.eu under the heading "Consultations". The final draft standards are intended to be submitted to the European Commission for endorsement by 30 September 2012.

EMIR is anticipated to apply from the end of 2012, in accordance with the G20 deadline.

Investment Firms

(i) Revised Rules of the Irish Stock Exchange published

The Rules of the Irish Stock Exchange ("ISE") have been revised with effect from the 1st May 2012 (Release 15), (the "Rules"). All member firms are bound by these Rules. The Rules relate to;

(a) the application and ongoing notification requirements for member firms and registered traders;
(b) Trading on ISE Xetra;
(c) Trading in Irish Government Bonds and other securities;
(d) Clearing and settlement of trades; and
(e) The ISE's disciplinary process.

The changes published by the ISE include amendments to programme trading facilities, an outline of the obligations for firms that provide Direct Market Access, increased requirements for restricted trading member firms and additional definitions such as Direct Market Access and Trading Algorithm.

The ISE also published a document on market parameters designed to be read alongside the Rules. The Market Parameters document is a guide for member firms trading securities on the ISE's markets. It covers topics such as;

- Trading securities on ISE Xetra;
- Trading in Government Bonds and other securities; and
- Market making parameters.

The "Market Parameters" document is a guide for member firms trading securities on the ISE's market. This document is designed to be read alongside the Rules and was also updated on the 1st May 2012. See link below to The Markets Parameters document on the ISE website;

http://www.ise.ie/ISE_Regulation/Rules-of-the-ISE/

(ii) Central Bank writes to MiFID firms about governance concerns

On the 22nd May 2012, the Central Bank wrote to Irish investment firms (MiFID firms), setting out its concerns about corporate governance in the sector. These concerns were provoked by recent thematic inspections into corporate governance practices at such firms. The themed review focused on the approach by investment firms to corporate governance, compliance with the relevant MiFID Regulations and took stock of best practice in the industry. The Central Bank circulated a list of nine recommendations for firms as follows;

1. MiFID firms without an independent non-executive director should challenge themselves to review their board arrangements and to consider the value and benefit of such an appointment in the context of their corporate governance arrangements.

2. MiFID firms must give appropriate consideration to determining if a director is "independent". The fact that the director is a non-executive director does not mean that the director is independent. Significant shareholdings and provision of services outside the capacity of a director may mean the non-executive director is not independent.

3. The role of Chairman and CEO should be separate and where possible an independent non-executive director should be appointed as Chairman.

4. Where board committees are established, there should be appropriate terms of reference and reporting procedures.

5. Corporate governance structures should be clearly documented.

6. All fundamental board reporting should be in writing and couched so as to inform an outside observer. Board minutes should reflect discussions and participation of attendees.

7. Detailed job descriptions should be in place for all staff including board members.

8. Firms should ensure their organisational charts are up to date and reflective of the current position.

9. Firms should carry out an annual review of board performance and corporate governance arrangements.

The Central Bank has called for a review by MiFID firms of their corporate governance arrangements in light of these nine recommendations and has requested that any necessary changes are made to ensure that MiFID firms are consistent with their peers.

(iii) MiFID Questions and Answers- Investor Protection and Intermediaries

On the 22nd of June 2012 ESMA published a MiFID Questions and Answers document. The document is entitled 'MiFID Questions and Answers –Investor Protection and Intermediaries' and provides answers to questions on MiFID posed by the general public and by competent authorities. The document seeks to provide assistance to competent authorities so that their supervisory activities relating to MiFID are consistent across EU Member States. It is also intended that the document will provide assistance to MiFID investment firms as it will provide additional clarity regarding the content of MiFID. It does not seek to impose additional requirements on MiFID investment firms.

The questions relate to the practical application of MiFID including guidance on;

- Article 19(4) of MiFID – Client profile review
- Article 19(5) of MiFID – Appropriateness
- Articles 48 and 49 of the MiFID Implementing Directive – Aggregated orders and trade allocations
- Article 32(2) of MiFID – Tied agents
- Article 41(3)(c) of the MiFID Implementing Directive – Leveraged portfolio
- Articles 17(1) and 18(3) of the MiFID Implementing Directive – Due diligence on sub-custodians.
- Article 23 of MiFID – Tied agents
- Article 4(1)(4) of MiFID, and Article 24(1) of the MiFID Implementing Directive – Investment advice and investment research

- Article 4(1)(9) of MiFID – Automatic execution of trade signals.

European Authorities

(i) Banking Capital Rules: General approach agreed ahead of talks with Parliament

On 15th of May 2012 the Council of the European Union unanimously agreed a general approach on two proposals - the so-called "CRD 4" package - amending the EU's rules on capital requirements for banks and investment firms, with a view to negotiations with the European Parliament.

The proposals set out to amend and replace the existing capital requirement directives by two new legislative instruments: a *regulation* establishing prudential requirements that institutions need to respect and a *directive* governing access to deposit-taking activities.

The proposals are aimed at transposing into EU law an international agreement approved by the G-20 in November 2010. The so-called Basel 3 agreement, concluded by the Basel Committee on Banking Supervision, strengthens bank capital requirements, introduces a mandatory capital conservation buffer and a discretionary countercyclical buffer, and foresees a framework for new regulatory requirements on liquidity and leverage.

The consolidated texts of the proposed Capital Requirements Directive (CRD 4 Directive) and the proposed Capital Requirements Regulation (CRR), as amended by the European Economic and Financial Affairs Council (ECOFIN) on the 15th May 2012, have now been published.

(ii) Consultation Paper on Draft Regulatory Technical Standards on Own Funds

The EBA published the first part of a consultation on draft Regulatory Technical Standards ("RTS") on own funds. The EBA has developed the draft RTS based on the proposed legislative texts for the CRR/CRD IV. The RTS cover areas such as Common Equity Tier 1, Additional Tier 1 Capital, deductions from Common Equity Tier 1 Capital, general requirements such as, indirect holdings arising from index holdings, supervisory consent for reducing own funds and transitional provisions for own funds in terms of grandfathering. The EBA invites comments on the proposals put forward in this paper by 4 July 2012. Comments should be sent to the EBA by email to CP-2012-02@eba.europa.eu indicating the reference "EBA/CP/2012/02".

(iii) Consultation Paper on Draft Implementing Technical Standards on Disclosure for Own Funds by Institutions

On the 7th of June 2012, the EBA published a consultation paper on draft Implementing Technical Standards ("ITS") on disclosure for Own Funds by institutions. This consultation paper as with the above paper is based on the proposed legislative texts for the CRR/CRD IV. It puts forward draft ITS related to Article 424(2) of the CRR related to disclosure for own funds by institutions. The EBA invites comments on the proposals put forward in the paper by the 31 July 2012. Comments should be sent to the EBA by email to CP-2012-4@eba.europa.eu indicating the reference "EBA/CP/2012/04".

(iv) Consultation Paper on Draft Implementing Technical Standards On Supervisory reporting requirements for liquidity coverage and stable funding

On the 7th of June 2012 the EBA published a second consultation paper, this paper focused on ITS on supervisory reporting requirements for liquidity coverage and stable funding. As with the above papers, it is based upon the proposed legislative texts of the CRR/CRD IV. This consultation paper puts forward proposals regarding the reporting requirements according to the mandate of the EBA provided in Article 481 of the CRR to monitor and evaluate the liquidity reporting requirements made in accordance with Article 403(1). The EBA invites comments on the proposals put forward in the paper by the 27th August 2012. Comments should be sent to the EBA by e-mail to CP-2012-5@eba.europa.eu indicating the reference "EBA/CP/2012/05".

(v) EBA Consultation Paper on Draft Regulatory Technical Standards on the concept of Gain on Sale associated with future margin income in a securitisation context

On the 12th of June 2012, the EBA published another consultation paper on draft RTS, this time with a focus on the concept of gain on sale associated with future margin income in a securitisation context. As with the RTS's mentioned above, they are based on the proposed legislative texts for CRR/CRD IV. The Consultation Paper puts forward a draft RTS related to Article 29.2 of the CRR related to prudential filters in the own funds (securitised assets). In particular it requires the EBA to further specify the concept of a gain on sale referred to in Article 29.1(a). The EBA invites comments on the proposals put forward in the paper by the 12 August 2012. Comments should be sent to the EBA by email to CP-2012-7@eba.europa.eu indicating the reference "EBA/CP/2012/07".

(vi) EBA Consultation Paper on Draft Regulatory Technical Standards on Capital Requirements for CCP's

On the 18th of June 2012, the EBA published a consultation paper on draft RTS on capital requirements for CCP's. The RTS are based on the proposed legislative texts for CRR/CRD IV. The consultation paper includes the proposed legal text of the provisions constituting the draft RTS, an explanation of the proposed measures and a cost-benefit analysis. The EBA invites comments on the proposals put forward in the paper by the 31 July 2012. Comments should be sent to the EBA by email to EBA-CP-2012-08@eba.europa.eu, indicating the reference "EBA-CP-2012-08".

(vii) ESMA work on transaction reporting for MIFID

ESMA has published a call for evidence on transaction reporting which closed on the 4th June 2012 and will be followed by a consultation and cost-benefit analysis. ESMA is working to develop guidelines on harmonised transaction reporting under MiFID with a view to updating the May 2007 Level 3 guidelines on MiFID transaction reporting issued by the Committee of European Securities Regulators (CESR). ESMA will also update CESR's October 2010 guidance on reporting transactions on over-the-counter (OTC) derivative instruments. ESMA will be monitoring the development of the MiFID II proposals to avoid inconsistencies, where possible.

(viii) EBA Consultation Paper for Assessing the Suitability of Members of the Management Body of a Credit Institution

Article 11(1) of Directive 2006/48/EC provides that a credit institution shall only be authorised where there are at least two suitable persons who effectively direct the business and asks the EBA to develop guidelines for the assessment of the suitability of persons who effectively direct the business of the credit institution.

On the 18th April 2012 the EBA published a consultation paper on the draft guidelines on the assessment of the suitability of members of the management body and key function holders of a credit institution. The proposed guidelines in the Consultation Paper set out the process, criteria and minimum requirements for assessing the suitability of those persons. The proposed guidelines provide that credit institutions and competent authorities should intervene in cases where the person concerned is not suitable. Measures may range from requesting that an individual be trained up, the prohibition of that individual performing certain tasks and the temporary ban/dismissal of an individual.

The proposed guidelines will apply to credit institutions, financial holding companies and mixed financial holding companies, however they will not apply to investment firms, as the proposed MiFID II Directive will contain similar requirements on the assessment of persons who effectively direct the business of investment firms.

(ix) ESMA Guidelines on Automated Trading

The Central Bank published the final ESMA Guidelines on "systems and controls in an automated trading environment for trading platforms, investment firms, and competent authorities", (the "Guidelines") on the 30th March 2012. All market participants are required to comply with the Guidelines from the 1st May 2012.

The Guidelines have implications for Investment Firms;

- who use electronic trading systems, including a trading algorithm for dealing on own account or for the execution of orders on behalf of clients; and

- who provide direct market access or sponsored access as part of the services of the execution of orders on behalf of clients.

The Guidelines also have implications for unauthorised firms;

- who deal on their own account and who access trading platforms directly as members, participants or users or through direct market access or through sponsored access. They will be affected by the guidelines on fair and orderly trading for trading platforms in relation to the requirements for members, participants and users who are not authorised, and the guidelines for trading platforms and Investment Firms relating to direct market access and sponsored access;

- who sell electronic trading systems to market operators or Investment Firms;

- who act as the outsourced provider of electronic trading systems; and

- who provide connectivity services to Investment Firms when accessing trading platforms.

The Guidelines provide that Investment Firms who use algorithms for the trading of financial instruments (as defined in MiFID) must have organisational arrangements to maintain fair and orderly trading. This includes amongst other things:

- an appropriate governance process for developing or buying algorithms;

- using the algorithm in a cautious fashion for example limits being placed on the number of financial instruments being traded, the value and number of orders, and the number of markets to which orders are sent to enable the firm to check that an algorithm performs as expected;

- ensuring staff have adequate skills and expertise to run and monitor the algorithm;

- pre-trade controls which address erroneous order entry and maintain pre-set risk management thresholds, including thresholds on maximum exposure to individual clients; and

- post-trade controls to ensure an orderly functioning of the trading platform.

In addition, regulated markets, Multilateral Trading Facilities and Investment Firms must keep adequate records of their systems and controls covered by the Guidelines, to enable competent authorities to assess their compliance with MiFID and other relevant regulatory obligations.

ESMA has included electronic systems to send orders to trading platforms (whether or not orders from clients are submitted electronically to the Investment Firm) and electronic systems which automatically generate orders (trading algorithm) within the scope of electronic trading systems.

(x) EBA Survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices

The EBA has published its survey on the 12th April 2012 on the implementation of CEBS Guidelines on remuneration policies and practices, (the “ CEBS Guidelines”). The survey looks at how the CEBS Guidelines have been implemented in legislation (focusing on possible differences between domestic implementations and how they have been supervised in practice).

The findings of the survey have shown a satisfactory implementation of the CEBS Guidelines into the respective legal and supervisory frameworks and in particular the survey has shown that the governance of remuneration has made “considerable progress”, however, the survey also provides that the EBA has a “genuine concern” about supervisory differences in the ways in which staff are identified between countries which may lead to “regulatory arbitrage and competitive disadvantages”. In particular the survey highlighted inconsistencies across institutions in the criteria used to identify staff that have a material impact on the firm's risk profile.

The EBA also has concerns relating to the relationship between variable and fixed remuneration and in particular it is concerned that variable remuneration "considerably" exceeds fixed remuneration, which the EBA argues "could incentivise staff to take too much risk in order to assure a certain minimum pay level."

In light of the shortcomings identified by the survey, the compromise text on the CRD IV package has proposed to widen the scope of the mandate for the EBA to elaborate criteria to identify categories of staff whose professional activities have a material impact on the institution's risk profile.

(xi) Report on working towards effective Governance of Financial Institutions

The G30 is an international forum of public and private sector financial leaders. The Steering Committee and Working Group formed by the G30 to consider the governance of major financial institutions has published its report entitled "toward effective governance of financial institutions".

The report argues that boards, managers, supervisors and long-term shareholders need to reassess their approach to governance and, in this regard, provides recommendations regarding what each of these parties needs to do in order to bring about more effective governance. The report also provides that further improvements in corporate governance of major financial services firms are crucial to securing financial stability. It also recognised that effective governance depends on the tone set at the top saying that corporate culture dictates the values and the behaviours of people in a firm and how they interact. The report blamed "pervasive failure of governance at all levels as a large contributing factor to 2008/2009 financial crisis".

(xii) ESMA - Memorandum of Understanding concerning Consultation, Co-operation and Exchange of Information relating to the Supervision of Cross-Border Regulated Entities

ESMA and the US Securities and Exchange Commission signed a Memorandum of Understanding to facilitate the sharing and collection of information on regulated entities operating across borders on the 14th of March 2012. The Memorandum of Understanding documents the intention of the two authorities to co-operate and to fulfil regulatory duties with respect to globally active firms and markets.

(xiii) ESMA - Transparency Directive (2004/109/EC) - Updated Questions and Answers

ESMA issued an updated version of "Questions and Answers" on the Transparency Directive on the 2nd of April 2012 to promote common supervisory approaches and practices in the implementation of the Transparency Directive. The Q&A:

- Updates the answer to question 1 on the determination of the home member state for third country issuers in the case of delisting and admission to trading in another member state.

- Adds a new question 15 on the designation of an agent for the exercise of financial rights.

(xiv) EU Regulation on short selling and certain aspects of Credit Default Swaps

Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (the "Regulation") was published in the Official Journal of the European Union on the 24th March 2012 and will be applicable from the 1st November 2012.

Further to a letter received from the Commission on the 24th November 2011 (which requested ESMA to provide advice on all the delegated acts contained in the Regulation), ESMA published its final report on the 20th April 2012. The final report is made up of seven sections. The sections provide advices in relation to the following matters;

- Section I specifies the definition of when a natural or legal person is considered to own a financial instrument for the purposes of the definition of short sale.

- Section II relates to the net position in shares or sovereign debt covering the concept of holding a position, the case when a person has a net short position and the method of calculation of such a position including when different entities in a group have long or short positions or for fund management activities related to separate funds.

- Section III sets out the advice on the cases in which a credit default swap (CDS) transaction is considered to be hedging against a default risk or the risk of a decline of the value of the sovereign debt and the method of calculation of an uncovered position in a CDS.
- Section IV defines the initial and incremental levels of the notification thresholds to apply for the reporting of net short positions in sovereign debt.
- Section V specifies the parameters and methods for calculating the threshold of liquidity on sovereign debt for suspending restrictions on short sales of sovereign debt.
- Section VI sets out ESMA's proposal of advice on what constitutes a significant fall in value for various financial instruments.
- Section VII also specifies the criteria and factors to be taken into account by competent authorities and ESMA in determining when adverse events or developments arise.

(xv) ESMA update on measures adopted by competent authorities on short selling

EU securities regulators are closely monitoring the functioning of the markets and continue to consider possible actions which might be taken to contribute to orderly functioning markets. Any such actions will be taken with a view to strengthening confidence in financial markets and protecting investors.

Some EU securities regulators have adopted measures in their respective markets either to limit, or to introduce stringent requirements or further reporting obligations by firms to supervisory authorities on short-selling.

The link below provides statements or links to the statements made by the relevant regulatory authorities on 29 May 2012; http://www.esma.europa.eu/system/files/2011-39_0.pdf

(xvi) ESMA approves credit ratings from Brazil for use in the EU

On the 27th of April 2012 ESMA announced that it considers the regulatory framework for credit rating agencies of Brazil to be in line with European Union rules. This allows European financial institutions to continue using credit ratings issued in Brazil for regulatory purposes after the 30th April 2012.

Central Bank of Ireland

(i) Central Bank (Supervision and Enforcement) Bill 2011 - Consultation Document

The Minister for Finance has issued a Consultation Document on the proposed Committee Stage amendments to the Central Bank (Supervision and Enforcement) Bill 2011, (the "Bill"). The Bill was published on 28 July 2011 as part of Ireland's legislative programme imposed by the European Union/International Monetary Fund Programme of Financial Support for Ireland. The Bill will apply to financial service providers regulated by the Central Bank and provides a range of additional powers for the Central Bank to ensure proper and effective regulation of financial services. The amendments are the result of a comprehensive collaboration between the Department of Finance and the Central Bank to improve and complement the provisions in the published Bill. The Minister said that the purpose of the consultation was "to ensure that all stakeholders are fully informed of the intent of the Committee stage amendments and can submit their views on what is proposed". Comments were invited by close of business on 25 May 2012.

(ii) Fitness and Probity Service Standards

On the 29th of June 2012 the Central Bank published new Fitness and Probity Service Standards outlining target turnaround times for processing Individual Questionnaires. The document contains a summary of the targets and reasons why an Individual Questionnaire may be returned by the Central Bank. The document is available on the Central Bank site.

http://www.centralbank.ie/regulation/processes/fandp/Documents/Fitness%20and%20Probity%20Service%20Standard.pdf

(iii) Consultation on the handling of insider information

The Central Bank has issued Consultation Paper 58 on "The Handling of Inside Information under the Market Abuse (Directive 2003/6/EC) Regulations
2005." The consultation paper sought commentary on three issues:-

1. Determining what information is sufficiently significant for it to be deemed inside information;
2. Types of insider lists; and

3. Director and personal account dealing and the definition of persons discharging managerial responsibility.

The consultation closed on the 14th June 2012.

Anti-Money Laundering/Counter-Terrorism Financing

(i) Reports relating to the implementation of the Third Anti-Money Laundering Directive

On the 11th of April 2012 the Joint Committee of the three European Supervisory Authorities (EBA, ESMA and EIOPA) published two reports on the implementation of the third Anti-Money Laundering Directive.

The "Report on the legal, regulatory and supervisory implementation across EU Member States in relation to the Beneficial Owners Customer Due Diligence requirements" analyses EU Member States' current legal, regulatory and supervisory implementation of the anti-money laundering/counter terrorist financing (AML/CTF) frameworks related to the application by different credit and financial institutions of Customer Due Diligence (CDD) measures on their customers' beneficial owners. The aim of the report was to pinpoint discrepancies in the implementation of the Directive to establish whether such divergences create a gap in the EU AML/CTF regime that could be exploited by criminals for money laundering and terrorist financing purposes.

The "Report on the legal and regulatory provisions and supervisory expectations across EU Member States of Simplified Due Diligence requirements where the customers are credit and financial institutions" provides an overview of EU Member States' legal and regulatory provisions and supervisory expectations in relation to the application of Simplified Due Diligence (SDD) requirements. The report focuses exclusively on one particular situation of low risk where SDD is applicable, namely where the customer is a credit or financial institution situated in an EU/EEA state or in a country that imposes equivalent AML/CFT requirements. The aim of the report was to identify differences in the implementation of the Directive and to establish whether such divergences could be exploited by criminals for money laundering and terrorist financing purposes.

The conclusion of both reports is that significant divergences exist in relation to the implementation of the Directive by EU Member States. The reports state that a number of these differences could create undesirable effects on the common European Anti Money Laundering Regime. The reports find that some of these differences are not due to the

Directive's minimum harmonisation approach, but instead arise from different national interpretations of the Directive's requirements.

The reports have invited the Commission to consider whether convergence of national beneficial ownership identification standards should occur.

(ii) Shah Case

The English High Court recently delivered its judgment in the long running dispute between HSBC Private Bank (UK) Limited and Mr. Jayesh Shah, a former customer of HSBC. Although the ruling relates to particular aspects of the English Proceeds of Crime Act, 2002 ("2002 Act"), the ruling provides guidance as to how a court in Ireland may interpret certain provisions of the Criminal Justice (Money Laundering and Terrorist Financing) Act, 2010 ("2010 Act"), (notwithstanding that there are differences between the statutory regime in Ireland and in the United Kingdom). In particular the judgment should prove useful to MLROs and should also provide guidance about the procedures which an organisation should put in place with regards to its suspicious transaction reporting regime.

Mr Shah and his wife brought a claim for damages of over USD300 million arising out of delays caused by HSBC in executing four transfers from his account during the period September 2006 to March 2007 and the failure of HSBC to explain the reasons for the delays. The reason that HSBC delayed the transactions was because it suspected that the funds constituted the proceeds of criminal activity and consequently made a Suspicious Activity Report ("SAR") to the Serious Organised Crime Agency ("SOCR"). In the United Kingdom a designated person must obtain the "appropriate consent" of SOCR before proceeding with any transactions which are the subject of a SAR (there is no similar requirement in Ireland). HSBC explained the delay to Mr. Shah by saying that it was complying with its statutory obligations. HSBC did not want to provide any further information as it did not want to be guilty of the "tipping off" offence in the 2002 Act.

The Court held that there was an implied term in its contract that permitted HSBC to refuse to execute payment instructions in the absence of "appropriate consent" under 2002 Act where HSBC suspected a transaction constituted money laundering. In order to be able to rely on the implied term enabling it to refuse to execute payment instructions, HSBC had to demonstrate that it did in fact suspect that the transaction constituted money laundering. The MLRO gave evidence that there were several factors which gave rise to his suspicion and led to his decision to send the SAR to SOCR. The Court held that in the case of each SAR, the submission was made after the MLRO had formed his own independent suspicion based on the factual information known to him. The word of each SAR was examined and the MLRO was extensively cross examined. This underlines the importance of an MLRO having robust systems in place to demonstrate that any decisions are made independently and appropriately documented.

The Court also held that HSBC was correct to refuse to provide information where in providing such information it might contravene its duties under 2002 Act, in particular the provisions relating to tipping off. The Court held that HSBC was correct not to provide any information to Mr. Shah relating to his communications with SOCR. This serves to underline that MLROs should not engage in any dialogue about the fact a SAR has been made.

(iii) Criminal Justice (Money Laundering and Terrorist Financing) (Amendment) Bill 2012

The Department of Justice has published the draft heads of a new Bill in the area of anti money laundering - the Criminal Justice (Money Laundering and Terrorist Financing) (Amendment) Bill 2012 (the "Bill"). The Bill is seeking to clarify certain aspects of the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 (the "Act"), following concerns raised by the Department of Justice as well as matters raised by the Central Bank. The accompanying press release to the Bill states that the Government intends to make further amendments to the Bill at a later date as it considers its response to the Mahon Tribunal and representations from IFSC firms who use the services of parties outside the State for customer identification purposes.

The amendments proposed in the Bill include;

- Lowering the identification threshold for private members gaming clubs from €15,000 to €2,000;

- Section 31 of the Act (which permits the Minister for Justice, Equality and Law Reform (the "Minister") to designate certain countries outside the EU as having equivalent standards to those specified in the Third AML Directive) will be amended such that a designated person must carry out its own risk assessment on such specified countries if the designated person wishes to rely on a relevant third party in such countries or apply simplified due diligence to specified customers from such countries. Unfortunately the Bill is silent as to what measures a designated person can take in relation to third parties in those Non-EU countries which are not on the list of specified countries (i.e. those countries which are not on the good list of countries under Section 31 or the bad list of countries under Section 32);

- Section 34 of the Act, which deals with specified customers and specified products – i.e. the situations where simplified due diligence can be applied – is proposed to be amended whereby the designated person can apply simplified due diligence to such customers/products where the designated person has taken steps to determine whether or not the customer or product is a specified customer or product;

- Section 54 of the Act will be amended to specifically include the keeping up to date of documents obtained for due diligence purposes and the future-proofing of procedures to accommodate new technological developments; and

- Section 55 of the Act is to be amended such that records will no longer have to be kept in the State.

Dillon Eustace

This Funds Quarterly Legal and Regulatory Update is for information purposes only and does not constitute, or purport to represent, legal advice. It has been prepared in respect of the current quarter and, accordingly, may not reflect changes that have occurred subsequent to the start of such period. If you have any queries or would like further information regarding any of the above matters, please refer to your usual contact in Dillon Eustace.

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