



EVERYTHING MATTERS

FINANCIAL SERVICES REGULATION

Exchange – International Newsletter

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INTRODUCTION

WELCOME

DLA Piper's Financial Services International Regulatory team welcomes you to the twelfth edition of 'Exchange – International' – an international newsletter designed to keep you informed of regulatory developments in the financial services sector.

This issue includes updates from Australia, Austria, Hong Kong, Sweden, UK and USA as well as news from the G20 Cannes Summit and forthcoming European legislation. Please click on the links below to access updates for the relevant jurisdictions.

Our aim is to assist you in providing an overview of developments outside your own jurisdiction which may be of interest to you. In each issue we will also focus on a topic of wider international interest. In this edition, "In Focus" takes a closer look at the European Commission's legislative proposals to amend the Markets in Financial Instruments Directive, known as MiFID II.

Please click on the links below to access updates for the relevant jurisdictions.

Your feedback is important to us. If you have any comments or suggestions for future issues, we would be very glad to hear from you.

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USEFUL INFORMATION

If your colleagues would like to be added to our mailing list to receive future client alerts or newsletters, please email nicola.spurrell@dlapiper.com with their contact details. For recent publications, legal updates and an overview of our Litigation & Regulatory capabilities please see our [global website](#).

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G20 COUNTRIES ISSUE CANNES SUMMIT DECLARATION

4 November 2011

The G20 published a [final declaration](#) following the G20 leaders' summit which was held in Cannes on 3 and 4 November 2011. Some of the points agreed by the G20 included:

- Reforming OTC derivatives – the G20 endorsed the [progress report](#) of the Financial Stability Board (“FSB”) on the implementation of reforms to the OTC derivatives markets and agreed that all standardised OTC derivatives should be traded on regulated exchanges or electronic trading platforms.
 - Addressing compensation practices – the G20 called on the FSB to carry out ongoing monitoring and public reporting on compensation practices focusing on identifying gaps and impediments to the full implementation of agreed FSB principles and standards on compensation. The FSB was encouraged to consider setting out additional guidance on the definition of material risk takers based on its findings.
 - Reliance on external credit ratings – The G20 called for a reduction in the reliance of national authorities and financial institutions on external credit ratings and called on stakeholders to implement the agreed FSB principles and end practices that rely mechanistically on these ratings.
 - Addressing the “too big to fail” issue – The G20 endorsed the FSB’s [comprehensive framework](#) comprising of a new international standard for resolution regimes, more intensive and effective supervision and requirements for cross-border co-operation and recovery and resolution planning.
 - Shadow banking – The G20 agreed to develop the regulation and oversight of shadow banking. It will develop further its regulation on market integrity and efficiency, including addressing the risks posed by high frequency trading and dark liquidity. The G20 have tasked IOSCO to assess the functioning of Credit Default Swaps markets.
- Commodity markets – the G20 endorsed the International Organisation of Securities Commissions (“IOSCO”) recommendations to improve regulation and supervision of commodity derivatives markets. The G20 agreed that market regulators should be granted effective intervention powers to prevent market abuses. In particular, the G20 agreed that market regulators should have and use formal position management powers, among other powers of intervention, including the power to set position limits, as appropriate.
 - Consumer protection – the G20 endorsed the FSB report on consumer finance protection and the high level principles on financial consumer protection prepared by the Organisation for Economic Co-operation and Development (“OECD”) together with the FSB. The G20 has asked the FSB and OECD (along with other relevant bodies) to report on progress on their implementation and develop further guidelines if appropriate.

The G20 also agreed to reforms intended to strengthen the capacity, resources, and governance of the FSB, giving it legal personality and greater financial autonomy.

FSB PROGRESS REPORTS ENDORSED BY G20 SUMMIT

On 4 November 2011, the G20 summit endorsed the FSB paper “[Policy Measures to Address Systemically Important Financial Institutions](#)” which summarises the agreed “multipronged and integrated” set of policy measures designed to address the “too big to fail” problem. Implementation of the measures will begin in 2012. Full implementation is targeted for 2019. The measures are set out in detail in a number of reports published separately on 4 November 2011:



FSB issues International Standard for Resolution Regimes

The Financial Stability Board (“FSB”) published a new internationally-agreed standard, “[Key Attributes of Effective Resolution Regimes for Financial Institutions](#)” that sets out the responsibilities, instruments and powers that national resolution regimes should have to resolve a failing systemically important financial institution (“SIFI”). It also sets out requirements for resolvability assessments and recovery and resolution planning for global SIFIs (“G-SIFIs”), as well as for the development of institution-specific cooperation agreements between home and host authorities. The new standard hopes to help address the “too-big-to-fail” problem by making it possible to resolve any financial institution in an orderly manner and without exposing taxpayers to the risk of loss.

FSB progress report on intensity and effectiveness of SIFI supervision

The FSB also released a [progress report](#) in implementing the FSB’s November 2010 Recommendations on Intensity and Effectiveness of SIFI Supervision. This report describes the progress many supervisors are making in intensifying their supervision of SIFIs and improving their supervisory tools and methods.

BCBS final rules for global systemically important banks

The Basel Committee on Banking Supervision (“BCBS”) also issued its rules for global systemically important banks (“G-SIBs”). [Global systemically important banks: Assessment methodology and the additional loss absorbency requirement](#) sets out the Basel Committee’s framework to identify G-SIBs, the magnitude of additional loss absorbency that G-SIBs should have, and the arrangements by which the requirement will be phased in.

PROGRESS REPORT ON BASEL III IMPLEMENTATION

On 18 October 2011, the BCBS published a [progress report](#) providing a high level view on the progress of Basel Committee members towards implementing Basel III as at the end of September 2011. The progress report focuses on each member’s domestic rule-making processes to ensure that Basel III is transformed into law or regulation according to the agreed international timelines. In December 2010, the BCBS released Basel III, which has set higher levels of capital requirements and introduced a new global liquidity framework. The Basel Committee members have agreed to implement Basel III from 1 January 2013.

BASEL III DEFINITION OF CAPITAL – FAQ’S UPDATED

On 20 October 2011, the BCBS published answers to a second set of [Basel III FAQ’s](#) relating to the definition of capital. The publication updates the first set of FAQ’s which was published in July 2011. To help ensure a consistent global implementation of Basel III, the Basel Committee has agreed to periodically review frequently asked questions and publish answers along with any technical elaboration of the rules text and interpretative guidance that may be necessary.

EUROPE



AGREEMENT REACHED ON REGULATION ON SHORT SELLING AND CREDIT DEFAULT SWAPS

On 18 October 2011, the European Parliament and the Polish Presidency of the Council of the European Union reached an [agreement](#) on the proposed Regulation on short selling and certain aspects of credit default swaps (“CDS”).

The press release states that agreement has been reached on the following issues:

- A permanent ban on naked CDS trading. A national authority may temporarily suspend the restrictions where it believes that its sovereign debt market is not functioning properly and that such restrictions might have a negative impact on the sovereign credit default swap market, especially by increasing the cost of borrowing for sovereign issuers or affecting the sovereign issuer’s ability to issue new debt.
- National authorities to have all the powers necessary, as well as rules on administrative measures, sanctions and pecuniary measures, to enforce the proposals. The European Securities and Financial Markets Authority is also given the power to conduct inquiries into specific issues or practices relating to short selling and to publish a report setting out its findings.
- Increased reporting requirements.

The Regulation is expected to come into force in November 2012.

DRAFT DIRECTIVE ON FINANCIAL TRANSACTION TAX PUBLISHED

On 28 September 2011, the European Commission published a [draft Directive](#) on the EU Financial Transaction Tax (“FTT”). The Commission presented its proposals at the Cannes summit on 3 and 4 November 2011. The Cannes summit endorsed the right of G20 countries to impose the levy but was lukewarm with both USA and India indicating they were not in favour of an FTT. It appears unlikely that an FTT will be adopted by most G20 countries.

The European Commission already explored the idea of implementing a FTT in its Communication of 7 October 2010 on “Taxation of the Financial Sector”.

The Commission believes the draft directive is a first step:

- to avoid fragmentation in the internal market for financial services, bearing in mind the increasing number of uncoordinated national tax measures being put in place;
- to ensure that financial institutions make a fair contribution to covering the costs of the recent crisis and to ensure a level playing field with other sectors from a taxation point of view; and
- to create appropriate disincentives for transactions that do not enhance the efficiency of financial markets.

The scope of the tax is wide and will include all transactions in financial instruments including equities, bonds, foreign currencies and derivatives. Residential mortgages, bank loans, insurance contract and “day-to-day” activities are ring fenced and would fall outside the scope of the FTT, as would spot currency conversions, capital raising and physical commodity transactions.

The scope of the tax is not limited to trade in organised markets, such as regulated markets, multilateral trading facilities, but also covers other types of trades including over-the-counter trade. It is also not limited to the transfer of ownership and will include sale and repurchase and securities lending transactions.

The scope of the tax is focused on financial transactions carried out by financial institutions acting as party to a financial transaction, either for their own account or for the account of other persons, or acting in the name of a party to the transaction. The definition of financial institutions is broad and essentially includes investment firms, organised markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies, special purpose entities, and

where possible refers to the definitions provided by the relevant EU legislation adopted for regulatory purposes. Additionally other persons carrying out certain financial activities on a significant basis should be considered as financial institutions.

Central Counterparties, Central Securities Depositories, and International Central Securities Depositories where carrying on their respective functions will not be liable to the FTT. Transactions with the European Central Bank and national central banks are however excluded from the scope so as to avoid any negative impact on the refinancing possibilities of financial institutions or on monetary policies in general.

A financial institution would be deemed to be established in the territory of a Member State, if it is authorised in that Member State, has a regulatory office in the Member State, is resident in the Member State or is acting through a branch in that Member State.

Chapter II of the draft directive sets out the chargeability, taxable amounts and rates of the FTT. The moment of chargeability is defined as the moment when the financial transaction occurs. The draft directive provides that the rate of FTT will be fixed by each member state subject to a minimum of 0.1% for share and bond transactions and at 0.01% for derivatives. Each financial institution that is party to the transaction would have to pay FTT but all parties would be jointly and severally liable for it if the financial institution fails to pay FTT when due. Member states will be required to implement compliance, reporting and anti-avoidance rules.

The draft directive specifies a start date for the FTT regime of 1 January 2014. In order to be implemented, the draft directive needs to be discussed and agreed unanimously amongst the 27 EU member states at a EU Council of Ministers. With strong opposition from the UK and some other EU countries it is unclear where and to what extent the FTT will come into force.



COMPROMISE PROPOSAL FROM POLISH PRESIDENCY ON PROPOSED RESIDENTIAL MORTGAGES DIRECTIVE

Council of the European Union, 4 November 2011

The [proposal](#) published by the Polish Presidency of the EU on 4 November 2011 was prepared for a meeting of the working party on financial services on 7 November 2011. It makes changes to the previous proposal dated 6 September 2011.

The directive was originally proposed by the European Commission in March 2011 with a view to achieving a single market for residential mortgages that is competitive, responsible and promotes financial stability. If adopted, the directive will put in place European standards, going beyond domestic requirements.

EUROPEAN PARLIAMENT COMMITTEE PUBLISH CONSUMER POLICY STRATEGIC REPORT

European Parliament, 4 November 2011

The European Parliament Committee on the Internal Market and Consumer Protection (“Committee”) published a [non-legislative report](#) (dated 21 October 2011) on a new strategy for consumer policy. The report includes a motion for a Parliament non-legislative resolution on a new strategy for consumer policy. The report set out several issues in the financial services arena:

- The Committee called for better regulation of financial advisory services.
- The Committee called on the Commission to look into the remaining obstacles to bank switching and asks the Commission to consider ways of eliminating impediments such as setting up an EU-wide bank account number portability system.



- The Committee asked the Commission to formulate a strategy to reflect the new powers and responsibilities relating to consumer protection of the European Supervisory Authorities and enhance their consumer protection capabilities.
- The Committee asked for a higher level of consumer protection in the field of financial services throughout the EU so that the internal market could be further strengthened and protectionist policies could be combated.
- The Committee noted that 30 million EU citizens do not have access to basic banking services and called on the Commission to put forward a proposal to address this issue.

NEW PROPOSALS FOR MARKET ABUSE REGIME

On 20 October 2011, the Commission published its proposals to replace the Market Abuse Directive with a [Regulation on insider dealing and market manipulation](#) (“MAR”) and a new [Market Abuse Directive](#) on criminal sanctions. The new Regulation extends the scope of the market abuse framework to apply to any financial instrument admitted to trading on an MTF or organised trading facility, as well as to

any related financial instruments traded OTC which can have an effect on the covered underlying market. This is necessary to avoid any regulatory arbitrage among trading venues, to ensure that the protection of investors and the integrity of markets are preserved on a level playing field in the EU, and to ensure that market manipulation of such financial instruments through derivatives traded OTC, such as credit default swaps (CDS), is clearly prohibited. The draft Directive requires all Member States to introduce criminal sanctions for intentional insider dealing and market manipulation.

The proposals aim to ensure the market abuse regime is aligned to the broader scope of MiFID in relation to trading platforms, financial instruments covered, and regulated entities (see our “In Focus” section which reviews the MiFID II proposals).

AUSTRALIA



NEW AUSTRALIAN EQUITY MARKET

Chi-X Australia Pty. Ltd (“Chi-X”) a subsidiary of the Japanese company Chi-X Global Inc., commenced its Australian operations on Monday 31 October 2011. Chi-X is the first foreign organisation to be granted a market licence in Australia.

Operations have started with a “soft launch” trading in eight securities which if successful will lead to trading in all S&P/ASX 200 component securities and ASX-listed ETFs. Chi-X has announced that 24 firms have registered as Participants under its Operating Rules.

The Australian Securities and Investments Commission (“ASIC”) released two new chapters in the ASIC Market Integrity Rules to reflect the existence of the Chi-X market. Participants in both the Australian Securities Exchange and Chi-X markets are able to satisfy their capital rules for both markets with a single amount of capital and are only required to report to ASIC under one set of Rules.

On 31 October 2011, ASIC issued [Consultation Paper 168](#): Australian Equity Market Structure: Further Proposals. It proposes modifications to the ASIC market integrity rules to address regulatory issues resulting from recent market developments in Australia and in particular:

- the automated trading environment, including high-frequency trading;
- volatility controls for extreme price movements;
- enhanced data for market surveillance;
- the product scope for best execution; and
- pre-trade transparency and price formation in the market.

COVERED BONDS

The Banking Amendment (Covered Bonds) Act 2011 (“Covered Bonds Act”), which became law on 17 October 2011 now allows for the issuing of covered bonds by Australian Deposit Institutions (“ADIs”). The Australian Prudential and Regulatory Authority (“APRA”) has accordingly removed the prohibition on the issuing of covered bonds from paragraph 7 of Prudential Standard APS 120 Securitisation.

APRA has issued a draft for a new Prudential Standard APS 121: Covered Bonds setting out proposed prudential requirements to apply to ADIs that issue covered bonds in accordance with the Covered Bonds Act. The new standard deals mainly with the capital treatment of covered bonds. It is APRA’s intention to issue a final version of APS 121 by early 2012 with APRA’s prudential requirements to come into effect from the date of that standard.

CARBON CREDITS NOW A FINANCIAL PRODUCT

The Australian Government’s ‘[Securing Australia’s Energy Future – the Australian Government’s Climate Change Plan](#)’ (“Clean Energy Plan”) was released on 10 July 2011. The Clean Energy Plan introduces significant changes that will affect many Australian and overseas businesses. It has a proposed start date of 1 July 2012.

The Carbon Units (Carbon Farming Initiative) Act 2011 and the Clean Energy (Consequential Amendments) Act 2011 were passed on 15 September 2011 and are waiting proclamation. These reforms amend the Australian Corporations Act 2001 to declare carbon units financial products. The effect of these reforms is to make advising and dealing in relation to such products a financial service and so subject to Australian financial services legislation such as licensing and disclosure.



In addition to creating new financial products with implications for environmental consultants and funds managers, the Clean Energy Plan, if passed, introduces changes to directors obligations as well as approaches to contract drafting and due diligence on mergers and acquisitions.

Please click [here](#) for a copy of the DLA Piper overview of the proposed reforms.

AUSTRALIAN REGULATORS COMMITTED TO PRINCIPLES BASED REGULATION

Since 2001, Australia has operated in a principles based regulatory system for financial services and products. The principles based philosophy recognises the need for a flexible approach to regulation that allows entities to comply with the required principles while adapting the implementation of the principles to the specific needs of the business, its products and distribution channels.

Principles-based regulation is distinguishable from the more prescriptive rules-based regulation because it does not prescribe detailed mandatory matters that must be complied with but instead establishes an overarching objective to be achieved and then provides guidance through prudential standards or regulatory guides to assist regulated entities to achieve the required outcomes. The principles based approach is outcomes focused and the regulation facilitates compliance through the statement of general principles that can be applied to new and changing situations with an emphasises on compliance with the spirit of the law.

This approach is quite different to the prescriptive approach to regulation that operates in other financial systems and markets. Both APRA, the prudential supervisor and ASIC, the markets and consumer supervisor, are committed to the concepts of principles based regulation and have worked closely with Australian industry groups in the development of guidelines and standards.

One of the APRA proponents of the principles approach was Wayne Byres who until June 2011 was APRA's Executive General Manager, Diversified Institutions Division. On 13th October 2011 he was appointed Secretary General of The Basel Committee on Banking Supervision. When discussing principles versus prescriptive rules in 2011 he stated:

"APRA applies an alternate philosophy: we believe no set of rules can adequately and efficiently deal with a system as complex as a financial system. Our approach views supervision as the primary means by which we can promote long-term safety and soundness of financial institutions. So we endeavour to establish regulation that supports supervision, and then seek to use balanced supervision as the key to long term financial safety and stability. We also expect this approach, which can be tailored and take account of nuances and subtleties in individual circumstances in a manner a rulebook cannot, will be more flexible and responsive, and therefore hopefully less costly, than "regulation-first" philosophies."

ASIC FOCUS ON "GATEKEEPERS"

In keeping with the emphasis on principles and outcomes, in October 2011 ASIC's Chairman, Greg Metcalf, set out ASIC's regulatory priorities for the coming year and indicated that as part of ASIC's commitment to having confident and informed investors and financial consumers it was also committed to holding 'gatekeepers' accountable for their actions and taking action if they failed to meet their responsibilities. In the week following his speech ASIC entered into enforceable undertakings with two auditors following investigations that raised concerns over the standard of the audits they had conducted and their failure to adequately discharge their professional duties which in turn jeopardises the confidence in and integrity of Australia's capital markets. ASIC defines gatekeepers widely as including accountant, directors, advisors, custodians, product manufacturers, market operator and participants.



APRA ISSUES NEW PRUDENTIAL STANDARDS

On 12th September 2011, APRA issued four consolidated prudential standards on governance, fitness and propriety, outsourcing and business continuity management to replace 12 existing standards for ADIs, general insurance and life insurance. The new standards will take effect from 1 July 2012.

On 5th October 2011, APRA issued its new refinements to the prudential supervision of general insurance groups, which are mainly consistent with the proposals APRA released in its May 2011 discussion paper.

A Level 2 general insurance group is consolidated general insurance group headed by either an APRA-authorized Level 1 insurer or an APRA-authorized Non Operating Holding Company (NOHC) and includes all general insurance controlled entities (both domestic and international) and any other controlled entities integral to its general insurance business. The Level 2 insurance group includes any entities APRA determines to be within the Level 2 insurance group and does not include entities that are treated as non-consolidated subsidiaries.

APRA's prudential framework for Level 2 groups is focussed on contagion risk: the risk that adverse developments in activities conducted by other group members could affect the health of the regulated insurer (or insurers) in the group. APRA's approach is to treat the Level 2 group, in principle, as one economic entity and apply prudential requirements to the group similar to those applying to individual APRA-authorized insurers (Level 1 insurers).

The new prudential standards effective on 1 December 2011 are Prudential Standard GPS 001 Definitions; Prudential Standard GPS 111 Capital Adequacy: Level 2 Insurance Groups; and Prudential Standard GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance Groups.

The capital standards no longer require reinsurance assets not meeting governing law requirements in foreign jurisdictions to be deducted. However, APRA expects that Level 2 insurance groups understand and comply with relevant regulatory requirements in jurisdictions in which they operate.

For the purposes of determining the Level 2 insurance groups' capital base, reserves from equity-settled share-based payments (shares or share options) granted to employees as part of their remuneration package may only be included in reserves if certain conditions in GPS 111 are met.

In assessing the overall capital strength of a Level 2 insurance group, APRA may request that the parent entity provide details of the group's intra-group exposures, including capital transactions and intra-group guarantees such as details of all intra-group exposures provided by the parent entity to the Level 2 insurance group. APRA may also request details of material exposures between entities controlled by the parent entity.

The reporting standards effective for reporting periods beginning on or after 1 July 2011 are:

- Reporting Standard GRS 110.0_G Minimum Capital Requirement
- Reporting Standard GRS 120.0_G Determination of Capital Base
- Reporting Standard GRS 210.0_G Outstanding Claims Liability – Insurance Risk Charge
- Reporting Standard GRS 210.1_G Premiums Liabilities – Insurance Risk Charge
- Reporting Standard GRS 300.0_G Statement of Financial Position
- Reporting Standard GRS 301.0_G Reinsurance Assets and Risk Charge
- Reporting Standard GRS 302.0_G Statement of Financial Position by Region
- Reporting Standard GRS 310.0_G Income Statement

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AUSTRIA



BANKING SECRECY IN MOTION

The Austrian statutory banking secrecy provision in Article 38 of the Banking Act (BWG) is being materially redefined. Simply put, the banking secrecy provision imposes an obligation upon credit institutions to keep confidential any and all information pertaining to their business relations with customers, subject to a closed number of exceptions (such as when it is significant to criminal proceedings). Any changes to this regime requires adoption of rules with the constitutional character.

Following Austria's withdrawal of its reservation to Article 26 on exchange of information of the OECD Model Tax Convention, it has enacted the Administrative Assistance – Implementation Act (ADG). Accordingly, provided an international treaty implementing that provision and being binding upon both states, a request by a foreign competent authority will in principle – and notwithstanding the banking secrecy provision – have to be met by an Austrian credit institution whenever it is of any foreseeable relevance to a tax matter. With a view to this, a revisionary protocol to the Tax Treaty between Austria and Germany has been signed, though not yet ratified.

In addition, in order to comply with the Report on the Observance of Standards and Codes on the Financial Action Task Force (FATF) Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism for Austria (i) the banking secrecy provision can presently be breached in connection with an extended number of criminal offences; and (ii) new obligations have been introduced for credit institutions to actively report to a money laundering reporting office on suspicion or in case of existence of reasonable grounds. The former has been effected on two levels: either through imposing such obligations a new (e.g. as is the case with attempted transactions) or by redefining offences triggering them (e.g. the list of the predicate offences to the offence of money laundering has been redrafted to include some forms of tax evasion, product piracy etc.).

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HONG KONG



SFC AND HKMA PUBLISHES HONG KONG OTC DERIVATIVES MARKETS CONSULTATION

On 17 October 2011, The Hong Kong Monetary Authority (“HKMA”) and Securities and Futures Commission (“SFC”) issued a [joint consultation paper](#) on the proposed regulatory regime for Hong Kong’s over-the-counter (“OTC”) derivatives market.

The focus has been on developing a regime that is on a par with international standards but takes into account local market conditions and characteristics. Both regulators acknowledged the local OTC derivatives market is relatively small compared with other major markets and the OTC derivatives market is global in nature.

The G20 has said set a deadline of year end 2012 for all OTC standardised derivatives to be traded on exchanges or electronic platforms and cleared through central counterparties. OTC derivative contracts will also have to be reported to trade repositories. The G20 also said that non-centrally cleared contracts should be subject to higher capital requirements.

As key aspects of the OTC regulatory reform are still under discussion in the global arena, the proposed regime for Hong Kong may be subject to further change. The joint consultation paper however sets out the HKMA’s and SFC’s current thinking on how the regime might be cast given the present status of the global reform efforts. The consultation period runs until 30 November 2011.

The proposed regime will be set out in the Securities and Futures Ordinance (“SFO”), and will be jointly overseen and regulated by the HKMA and SFC. Essentially, the HKMA will oversee and regulate the OTC derivatives activities of authorized institutions (“AIs”), while the SFC will oversee and regulate such activities of persons other than AIs. AIs refers to institutions that are licensed under the Banking Ordinance and regulated by the HKMA (such as banks, restricted licence banks, and deposit-taking companies).

OTC derivatives transactions will have to be reported to the trade repository, which is being set up by the HKMA for the collection of data relating to OTC derivatives transactions. This reporting obligation will initially apply only to certain interest rate swaps (“IRS”) and non-deliverable forwards (“NDF”), but will subsequently be extended to other product classes (such as equity derivatives and other types of interest rate derivatives) after further market consultation. Standardised OTC derivatives transactions will have to be centrally cleared through a designated central counterparty. This mandatory clearing obligation will also initially be limited to only certain IRS and NDF, and subsequently extended to other product classes after further market consultation. The regulators added that OTC derivatives transactions will not initially be traded on an exchange or electronic trading platform as further assessments are required on how best to implement such a requirement in Hong Kong.

The regulators also stated that OTC derivatives activities by AIs are already subject to the HKMA’s regulatory oversight in respect of capital, liquidity and other relevant requirements and should remain so under the proposed regime.

SWEDEN



IMPLEMENTATION OF THE UCITS IV DIRECTIVE IN SWEDEN

During the 1980's the majority of the Swedish population began saving in Investment Funds and has continued to do so. It is estimated that 82 per cent of the Swedish adults save in Investment Funds in addition to their Premium Pension, making Sweden one of the countries with the highest rates of fund saving per capita in the world. If Premium Pensions would be included in the calculation, 99 per cent of the Swedish population save in Investment Funds. The total amount of fund savings accumulated to SEK 1,928 billion (approx EUR 211 million) at the end of 2010. The Swedish Investment Funds average Management Fees are one of Europe's lowest amounting to 1,44 per cent.

The Swedish legal framework offers only one sort of vehicle for UCITS and non-UCITS Investment Funds; funds constituted in accordance with contract law. As an unincorporated body, the Swedish fund vehicle does not constitute a separate legal entity but is regarded as a person for tax purposes. The ownership interest of investors is represented by units, which are issued and redeemed by the Investment Fund's Fund Management Company.

The UCITS IV directive was implemented into the Swedish Investment Funds Act (the "Act") on 1 August 2011. In accordance with the directive, the updated Act provides new provisions regarding Notification Procedure, Key Investor Information, adapted framework for mergers, Master-Feeder Structures, cooperation between member state supervisory authorities and Management Company Passport. Prior to the UCITS IV regime, it has been difficult for Fund Management Companies to change the strategy of an Investment Fund or to merge or wind up an Investment Fund. Over the years, this has led to new Investment Funds being established in Sweden when conditions in the outside world changed and the funds' strategies got outdated, resulting in plenty of unattractive funds left under management for the managers in the Swedish market.

The new opportunities that came with the UCITS IV have been welcomed by the major Fund Management Companies in Sweden. The Fund Management Companies now have the possibility to streamline their Investment Fund product range by either amending the strategy of the funds or merging them in order to ultimately save costs. We are expecting to see numerous fund mergers in the Swedish market by the Fund Management Companies with wide fund product ranges. For instance, Thomas Eriksson, CEO of Swedbank Robur Fund Management ("Robur"), Sweden's largest Fund Management Company, announced to the press that Robur's 150 Investment Funds are going to be reduced to approximately 100 after all planned mergers have been completed. Robur estimates to raise its result by 33 per cent due to saved costs and due to some other strategic measures which will be adopted in connection with the mergers.

The implementation of the UCITS directive has also shown its first side effects. The new legislation has not only provided new opportunities for the major Fund Management Companies, but it has also raised the administrative costs of the Fund Management. The higher costs mainly refer to stricter provisions regarding compliance and internal control of the fund, which also applies to the non-UCITS. Recently the first Fund Management Company announced that it was going to wind up its business due to the augmented administrative costs. The Fund Management Company is quite small consisting of four Investment Funds which are being managed. It has been reported by the press that in order to fulfil the new requirements, the Fund Management Companies need to have two administrative personnel for each fund manager. This cost might be too high for small Fund Management Companies to cope with in an already down turning market. Unfortunately, we will probably see more Fund Management Companies which will have to wind up, or, best case being acquired by the larger actors on the market.

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ENFORCEMENT DECISIONS

FSA imposes record fine on Dubai based investor for market manipulation

FSA, 9 November 2011

The FSA imposed a [financial penalty](#) on Rameshkumar Goenka, a Dubai based private investor, USD \$9,621,240 (approximately £6 million) for manipulating the closing price of Reliance Industries (“Reliance”) securities on the London Stock Exchange (“LSE”). The fine is the largest yet imposed by the FSA on an individual for market abuse. The penalty was calculated under the FSA’s new penalty regime.

On 18 October 2010, Mr Goenka placed orders and executed trades which artificially inflated the closing price of Reliance securities. Mr Goenka had arranged for a pre-planned series of substantial and carefully timed orders to be placed in the final seconds of the LSE’s closing auction. The orders were placed and the trades executed with the intention of increasing the closing price of the Reliance securities above a certain level. The timing of the substantial orders was intended to ensure that market participants had insufficient time to respond before the closing price was determined. By increasing the closing price Mr Goenka avoided a loss of USD \$3,103,640 under the terms of the structured product. The bank, which was the counterparty to the structured product, overpaid Goenka USD \$3,103,640 as a result of his manipulation of the Reliance closing price.

Goenka had planned to engage in similar behaviour in relation to a separate structured product in April 2010 but on that occasion no actual trading took place due to an unexpected announcement by President Putin which caused the price of the Reliance securities to fall just before the trade was due to take place.

The FSA’s new penalty regime is founded upon a five-step framework based on the principles of disgorgement, discipline and deterrence. In outline, the steps are as follows:

- Step 1** Removing any profits made from the misconduct (i.e. disgorgement);
- Step 2** Setting a figure to reflect the seriousness, nature and impact of the breach;
- Step 3** Adjusting the figure arrived at under Step 2 upwards or downwards to take into account any aggravating and mitigating factors;
- Step 4** If appropriate, increasing the amount arrived at in Step 3 to achieve the appropriate deterrent effect; and
- Step 5** Applying any early settlement discount.

The FSA stated that Mr Goenka’s market abuse was not referable to his employment therefore the appropriate basis for calculation at Step 2 was the loss he avoided as a result of his market abuse (USD \$3,103,640). The FSA considered that that the behaviour of Mr Goenka was at level 4 of seriousness as the market abuse was intentional. Mr Goenka intended or foresaw that the likely consequences of his actions would result in an increase in the price of the Reliance securities and intended to benefit financially from the market abuse directly in that he intended to avoid a loss of USD \$3,103,640. Accordingly the multiple to be applied at Step 2 was therefore 3 and so the step 2 figure was USD \$9,310,920. The FSA did not consider it necessary to increase the step 3 figure so the fine remained at USD \$9,310,920. The FSA and Mr Goenka reached agreement at stage 1 and so a 30% discount applied at step 5. Therefore, the final penalty imposed on Mr Goenka was USD \$6,517,644.

Under section 384 of the Financial Services and Markets Act 2000, the FSA has the power to require restitution to be paid to the appropriate person who has suffered loss as a result of the market abuse. The FSA ordered Mr Goenka to pay the full amount of the loss, USD \$3,103,640, in restitution to the counterparty.

Towry Investment Management fined £494,000 for providing misleading information to the FSA

FSA, 14 September 2011

On 14 September 2011, the FSA issued a [final notice](#) to Towry Investment Management Limited (“Towry”) and a financial penalty of £494,900 pursuant to section 206 of the Financial Services and Markets Act 2000.

Towry is a fee-based, independent discretionary investment manager providing independent investment management services to private individuals and pensions and employee benefits advice to small and medium sized enterprises.

The FSA took action on the basis that Towry had breached Principle 10 (Clients’ assets) of the Principles for Businesses and Principle 11 (Relations with regulators). The FSA held that Towry breached Principle 10 because it failed to perform client money calculations and reconciliations accurately or in a timely manner and maintain adequate records to enable it to distinguish accurately and without delay. Towry was also found to have failed to ensure that client money held for one client and money held for any other client were properly segregated and had also failed to ensure that both were properly segregated from Towry’s own money. Towry was said to have breached Principle 11 because it failed to undertake adequate enquiries before replying to the FSA’s Dear CEO Letter dated 19 January 2010 stating that it was compliant with the FSA’s client money and custody requirements. The FSA did not find that Towry was seeking deliberately to mislead the FSA.



Credit Suisse (UK) Limited fined £5.95 million systems and controls failings in relation to sales by its private bank of structured capital at risk products

FSA, 25 October 2011

On 25 October 2011 the FSA imposed a [financial penalty](#) of £5.95 million on Credit Suisse UK. Credit Suisse UK agreed to settle at an early stage of the FSA’s investigation and therefore qualified for a 30% discount under the FSA’s executive settlement procedures. The FSA found that during the period from 1 January 2007 to 31 December 2009 Credit Suisse UK breached Principle 3 by failing to take reasonable care to establish and maintain effective systems and controls in respect of the suitability of its advice regarding structured capital at risk products (SCARPS) to its private banking retail advisory customers (Customers).

The FSA found that there was an unacceptable risk that Credit Suisse UK may not have accurately understood the level of risk that Customers were willing to accept from their investments. It also found that there was insufficient evidence of consideration of the Customer’s overall portfolio by Credit Suisse UK when determining whether the transactions were suitable for the Customer. The FSA noted that Credit Suisse UK had failed to monitor its staff effectively to ensure that they took reasonable care to guarantee the suitability of their advice. In addition the FSA noted that Credit Suisse UK management failed to use its internal evidencing tool adequately.

Credit Suisse UK has agreed to carry out a review, overseen by and involving an independent third party, in relation to its sale of SCARPs to Customers who purchased these products during the Relevant Period to ensure that Customers do not lose out as a result of the failings identified by the FSA.



LONDON STOCK EXCHANGE ACQUIRES FSA'S TRANSACTION REPORTING SYSTEM

25 October 2011

The London Stock Exchange Group Plc has completed its acquisition of the Transaction Reporting Service (“TRS”), the FSA’s Approved Reporting Mechanism. The TRS is an approved mechanism for firms to report transactions in regulated instruments to the FSA, and the information it gathers is used to detect and investigate suspected cases of market abuse, insider trading and market manipulation. The London Stock Exchange has stated its intention to migrate current TRS customers to its UnaVista platform, the LSE Group’s own ARM, which has acquired the rights to accept brokers’ TRS-formatted data submissions.

IMPLEMENTATION OF CRD III IN THE UK

On 3 November 2011, the FSA released a [policy statement](#) setting out its final rules regarding the implementation of CRD III in the UK.

CRD III will be implemented through the Capital Requirements Directive (Handbook Amendments No 4) Instrument 2011 which is due to come into force on 31 December 2011. The remuneration provisions in CRD III took effect in January 2011.

CRD III (2010/76/EU) is a directive forming part of a sequence of major amendments to the Capital Requirements Directive (2006/48/EC and 2006/49/EC) (“CRD”) initiated by the European Commission.

The FSA policy statement reports on the main issues raised by firms in response to the FSA’s Consultation Paper 11/9, “Strengthening Capital Standards 3” (which was published in May 2011). The FSA policy statement sets out the FSA’s policy and final rules relating to the following issues, consulted on in the May 2011 consultation paper:

- certain aspects of the CRD III trading book requirements;

- CRD III requirements relating to securitisation in the non-trading book; and
- guidelines published by the Committee of European Banking Supervisors (“CEBS”) in December 2010 on Article 122a of the Capital Requirements Directive.

The FSA policy statement also includes details of the FSA’s policy on a number of other CRD III-related changes, including Pillar 3 disclosure requirements, prudent valuation and certain technical amendments.

FSA ANNOUNCES RESTART OF FSCS FUNDING REVIEW

3 October 2011

The FSA has announced its [decision](#) to restart the Financial Services Compensation Scheme (“FSCS”) funding review and will look at issues including the composition of the nine funding classes under the FSCS and the levy thresholds applicable to each funding class and their tariff business. The FSCS is currently funded by levies paid by over 16,000 participating firms and the FSA makes rules on how the FSCS is funded.

The review initially started in October 2009 but was put on hold 12 months later due to uncertainties around the impact of the UK regulatory reform on the FSCS and the ongoing developments of EU legislation. The FSA hopes to launch a formal consultation in the first half of 2012.

FSA AND OFT PUBLISH DRAFT GUIDANCE ON PAYMENT PROTECTION PRODUCTS

FSA, 1 November 2011

On 1 November 2011 the FSA published the proposed guidance to firms in relation to payment protection products. The document was issued jointly by the FSA and the Office of Fair Trading (“OFT”) and is the result of joint working in the light of the



Competition Commission's market investigation into PPI and emerging concerns about new products and practices. Comments are invited by 13 January 2012. For payment protection products within the FSA's regulatory responsibilities, this document builds on existing high-level guidance. The FSA's guidance states that there are four key areas of concern that providers should think about carefully: firms not properly identifying the target market for the protection product, the protection not reflecting the needs of the intended consumers, the benefit of a successful claim not matching the needs of the claimant and product features or pricing structures creating barriers to comparing products, exiting a policy or switching cover.

For payment protection products within the OFT's regulatory responsibilities, the key messages for consumer credit licensees and applicants are that firms should be aware of the relevant statutory provisions and how these may impact on payment protection products, firms should ensure that they treat actual and potential customers fairly and do not engage in unfair or improper business practices. Failure to do so, or to comply with relevant statutory provisions, may cast doubt on fitness to hold a consumer credit licence and may lead to enforcement action by the OFT.

FSA PUBLISHES A REVIEW OF FIRMS' STRUCTURED PRODUCT DESIGN PROCESSES AND PROPOSES NEW GUIDANCE ON RETAIL PRODUCT DEVELOPMENT

FSA, 2 November 2011

On 2 November 2011 the FSA published further guidance for firms to consider when they develop new structured products to market to consumers. The FSA has noted that structured products are rising in popularity in the current low interest rate environment and is keen to make sure mis-selling does not take place.

The guidance has been produced in light of a review carried out by the FSA between November 2010 and May 2011. The review was of the seven major providers of structured products, responsible for approximately 50% of structured products in the UK retail market. The FSA found that while there has been some progress, there were still key weaknesses in the methods that firms use to design and approve their structured products and that these weaknesses were resulting in increased risk to consumers. As a result, the FSA made the decision to introduce further guidance. Whilst it has been produced with structured products in mind, the guidance is also relevant to other retail products.

The key elements of the guidance are; firms should identify the target audience and then design products that meet that audience's needs; firms must pre-test new products to ensure they are capable of delivering fair outcomes for the target audience; firms must ensure a robust product approval process is in place for new products; and they should monitor the progress of a product throughout its life cycle.

MF GLOBAL ENTERS SPECIAL ADMINISTRATION REGIME

On 31 October 2011, the FSA confirmed that MF Global UK Limited ("MF Global UK") has entered the Special Administration Regime ("SAR") and KPMG LLP have been appointed as joint special administrators. The SAR is a new administration procedure for investment banks which was introduced in February 2011 in the wake of the collapse of Lehman Brothers. This is the first time that the new procedure, set out in The Investment Bank Special Administration Regulations 2011 has been used.

An administrator appointed under the Regulations has three objectives; returning client property as soon as reasonably practicable; co-operating with the markets in resolving failed trades; and rescuing the firm as a going concern or winding it up in the best interests of the creditors. The FSA can direct the special administrator to prioritise one or more of these objectives if it deems that to be necessary on UK financial stability grounds but before it does so it must consult HM Treasury and the Bank of England.

FSA CONSULTS ON MODERNISING GUIDANCE ON FINANCIAL RESOURCES REQUIREMENTS FOR RECOGNISED BODIES

On 5 October 2011, the FSA published a [consultation paper](#) on modifying its guidance on the financial resources requirements for recognised bodies comprising Recognised Investment Exchanges (“RIEs”) and Recognised Clearing Houses (“RCHs”). The financial resources requirements for recognised bodies are set by HM Treasury through a recognition requirement. The FSA guidance on this is in Chapter 2.3 of its Recognised Investment Exchange and Clearing House sourcebook (“REC”) and this guidance provides greater clarification on the requirement. In particular the guidance sheds light on the principles which the FSA will take into account when determining whether the recognition requirement has been fulfilled. The FSA’s reasoning for the consultation is that the guidance in REC needs to be updated and modernised in order to take into account the many different market and regulatory developments that have taken place since its introduction. The consultation paper outlines the following proposed amendments to REC 2.3: clarification on what regulatory capital is for, strengthening the standard approach as an objective proxy for the cost of orderly closure by standardising the meaning of “operational expenses”, setting the standard approach as a floor to the financial resources requirement by not allowing alternative bespoke arrangements and introducing guidance on measuring group risk as a component of the financial resources calculation. Comments on the proposals have been invited up until 6 January 2012. In the light of responses the FSA expects to make the revised guidance in the first half of 2012.



MARKET WATCH: ISSUE 41

FSA, 24 October 2011

On 24 October 2011, the FSA published issue 41 of [Market Watch](#), the regulator’s newsletter on market conduct and transaction reporting issues. The latest issue covers the FSA’s finalised guidance on reported transactions for derivatives admitted to trading on a regulated market. There were no responses to the FSA consultation that raised any objections or requested any clarification to the proposed guidance and so the guidance has been made with immediate effect. The issue also contains the FSA’s finalised guidance on reporting transactions in derivatives conducted through clearing platforms of derivative markets (ISIN or Aii) where reference data is not available to the FSA or the Authorised Reporting Mechanisms.

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THE VOLCKER RULE AND IMPLICATIONS FOR FOREIGN BANKING INVESTMENTS

October 2011

In October 2011, U.S. federal banking and securities agencies, consisting of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission, jointly issued a proposed rule designed to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act – a provision commonly referred to as the “Volcker Rule.” By adding Section 13 to the Bank Holding Company Act (the BHC Act), the Volcker Rule, in part, limits the manner in which banking entities engage in certain proprietary trading activities and sponsor or invest in hedge funds and private equity funds.

The proposed rule has 347 questions requesting specific comment on the substantive aspects of the proposal. In the preamble, the agencies admit the complexities associated with implementing the concepts embodied in the statutory text of the Volcker Rule in manageable and workable rules, specifically noting that “the delineation of what constitutes a prohibited or permitted activity under Section 13 of the BHC Act often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice.” Given the relatively complex issues involved, a great deal of industry comment and expertise is expected, and likely needed, before the agencies issue the final rule. Importantly, the international breadth of the proposed rule is of particular concerns for entities that may, unknowingly, fall within its scope due to their own ownership in banking entities or respective investors that are themselves banking entities. This summary discusses the scope of the proposed rule as it relates to foreign banking entity investments in non-US hedge funds and private equity funds (referred to as covered funds).

The Volcker Rule’s Statutory Provisions

In general, Section 13 of the BHC Act prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in a private equity fund – subject to certain exemptions. A banking entity includes, among other things, any foreign company “that is treated as a bank holding company for purposes of Section 8 of the International Banking Act[.]” This group of foreign companies generally includes any foreign bank that maintains a branch or agency in the US or a foreign bank or foreign company that controls a commercial lending company organized under US state law, and any parent company of such foreign bank or company. A private equity fund is any issuer that would be an investment company under the Investment Company Act of 1940, but for certain enumerated exemptions (the “enumerated Company Act exceptions”) Notably, these provisions apply even if the activity or investment is explicitly permitted for a banking entity under another provision of law, including the BHC Act. In other words, investments that are otherwise permissible under other provisions of the BHC Act as interpreted historically by the Federal Reserve Board may nonetheless be prohibited by the Volcker Rule.

In certain circumstances, the Volcker Rule permits a foreign-based banking entity to acquire and retain an interest in a private equity fund; provided that the following conditions must be met:

- The banking entity must acquire the interest solely outside the US pursuant to the one of the following provisions of the BHC Act.
- Investments in “shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the [US.]”
- Acquisitions of “shares of, or activities conducted by, any company which does no business in the [US] except as an incident to its international or foreign business[.]”



Additionally, for investments made under this authority, the investor must rely on a Federal Reserve Board determination, whether by regulation or order, that the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.

- No ownership interest in the private equity fund is offered for sale or sold to a resident of the US; and
- The banking entity is not controlled by a banking entity organized under the laws of the US.

In addition to these specific conditions, the Volcker Rule would remove the exemption if the investment or transaction would (i) involve or result in a material conflict of interest (as defined by rule) between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as these terms are defined by rule); or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the US.

The Proposed Rule's Construction

The proposed rule follows many of the statute's general definitions and requirements, including the definition of banking entity, covered foreign banks and companies. With respect to the definition of hedge funds and private equity funds, the proposed rule uses the term "covered fund," which includes (i) an issuer that would be an investment company as defined in the Investment Company Act, but for enumerated Company Act exceptions; or (ii) any commodity pool, as defined in Section 1a(10) of the Commodity Exchange Act. And the proposed rule expands the scope of covered fund to include any issuer that is organized or offered outside the US that would be a covered fund if it were organized or offered under US law or offered to one or more U.S. residents.

Accordingly, a foreign banking entity's investment in a non-US covered fund is subject to the proposed rule if two conditions are met:

- The foreign banking entity is treated as a bank holding company for purposes of Section 8 of the International Banking Act; and
- The foreign private equity fund organized or offered outside of the US would be an issuer if it were organized or offered under US laws, or offered to one or more US residents, and the foreign private equity fund (i) would be an investment company but for the enumerated Company Act exceptions; (ii) is a commodity pool; or (iii) is a similar fund defined by rule.

Under the proposed rule, a foreign banking entity may engage in investments in covered funds in certain circumstances. As a threshold matter, the foreign banking entity may not be directly or indirectly controlled by a banking entity organized under US law. In other words, a US banking entity cannot evade the Volcker Rule by conducting investment operations through a foreign subsidiary.

An investment may be permitted under this exemption, if it is made in (i) "shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the [US];"⁶ or (ii) "shares of, or activities conducted by, any company which does no business in the [US] except as an incident to its international or foreign business[.]"

The proposed rule provides further clarity on those investments that will be deemed to meet this standard. Specifically, if the foreign banking entity is a foreign banking organization, as defined by the Federal Reserve Board's Regulation K, then the foreign banking organization must be a qualifying foreign banking organization (again, as defined by Regulation K) and the investment must be made in compliance with Subpart B of Regulation K. Foreign banking organizations are defined as foreign banks (companies organized under the laws of a foreign country and engaged directly in the



business of banking outside the US) that operate a branch, agency or commercial lending company subsidiary in the US, control a bank in the US or control an Edge corporation acquired after 5 March 1987, and any company of which the foreign bank is a subsidiary. A foreign banking organization is qualifying if, disregarding its US banking, more than half of its worldwide business is banking, and more than half of its banking business is outside the US.

If the foreign banking entity is not a foreign banking organization under Regulation K, it must meet two of the following tests: (i) total assets held outside the US exceed total assets held in the US; (ii) total revenues derived from business outside the US exceed total revenues derived from business in the US; and (iii) total net income derived from business outside the US exceeds total net income derived from business in the US.

With respect to non-US covered funds, in order to meet the exemption, no ownership interest may be offered for sale in the US or sold to a resident of the US. Finally, the investment transaction must occur solely outside of the US. To meet this requirement, no subsidiary or affiliate of the banking entity involved in the offer or sale of an ownership interest may be incorporated or physically located in the US, and no employee of the banking entity involved in the offer or sale of an ownership interest may be physically located in the US.

Additional Legal Requirements

Although the Volcker Rule's prohibitions apply to foreign banking entity investments in covered funds that may otherwise be authorized by law, in the event that the investment meets the exemption described above, the entity must nonetheless ensure that the investment complies with all other laws. For example, if appropriate, such investments must also comply with the activities limitations of the BHC Act and the applicable federal securities laws.

Comments to Volcker Rule are due to the agencies by 13 January 2012, and a final rule cannot reasonably be expected until late first quarter of 2012, at the earliest. Absent legislation reform, Section 619 of the Dodd-Frank Act, importantly, will take effect on 21 July 2012, regardless of whether an implementing rule is finalized. We encourage clients to consider the application of the proposed rule to their activities and operations, particularly those outside of the US, and consider submitting comments in response to aspects of the proposed rule that may be particularly troublesome.

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REVIEW OF MIFID II PROPOSALS

On 20 October 2011, the European Commission published [the MiFID II proposals](#) to amend the Markets in Financial Instruments Directive (2004/39/EC) and its implementing legislation (together “MiFID”). These proposals consist of a Directive and a Regulation and aim to make financial markets more efficient, resilient and transparent, and to strengthen the protection of investors. The new framework will also increase the supervisory powers of regulators and hopes to provide clearer operating rules for all trading activities.

The proposed [Directive](#) will replace Directive 2004/39/EC and amends specific requirements regarding the provision of investment services, the scope of exemptions from the current Directive, organisational and conduct of business requirements for investment firms, organisational requirements for trading venues, the authorisation and ongoing obligations applicable to providers of data services, powers available to competent authorities, sanctions, and rules applicable to third-country firms operating via a branch. These provisions are best situated in a directive to account for differences in national markets and legal structures as well as the profile of local investors.

The proposed [Regulation](#) sets out requirements in relation to the disclosure of trade transparency data to the public and transaction data to competent authorities, removing barriers to non-discriminatory access to clearing facilities, the mandatory trading of derivatives on organised venues, specific supervisory actions regarding financial instruments and positions in derivatives, and the provision of services by third-country firms without a branch.

The general goals of the revision of MiFID are to strengthen investor confidence, to reduce the risks of market disorder and systemic risks and to increase efficiency of financial markets while reducing unnecessary costs for participants. In order to reach these goals, the European Commission has targeted five broad policy objectives in MiFID II:

(i) **Ensure a level playing field between market participants**

The MiFID review proposes to introduce a new category of platform to adequately regulate all kinds of organised trading and to level the playing field in the EU. More specifically, the Commission proposes to introduce the new category of an organised trading facility (“OTF”), which will be subject to the same core requirements for the operation of a trading venue as other existing platforms. This new type of platform is defined in a broad way, so that it captures all forms of organised trading not matching the existing categories. There are fears that attempts to enhance fairness and create a more level playing field may lead to a reduction in competition and innovation as different regimes allows for flexibility and increased choice for investors. The new category will, for example, capture all crossing networks, and will also capture any organised trading between a firm and its clients, even if this not done electronically. This has a big impact on firms internal arrangements for trading with customers where the firm is acting in a proprietary capacity.



Consistent with the requirements already proposed by the European Commission to increase central clearing of OTC derivatives (“EMIR”), the proposed provisions in the Regulation will require trading in standardised derivatives to be traded only on eligible platforms, i.e. regulated markets, MTFs or OTFs. This obligation will be imposed on both financial and non financial counterparties exceeding the clearing threshold in EMIR.

The Commission considers it important to replace the various third country regimes for granting access to EU markets for firms and market operators to ensure a level playing field for all financial services participants in the EU. A non-EU firm wanting to service EU retail clients would have to be based in a jurisdiction that the Commission has decided met an “equivalence assessment” criteria, and the firm would then have to be authorised by a member state, and if authorised would have to establish a branch. It could then provide services in the EU. Third country firms providing services to eligible counterparties would not have to establish a branch, but will need to register with the European Securities and Markets Authority (“ESMA”).

This will lead to the loss of the “with or through” exemption in the UK and, overall, while facilitating a wider range of options for business to be done long-range into Europe, will increase the compliance burden on non-EU firms doing business from overseas into the EU.

(ii) Increase market transparency for market participants

Currently, MiFID imposes harmonised pre and post-trade transparency requirements only on shares admitted to trading on regulated markets. The scope of transaction reporting will be substantially extended and thus aligned with the scope of market abuse rules. The Commission proposes to introduce pre and post-trading transparency requirements for bonds, structured finance products, emission allowances and derivatives. The reason for the introduction of pre and post-trade transparency requirements for these instruments is that the absence of harmonised transparency requirements in non-equity markets (e.g. bonds, structured products, derivatives) has

been perceived by many, including EU securities regulators, to lead to lower market efficiency and higher risks than would otherwise be the case. The European Commission believes that modifications and improvements are needed to strengthen the framework for the provision of investment services. Potentially, however these changes could reduce liquidity in some, or all, of these asset classes.

There are concerns, within the EU and beyond, about the change in trading patterns caused by algorithmic trading and in particular the dangers of high frequency automated trading which have drastically increased the speed of trading and pose possible systemic risks. MiFID II introduces new safeguards for firms engaging in algorithmic and high frequency trading activities including the obligation to report to the respective national regulator on its trading strategy and parameters and setting out rules to prevent firms from adding to volatility by moving in and out of markets. Additional requirements apply to firms with direct electronic access to trading venues and general clearing members.

The proposals aim to bring all entities engaged in high-frequency trading into MiFID. It requires appropriate organisational safeguards from these firms and those offering market access to other high-frequency traders. Trading venues will have to adopt appropriate risk controls to mitigate disorderly trading and ensure the resiliency of their platforms. The need to report details of highly sophisticated and confidential algorithmic trading strategies to national regulators may have significant implications. There is also the question of whether national regulators will have both the storage capacity and intellectual resources to handle and understand the volume of information it receives.

(iii) Reinforce transparency towards and power of regulators in key areas and increase co-ordination at a European level

The proposed amendments hope to greatly increase the supervision of products and services by introducing the possibilities for competent authorities to set permanent bans on financial products or activities with coordination by ESMA, and for ESMA to also temporarily ban products, practices and services. The ban can consist of a prohibition



or restriction on the marketing or sale of financial instruments, or on a certain practice or on persons engaged in the specific activity. It also gives ESMA specific powers to manage or limit positions for market participants. The proposed provisions set precise conditions for this to happen notably in terms of a threat to the orderly functioning of markets or delivery arrangements for physical commodities, or to the stability of the financial system in the EU. The FSA already has the power to intervene in the provision and management of financial products, activities and practices. Firms may have to adapt their businesses in line with such potential intervention, ensuring that their businesses are flexible enough to respond to the requests of their respective national regulator.

Regulators will also be empowered to monitor and intervene at any stage in trading activity in all commodity derivatives (including the shape of position limits where there are concerns about disorderly markets). This may be an area of major contention and one that many of the member states in the Council will seek to water down in order to preserve the power of their local regulators.

Regarding transparency towards regulators, the favoured route is to combine the extended scope of transaction reporting with better reporting through the set-up of Approved Reporting Mechanisms (“ARMs”) which the Commission believes will allow a much more extensive monitoring of markets by regulators. This is already in place in the UK.

Transaction reporting under MiFID enables supervisors to monitor the activities of investment firms and ensure compliance with MiFID and to monitor for abuses under the Market Abuse Directive (“MAD”). The Commission proposes to extend the scope of transaction reporting to all financial instruments, with the exception of instruments which are not susceptible to or cannot be used for market abuse. National regulators will have full access to records at all stages in the order execution process, from the initial decision to trade, through to its execution.

There will be a new EU requirement for national regulators to have effective non-criminal sanctions and remedies available for certain breaches (such as failing to meet MiFID requirements on conflicts of interest). Such sanctions include a maximum sanction of at least EUR 5 million against individuals and at least a maximum sanction of 10% of group world-wide turnover for companies with the power to apply sanctions to the relevant directors and other individuals involved. Significantly, changes to calculating penalties will likely lead to tougher enforcement. The reference to 10% of group world-wide turnover is modelled on EU competition rules where the record fine is over EUR1 billion which is of a different range to the fines imposed by the FSA which rarely exceed £10 million (although the compensation paid to customers is often much greater). The EU has no power under the EU Treaties to impose criminal sanctions.

(iv) Raise investor protection

Building on a comprehensive set of rules already in place, the revised MiFID sets stricter requirements for portfolio management, investment advice and the offer of complex financial products such as structured products.

Any firm providing investment advice will be required to state whether the advice is provided on an independent basis or a restricted basis, whether it is based on a broad or more restricted analysis of the market, and indicate whether the firm will provide an on-going assessment of suitability of the recommendations to clients. This requirement reflects the new Retail Distribution Review (“RDR”) rules in terms of separating advisers into two categories. The RDR rules would seem to go further than the MiFID rules in relation to the definition of “independent”. The FSA require firms to conduct a “comprehensive and fair analysis”. MiFID requires firms to “assess a sufficiently large number of financial instruments”. The MiFID definition may need to be refined as it could lead to multiple interpretations by Member States. It could also mean that an adviser simply has to do just slightly less than what is set out in the MiFID definition and continue to receive commission.



Non-independent advisers will be able to continue to receive inducements from product providers. The European Commission is looking to introduce the ban on commission for independent advisers only. In order to prevent potential conflict of interest, independent advisers and portfolio managers will be prohibited from making or receiving third-party payments or other monetary gains. The current FSA rules go further than the MiFID proposals by banning commission payments to restricted advisers as well as independent advisers. It is unclear whether such a prohibition on commission for restricted advisers would be regarded as gold plating and is an issue that many analysts believe the FSA should consider in the following months.

Under the current MiFID best execution regime, the relevant firm must provide “appropriate information” to the client when executing orders, which may be in the form of a summary of the order execution policy. The new proposals seek to address concerns that such disclosures have become uninformative and formulaic by clarifying that “appropriate information” should explain clearly and in sufficient detail, how orders will be executed by the firm for the client. Firms will also be required to summarise and make public the top five execution venues where they executed client orders for each class of financial instruments in the preceding year. Execution venues would also be required to publish data on execution quality.

(v) Address organisational deficiencies and excessive risk taking or lack of control by investment firms and market operators

Rules on corporate governance and managers’ responsibility are introduced for all investment firms. Conduct of business requirements will be modified in order to grant additional protection to investors. It is proposed to strengthen provisions relating to the

profile, role, responsibilities of both executive and non-executive directors and ensure a balance in the composition of management bodies. The Commission seeks to improve corporate governance through a combination of reinforcing the role of directors of firms, especially in internal control functions and specific organisational requirements in portfolio management and underwriting.

MiFID requires persons who effectively direct the business of an investment firm to be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the investment firm. In line with the Commission’s work on corporate governance in the financial sector, it is proposed to strengthen provisions relating to the profile, role, responsibilities of both executive and non-executive directors and ensure a balance in the composition of management bodies. Members of a management body cannot combine more than (i) one executive directorship with two non-executive directorships; or (ii) four non-executive directorships (executive or non-executive directorships held within the same group are considered as one single directorship). This goes further than the FSA who look at time commitments when approving significant influence functions but do not impose a strict rule. As such, there needs to be a balance between ensuring better governance but not restricting the freedom of action by firms to choose qualified individuals who have the relevant business skills and experience.

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