

Regulatory Update – Hot Topics for Fund Managers, Banks and Broker Dealers

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Regulatory Update – Hot Topics for Fund Managers, Banks and Broker Dealers

- AIFMD – some level 2 issues
- AIFMD – effect of level 2 on hedge fund documentation
- MiFID II – an overview
- EU UCITS consultation
- Corporate governance
- Key considerations when taking out D&O insurance

AIFMD – Level 2 considerations

➤ Timetable

- Currently – deliberations on stakeholder input
- by 16 November 2011 – ESMA to finalise advice to Commission
- 16 November 2011 to July 2012 – Commission work on implementing measures
- July 2012 to July 2013 – Implementation at Member State level (but N.B. Commission favouring use of Regulation)

AIFMD – level 2 considerations

- Depositary obligations
 - liable to AIF and its investors for loss of custodied financial instruments held by depositary or delegate
 - Unless – depositary can prove that loss arises as a result of an external event beyond depositary's reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary

AIFMD – level 2 considerations

- Depositary obligations – ESMA’s draft views
 - financial instruments ‘lost’ in a case of insolvency of sub-custodian as soon as:
 - right of ownership ceases to exist or never existed; or
 - AIF permanently deprived of right of ownership; or
 - AIF permanently unable to directly or indirectly dispose of financial instrument
 - At the latest at the end of insolvency proceedings
 - Not temporarily unavailable or frozen
 - AIFM should closely monitor insolvency proceedings and regularly assess whether there is a reasonable chance of recovering all or part of the assets – normally book loss at end of proceedings

AIFMD – level 2 considerations

- Depositary obligations – ESMA’s draft views
 - ‘external event beyond depositary’s reasonable control’
 - despite rigorous and comprehensive due diligence, depositary could not have prevented the loss
 - when assessing whether an event is internal or external it is necessary to establish whether the event is external to the depositary and/or its sub-custodian
 - e.g. fraud or operational error in sub-custodian an internal event
 - depositary also liable if sub-custodian has failed properly to segregate assets (but if segregation fails because of local law depositary may be able to escape liability if there is nothing it could reasonably have done about this)

AIFMD – level 2 considerations

➤ Depositary obligations

- **AIMA** – increased costs for depositary services of 100-150 basis points
- particular problem with depositary being responsible for unaffiliated sub-custodian

- **State Street** – insolvency of non-affiliate sub-custodian should be external event beyond depositary's reasonable control
- concern about depositary liability for external events if all reasonable care to avoid not exercised
- not fair for depositary to be de facto insurer against crimes of third parties
- 'rigorous and comprehensive due diligence', goes beyond level 1 -prefer 'to utilise reasonable efforts'

AIFMD – level 2 considerations

- The debate on ‘equivalence’
 - **A.20(1)(c)** – “where the delegation concerns portfolio management or risk management, it must be conferred only on undertakings which are authorised or registered for the purpose of asset management and subject to supervision”
 - **ESMA** – requirement on third country delegate to be authorised or registered for the purpose of asset management based on local criteria which are equivalent to those established under EU legislation and is effectively supervised by an independent competent authority
 - **AIMA** – some investments into non-EU jurisdictions would become difficult, if not impossible. Goes beyond level 1 text.

AIFMD – level 2 considerations

- The debate on ‘equivalence’
 - **A.21(6)** – third country depository must be subject to “effective prudential regulation”, including minimum capital requirements, and supervision which have the same effect as Union law and are effectively enforced
 - **ESMA** – requirement for ‘equivalence’ with EU law of criteria for eligibility to act as depository, of capital requirements, of operating conditions, and of duties of depository
 - **AIMA** – focus should be on the end result of regulation, not whether specific legal/regulatory requirements are the same. Goes beyond level 1 text.

AIFMD – level 2 considerations

- Liquidity management
 - **ESMA** – definition of ‘special arrangements’ includes gates. ‘Special arrangements’ may be regarded as an exceptional measure where the liquidity management process has failed. They have to be disclosed to investors periodically per A.23(4).
 - **AIMA** – prudent use of liquidity management tools, e.g. gates, should not be unnecessarily restricted. Gates are aid to liquidity not a bar to liquidity

AIFMD – Future impact on hedge fund documentation

- Offering Document
- Agreement(s) delegating AIFM's functions eg. portfolio management, valuation, regulatory compliance monitoring, marketing etc.
- Depositary Agreement
- Any sub-custody agreements
- Side letters

AIFMD – Future impact on hedge fund documentation

- Offering Document
 - Article 23 – mandatory disclosure to investors (i) before investment and (ii) upon material changes – includes (inter alia) description of investment techniques; types and sources of leverage permitted and associated risks; any collateral and asset re-use arrangements; procedures by which investment strategy/policy may be changed; description of delegations by AIFM and depositary; description of fund’s liquidity risk management (including redemption rights in both “normal” and “extraordinary” situations); description of preferential treatment and the type of investors who receive that treatment

AIFMD – Future impact on hedge fund documentation

- Applies to EU AIFMs for each AIF marketed in the EU with a passport, and to all EU and non-EU AIFMs marketing into the EU using private placement
- Level 2 (draft) – Immediate notification of investors when gates or side pockets activated or when redemptions suspended; main features of risk management systems employed to be made available to investors before investment; regular disclosure of a description of leverage measures or ratios and their appropriateness when considered against the AIF's investment strategy

AIFMD – Future impact on hedge fund documentation

- Agreement(s) delegating AIFM functions
 - Article 20 – AIFM’s liability towards AIF and its investors not affected by delegation
 - Task which is “critical or important for the proper performance of AIFM’s functions provided to fund” [draft – level 2] – eg portfolio management, valuation, regulatory compliance monitoring, marketing

AIFMD – Future impact on hedge fund documentation

- Contract with delegate should contain certain terms to ensure AIFM discharges its statutory responsibilities, eg [draft – level 2]:
 - Obligation on delegate to grant rights to AIFM of information, inspection and access etc. Rights of access also to regulator (cf. SYSC ch.8 and A.14 MiFID)
 - Agreement should allow AIFM “flexible” termination rights
 - If portfolio management is delegated, delegate should be instructed by the AIFM how to implement the investment policy
 - Delegate must disclose to the AIFM any development that may have a material impact on its ability to carry out the delegated functions
 - Delegate must establish a disaster recovery plan
 - AIFM consent required to sub-delegation

AIFMD – Future impact on hedge fund documentation

- Depositary Agreement
 - Article 21 – written contract required; new role
 - Draft level 2 – UCITS used as starting point for content, but ESMA not providing “model agreement”

AIFMD – Future impact on hedge fund documentation

- Draft level 2 – List of 14 elements the contract should contain including:
 - Procedures to be adopted for each type of asset
 - Types of assets that fall within the scope of depositary's function
 - Conditions for delegation of custody functions (NB “objective reasons”)
 - Information exchange to allow AIFM to do its job
 - The process by which the depositary will receive information from other parties appointed by the AIF or the AIFM

AIFMD – Future impact on hedge fund documentation

- When is depositary's agreement to modifications to fund required?
- Provisions dealing with depositary's rights to enquire into the conduct of the AIFM, and vice versa

AIFMD – Future impact on hedge fund documentation

- Depositary needs to be able to terminate the agreement as its ultimate recourse if the AIFM is taking excessive custody risks
- AIFMD liability provisions and delegation provisions must be hard-wired into Depositary Agreement (Article 21(6)(e)) where the depositary is established outside the EU

AIFMD – Future impact on hedge fund documentation

- Any sub-custody agreements
 - Sub-custodians are treated as delegates of depositary under AIFMD
 - By contrast the relationship is currently not usually seen as an outsourcing
 - The contract will need adequately to reflect this change

AIFMD – Future impact on hedge fund documentation

- (Article 21(11)(d)) Depositary has to ensure on an ongoing basis that the delegate (inter alia):
 - Has adequate structures and expertise
 - Is subject to minimum capital standards/prudential supervision (unless no local entity satisfies this)
 - Segregates its own assets from the depositary's client assets
 - Complies with the standard of care required by AIFMD for depositories

AIFMD – Future impact on hedge fund documentation

- Option (see Article 21(13)(b)) of transferring liability for “loss” of financial instruments to sub-custodian in sub-custody agreement if “objective reason” and AIF or AIFM have expressly allowed this by written contract (presumably the Depositary Agreement)

AIFMD – Future impact on hedge fund documentation

- Side letters
 - Article 12(1) – Obligation on AIFM to treat investors fairly. Any preferential treatment must be disclosed in AIF rules or instruments of incorporation.
 - Draft level 2 – proposed requirement that no investor may obtain a preferential treatment that has an overall material disadvantage to other investors
 - Not unfair to grant preferential treatment to seed investors – they take additional risk
 - Could prevent unfair treatment if other investors are informed of preferential treatment and have right to redeem free of costs. (cf. AIMA Guidance – need to disclose existence of side letters that contain “material terms”, and the nature of such terms)

EU Commission's MiFID II Proposals

- Expected 20 October 2011
- Proposed Regulation (on transparency of trade data, mandatory trading of derivatives on organised venues etc)
- Proposed Directive – organisational and conduct of business requirements for investment firms
- What can we expect?
 - Exemptions from MiFiD for own account dealers limited – high frequency traders can expect to be regulated
 - New regulated regime for organised trading facilities (which do not correspond to current categories)

EU Commission's MiFiD II Proposals

- What can we expect?
 - Venues to be required to adopt appropriate risk controls to mitigate disorderly trading
 - New limits/requirements to ensure orderly functioning of commodity derivative markets and transparency requirements
 - New powers for regulators to require changes to derivative positions
 - Extension of transparency requirements to non-equity markets – requirements for pre- and post-trade transparency for certain bonds, structured products and derivatives

EC Consultation Paper: UCITS Depositary Function and UCITS Managers' Remuneration – Dec 2010

- Follows 1st Consultation Paper and Feedback Statement of 2009
- Madoff and Lehman revealed differences in legal understanding of the duties of depositaries and the scope of their liability
- AIFMD depositary requirements to be imposed on UCITS depositaries to the extent AIFMD rules are stronger and appropriate

EC Consultation Paper: UCITS Depositary Function and UCITS Managers' Remuneration – Dec 2010

- Considering a passport for depositaries
- Consistent rules on sanctioning depositaries for breach of obligations
- Conduct of business rules for depositaries
- Remuneration code for UCITS managers similar to AIFMD

EC Consultation Paper: UCITS Depositary Function and UCITS Managers' Remuneration – Dec 2010

- Single depositary for UCITS
- Prohibition on UCITS opening cash accounts outside depositary
- Clarify custody (equities/bonds etc. registered with a central registry) and monitoring responsibilities (OTC contracts, instruments held in nominee accounts on issuers' books or Central Securities Depositories – i.e. where custody not possible)

EU UCITS Consultation

- New eligibility conditions aligned with AIFMD
- Inversion of the burden of proof where there is loss
- Conditions applicable to the delegation of depositary activities to be made consistent with the AIFM Directive
- Sub-custody network risks to be disclosed
- Initial and ongoing due diligence requirements to be imposed

EU UCITS Consultation

- Loss of Assets – likely to be aligned with AIFMD
- limitations on any right to 're-use' the funds assets by the sub-depositary
- requirements for information to unit-holders about the possibility that the funds may have a sub-depositary, the risks incurred in case of the failure or default of the sub-depositary and how the risks can be mitigated

EU UCITS Consultation - Remuneration

UCITS managers to be subject to similar remuneration rules to AIFMs.

Beyond UCITS V - ESMA ETF Review

- EC has asked ESMA to look at implementing beefed-up risk management guidelines for ETFs – specifically where ETFs are in the form of UCITS
- If that is insufficient to maintain the credibility of UCITS, EC intends to assess the assets UCITS are allowed to invest in
- Fidelity has said publicly:-

certain ETF products are too complex and pose risks to investors, and that it was time for the UCITS Directive to return to an era when derivatives were prohibited

Beyond UCITS V - ESMA ETF Review

- All funds using derivatives for investment purposes, such as synthetic ETFs and Newcits, should in future operate under the AIFMD; and
- existing funds should come under a new “complex/non-complex regime within Ucits”
- Eligible Assets Directive in 2007 allowed Ucits managers to employ complex derivatives, which paved the way for Newcits funds and swap-based ETFs

Beyond UCITS V - ESMA ETF Review

- In April 2011, the Financial Stability Board said: “The complexity and opacity characterising these innovations [such as leveraged ETFs and inverse ETFs] warrants closer surveillance as it may leave investors exposed to risks they have not anticipated.”

Weaving Macro Fixed Income Fund Case

Directors Responsibilities and Liabilities

- Clear case of failure to carry out duties
- Directors liable for \$111m losses
- Failure to oversee service providers or make enquiries regarding financial position resulting in breach of investment restrictions, inflation of returns and undisclosed exposure to related entity counterparty
- Directors “consciously [chose] not to perform their duties..... in any meaningful way.....”
- Failed to exercise independent judgement, reasonable skill, care and diligence and found guilty of wilful neglect or default and so not entitled to be indemnified by the Fund

Weaverling Macro Fixed Income Fund Case

- Willful neglect or default
 - Knowing and intentional breach of duty
 - Acting recklessly, not caring whether or not the act or omission is a breach of duty

(Re: City Equitable Fire Insurance)

- Directors generally assume they are covered by D&O insurance for any claims against them
- But in this case insurers believed to be refuting claims

The importance of insurance

- Take proper advice
 - Check experience in IM industry
 - Understand your own risks and expectations
 - Benchmarking for limits and retentions and premium
 - Policies differ – so do insurers

What D&O does – and does not cover

- Understand what indemnities exist between companies and employees and directors
- How does D&O policy fit with PI policy?
 - Side A
 - Side B
 - Side C
- Sharing limits
 - Non- executives
 - Identifying risks

Some things to look out for

- Wording issues
 - Exclusions
 - US
 - Professional services
 - Deliberate acts
 - Corporate directors
 - Regulatory investigation extension
 - Sublimits

Things which go wrong

- Non-Disclosure
- Notification
 - Claims
 - Circumstances
- Defence costs
- Selection of lawyers
- Acquisitions

Conclusions

- Be proactive
- Understand the risks
- You get what you pay for
- Commercial contract
- Understand notification obligations
- Take good advice

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