TRAVERS SMITH

# Financial Services and Markets

## 2011 – Another Happy New Year?

In the words of an old saying, there is no rest for the wicked, and precious little for the righteous. Regulators and politicians have decided there should be no rest for anyone in the financial services industry and the year will be packed with changes and new regulation. They are determined to regulate every aspect of the financial services industry and financial markets, and to force greater transparency in a number of areas. This may well result in laws which significantly change the way in which firms do business. This is not a passing fad; firms which want to survive and thrive in the future will need to adapt to the new tougher regulatory environment and invest in systems and staff to enable them to do so.

We set out below some of the things that should be on your radar. We start with a short list reminding you of things that you should have done recently or be doing now. We expand on these and on the changes ahead in the rest of the note.

### EARLY ACTION REQUIRED

- If your firm is subject to the Remuneration Code and rules you should have put in place a written remuneration policy consistent with the Code. The rules came into force on 1 January 2011, having been published towards the end of December 2010. By the **end of January 2011** the FSA expects firms to have identified any shortfalls in compliance with the Code and the rules and to have a time specific plan in place to resolve them.
- If your firm holds client assets or client money **CASS operational oversight should be apportioned** to an appropriate senior manager or director performing a significant influence function role with effect from **1 January 2011**. CASS large firms and CASS medium firms (i.e. broadly, those firms which hold £1 million or more of client money and/or £10 million or more of client assets) must make a record of the allocation and notify the FSA of the identity of the person to whom responsibility has been allocated by **31 January 2011** at the latest. Firms should be prepared to submit applications from **1 May 2011** for such individuals to be approved for the new CASS controlled function. All firms holding client assets and money should review their compliance with the rules, the FSA is taking an aggressive stance with any firm that it considers is failing to adequately protect its client assets.
- The FSA is introducing new categories of approved person. Firm should already have carried out an exercise to identify if the new categories will apply to them and, where relevant, allocate the relevant function to an individual. Some may wish to restructure their existing arrangements in the light of the final guidance from the FSA on the application of the rules to individuals employed in other parts of the firm's group. The new rules come into force on **1 May 2011** (subject to transitional arrangements). Where a person who is performing one of the new more "granular" roles is already approved, the firm only needs to make a notification to the FSA (rather than an application for approval) provided it submits that notification before the expiry of the transitional period. Notifications can be made from **1 May 2011** onwards. Broadly, firms must ensure that they have made their notifications by **31 July 2011** at the latest.
- Barring a late intervention by the U.K. government, The Bribery Act 2010 will come into force in **April** and the final guidance on the procedures that firms must have in place to prevent bribery is to be published this month. All firms should ensure they have considered the application of the Act to their activities and that they have reviewed and amended their procedures as appropriate. Procedures need to be devised and staff training given in readiness for the new Act.
- All investment managers with professional clients should by now be disclosing (usually on their website) the nature of their commitment to the Financial Reporting Council's Stewardship Code. This rule does not apply to firms whose permission is limited to venture capital business.
- In October 2010 the FSA published a proposed new rule that will ban authorised firms from paying financial penalties imposed by the FSA on their present or former employees, directors or partners or those of its affiliated companies. The FSA

says that it will be publishing its final text **this month** and it is **likely the new rule will come into effect immediately**. Any firms which have indemnity agreements with staff and which have not already done so should re-examine them now as a matter of priority and amend them where necessary.

- Firms providing custody need to consider if they will need to repaper their existing clients and amend their agreements to meet the requirements of the new rules on liens in custody agreements, which come into force on **1 March 2011** (under transitional provisions firms will have until **1 October 2011** to repaper their pre-existing clients).
- If your firm is a BIPRU firm you should be aware that many changes were made last year to the rules on what can be counted as regulatory capital and how much capital firms must have. These changes were complex and firms need to check that they have properly applied them.
- The deposit compensation limit was increased from £50,000 to £85,000 on **31 December 2010**. The new limit will apply to claims going forward. The limits for other types of business (e.g. investment business, insurance, insurance mediation) remain unchanged for the time being. Some documentation may need to be updated.

## MORE DETAIL ON "ACTION REQUIRED"

### Remuneration Code – pay regulation for financial services firms

Following consultation the FSA issued its Remuneration Code and related rules towards the end of December 2010, and, subject to limited transitional provisions, the new rules came into force on 1 January 2011.

Non-MiFID firms and CAD exempt firms are not subject to the rules. All other firms should by now have assessed the application of the Code and the rules to their business. In PS10/20 the FSA says that it expects all firms to be broadly compliant with Principles 1 to 6, 9, 10 and 11 from 1 January 2011. This means, amongst other things, that firms should have put in place a written remuneration policy consistent with the Code. By the end of January 2011 the FSA expects firms to have identified any shortfalls in compliance with the Code and the rules and to have a time specific plan in place to resolve them.

### Firms that hold client money and /or hold client assets

A number of changes are coming into force this year, with more likely to follow.

#### *Approved persons*

- **ALL** firms that hold client money and/or client assets must apportion **CASS operational oversight** to an appropriate senior manager or director performing a SIF (significant influence function) role. This should have been done with effect from 1 January 2011.
- CASS large firms and CASS medium firms (i.e. broadly, those firms which hold £1 million or more of client money and/or £10 million or more of client assets) must make a record of the allocation and notify the FSA of the identity of the person to whom responsibility has been allocated by **31 January 2011** at the latest. CASS small firms (i.e. broadly, those firms which hold less than £1 million of client money and less than £10 million of client assets) do not have to make this notification. They also only have to make a record of the allocation if they have allocated responsibility for CASS operational oversight to someone other than the person who performs the compliance oversight function (CF10).
- Firms which are CASS large firms and CASS medium firms are required to apply for an individual to be approved for the new **CASS operational oversight function (CF10a)** function.
- Applications for approval of individuals for the CF10a function can be made **from 1 May 2011** and firms must have received approval for the new controlled function **by 1 October 2011** at the latest. There is no provision for an extension of the 1 October 2011 deadline in respect of applications made by a certain date. Allowing for possible delays in the application process (including requests from the FSA for further information) **firms should therefore be looking to submit their CP10a applications on 1 May 2011 (or certainly as soon as possible after that date)**.

#### *FSA information requirements*

- The FSA is conducting a survey, known as the "**CASS stratification data collection exercise**". The FSA will e-mail firms with client money or asset permissions requesting certain information about their client money and asset holdings. This information will be used by the FSA to categorise firms as small, medium or large for the purposes of CASS and may therefore affect the future supervision of such firms. You must respond if your firm has permission to hold client assets or client money, even if you do not currently use these permissions. The FSA is taking an extremely aggressive approach to firms who fail to comply with the client asset and client money rules: a failure to return the survey would be an indicator that might cause the FSA to raise further questions.
- The **Client Money and Assets Return (CMAR)** will be resurrected and the requirements begin on **1 June 2011**. Broadly, this means that all firms subject to CASS will be required to report their June 2011 holdings in July 2011. We recommend that firms review the return now and work out how they will complete it to avoid any last minute problems. Failure to submit this form properly or on time is likely to provoke the FSA into further enquiry.

- **By 1 March 2011** prime brokers must have provided their clients with a **rehypothecation disclosure annex** summarising the key provisions within their prime brokerage agreement allowing them to use safe custody assets for their own account.

- **From 1 March 2011** there is an obligation for prime brokers to make available **daily reporting** to their clients, containing certain prescribed information.

### *Changes to custody agreements and practices*

- **1 June 2011** marks the introduction of a rule placing a 20% restriction on **intra-group client money deposits**.

- **General liens in custodian agreements** will be prohibited from **1 March 2011** (although there will be transitional relief **until 1 October 2011** to allow firms to re-paper their clients). The rules contain some exceptions to the prohibition. It does not apply to:

  - liens relating to charges and liabilities properly incurred in providing custody services to a particular client (e.g. including charges/liabilities arising out of intra-day payments, contractual settlement, standing credit lines);

  - liens in favour of international securities depositories, central securities depositories and securities settlements systems (where the lien is for the purposes of settlement of that client's trades only);

  - liens which arise in jurisdictions as a result of local regulatory requirements or market practice and the firm has determined that holding assets in that jurisdiction is in the best interests of the client.

### *And more to come!*

A comprehensive overhaul of CASS will need to be postponed until the Lehman client money litigation is finally determined, but the FSA has said that it will continue working the HM Treasury on further enhancements to the client assets regime. We expect consultations on the following topics at some point in the future:

- changes to the Part IV permission regime for firms that hold and control client money;

- the effectiveness of CASS 7.8 (notification and acknowledgment of trust);

- review of CASS 5 (Client money: insurance mediation activity).

## Approved persons regime

### *Extension to the significant influence controlled functions regime*

The rules for the FSA's new, more intensive approved persons regime come into force on **1 May 2011**. The changes form part of a wider review of corporate governance arrangements and implement, where appropriate, the recommendations made by Sir David Walker in his review of corporate governance in banks and other financial institutions. The Controlled Functions (Amendment) Instrument 2010 is at: http://fsahandbook.info/FSA/handbook/LI/2010/2010_48.pdf.

Central to the changes will be a number of new controlled functions for which approval is required. The policy statement and the final rules (PS10/15) came out in September 2010 and therefore, firms should already have started the process of analysing the extent to which each of the new functions will be relevant to them and, where relevant, allocating the relevant function to an individual (or individuals). **Firms should ensure that they understand and comply with the FSA's transitional arrangements regarding notification or application for approval (see below).**

### *Parent entity significant influence function*

- **CF00 – parent entity significant influence function** – the scope and application of controlled functions CF1 (director) and CF2 (non-executive director) were extended in August 2009 to include individuals employed by a parent undertaking or holding company whose decisions, opinions or actions are regularly taken into account by the governing body of the authorised firm and therefore likely to have a significant influence on the firm. This rule applied to authorised firms that were companies. The concept is now being given a separate controlled function, CF00, and extended to all firms, so firms constituted as LLPs will now need to consider this requirement. As a result, CF1 and CF2 will once again be narrowed to refer solely to acting as director and non-executive director respectively.

- Firms will need to consider if there is anyone who needs registration for the CF00 function. It will not be relevant to all firms. It is a question of fact as to whether there is an individual employed by a parent undertaking or holding company whose decisions, opinions or actions are regularly taken into account by the governing body of the authorised firm and who is therefore likely to have a significant influence on the firm. If there is such a person, but that person is already approved to

perform any one of functions CF1 to CF6 (excluding CF2a to 2e), he will not have to be specifically approved for the CF00 function.

- As the introduction of the CF00 parent entity significant influence function does not involve a change of substance for firms constituted as companies, most firms should already know if they have someone registered as CF1 or CF2 who will become a CF00. Nevertheless, the FSA received a considerable number of comments and has provided some Frequently Asked Questions by way of guidance (see new SUP 10 Annex 9, to be inserted by the Controlled Functions (Amendment) Instrument 2010). This guidance should be considered by all firms, as it may cause them to change views taken previously.

***New governing functions***

There will be five new "granular" governing functions:

- **CF2a – chairman function** – this is the function of acting as the chairman of the governing body;

- **CF2b – senior independent director function** – this is the function of acting as a non-executive director who has been appointed by the non-executive directors to act in this capacity;

- **CF2c – chairman of the risk committee function** (if there is such a committee) – typically to be filled by a non-executive director;

- **CF2d – chairman of the audit committee function** (if there is such a committee) – typically to be filled by a non-executive director;

- **CF2e – chairman of the remuneration committee function** (if there is such a committee) – typically to be filled by a non-executive director.

While the FSA does not preclude executive directors from performing the roles of chairman of the risk, audit or remuneration committees, it has said that it would expect this to be "in exceptional circumstances only". The senior independent director function (CF2b) must, of course, be filled by a non-executive director.

Whether or not a firm will need to fill these new roles will depend on the size and complexity of the firm – the FSA says that it envisages that "firms needing to appoint any or all of the proposed new roles, will do so proportionately, taking account of their specific circumstances and in consultation with their supervisor".

If a non-executive director does not have any of the above functions he will only be registered as a CF2. Only those individuals appointed by their firms to chair the governing body itself (CF2a), or some of its committees (e.g. CF2c to CF2e) or to assume the role of senior independent director (CF2b) will be required to be approved for these new "granular" governing functions. In such cases the individual needs to be approved for both CF2 and the applicable new function.

***Systems and controls functions***

The current systems and controls function (CF28) will be replaced by three new systems and controls functions:

- **CF13 – finance function** – this is the function of acting in the capacity of an employee with responsibility for reporting to the governing body in relation to the firm's financial affairs;

- **CF14 – risk function** – this is the function of acting in the capacity of an employee with responsibility for reporting to the governing body, or its risk committee (or its equivalent) in relation to setting and controlling the firm's risk exposure;

- **CF15 – internal audit function** – this is the function of acting in the capacity of an employee with responsibility for reporting to the governing body, or the audit committee (or its equivalent) in relation to controlling adherence to and effectiveness of the firm's systems and controls. The FSA expects that the person responsible for this function should not be responsible for any of the governing functions of the firm.

If someone is currently approved as a CF28, the FSA expects them to be moved to one of the new systems and controls functions. It also expects at least the most senior person filling the CF13, CF14 and CF15 roles to be approved. Firms do not have to appoint individuals to these roles, so depending on the nature, scale and complexity of a particular firm it may not always be necessary to have persons allocated to these roles.

It should be noted that if someone holds a governing function but also fulfils one of the systems and controls functions a notification or application for both functions will be required (i.e. the systems and controls function is not subsumed within the governing function) – see the transitional arrangements below.

### *Transitional arrangements - Existing approved persons*

So some persons who are already approved will need to be registered under the new functions. A new application for approval will not be required for persons who are already approved and who are already performing the relevant role *provided* that the firm makes an appropriate notification to the FSA through the Online Notifications and Applications System (ONA) by the relevant deadline.

It seems that notifications cannot be made before 1 May 2011. **The deadline for notifications is generally 31 July 2011**. However, the deadline for notifications of individuals who already hold a governing function but who will require separate approval for one of the new systems and controls functions (i.e. CF 13 (finance), CF14 (risk) or CF15 (internal audit)) is **30 April 2012 (except for** those large banks and firms who were subject to the Remuneration Code *before* 1 January 2011, in which case the deadline is 31 July 2011).

### *Transitional arrangements - New approved persons*

Transitional relief applies if, as a result of the extension of scope of the approved persons regime, a new application for approval for one of the new governing functions or the significant management function would be required (i.e. because the person performing the role immediately before 1 May 2011 was not an approved person). In such a case the function will not become a controlled function until 31 October 2011. Firms should make sure they submit an application for approval by 31 July 2011. This is because the transitional period will be extended for as long as it takes the FSA to decide the application *provided that the FSA received the application by 31 July 2011.*

Otherwise, outside the transitional rules the new rules apply from 1 May 2011 and, where relevant, firms should make applications for approval accordingly.

## Bribery Act 2010

Unless the government is swayed by late lobbying which is currently being made against The Bribery Act 2010, it will come into force **in April 2011**. As all firms will be within the scope of the Act every firm will need to put arrangements in place to show that it has "adequate procedures" to prevent bribery, if it is to have a defence against the corporate offence of failing to prevent bribery. The FSA will expect firms to have considered the adequacy of their existing arrangements in the light of the Act as it will be seen as part of the financial crime agenda. We are expecting the Ministry of Justice to publish its final guidance on such procedures later this month. Firms need to look out for this and be able to show they have considered the potential relevance of the Act to their business.

The Travers Smith alerter on what "adequate procedures" might mean in the light of the Ministry of Justice consultation is here:

The Travers Smith alerter summarising the provisions of the Bribery Act 2010 is here:

## Structural changes to the U.K. financial services regime

We are expecting the U.K. Government to issue its detailed proposals regarding the new architecture of the UK financial services regime, together with draft primary legislation in February 2011. This may contain some unexpected surprises for some firms as to the shape of future regulation. The FSA has already established a regulatory reform programme with a view to migrating to the new regulatory model; it will be introducing a "shadow" internal structure, which will allocate FSA staff and responsibilities in anticipation of the creation of the CPMA and the PRA. In **April 2011** the FSA will replace its Risk and Supervision business units with a Prudential business unit and a Consumer Protection and Markets business unit.

## SIGNIFICANT CHANGE AHEAD - THE EUROPEAN DIMENSION

### *Outline*

The new European Supervisory Authorities have started work and wield significantly enhanced powers compared to their predecessors. The future regulation of both the wholesale and the retail markets will be driven by European initiatives and national regulators will be answerable to European bodies. The European Parliament is flexing its muscles more in the financial services arena - the Alternative Investment Fund Managers Directive is an example of this. A vast range of European initiatives are underway. These include:

- The European Commission's consultation paper on the review of MiFID (MiFID II) sets out proposals in relation to wide range of important issues – it is important for UK firms to contribute to the consultation process. **Consultation closes on 2 February 2011**;
- The European Commission's consultation paper on the proposed Securities Law Directive is also out and may be of concern to a number of UK market participants, not merely the providers and users of services for the safeguarding and/or administration of intermediated securities. **Consultation closes on 21 January 2011**;

- As regards the Alternative Investment Fund Managers Directive, focus is now on the detailed Level 2 implementing measures that will be required. The call for evidence consultation issued by CESR (now ESMA) closed on 14 January 2011. Further consultation on ESMA's proposed advice to the Commission will be made over the coming months;
- UCITS IV must be implemented in the UK **by 1 July 2011**. A joint HMT/FSA consultation paper is currently open setting out transposition proposals. **Consultation closes on 21 March 2011**. The European Commission's consultation on UCITS V (on the UICTS Depositary function and on UCITS manager remuneration) is also out – consultation on this closes on **31 January 2011**.

***New European supervisory framework***

The new European supervisory authorities ("ESAs") began their work on January 1 2011. Say goodbye to CESR, CEIOPS and CEBS. Say hello to:

- **ESMA** (European Securities and Markets Authority), based in Paris (http://esma.europa.eu/);
- **EIOPA** (European Insurance and Occupational Pensions Authority), based in Frankfurt (https://eiopa.europa.eu/); and
- **EBA** (European Banking Authority), based in London (http://eba.europa.eu/).

Responsibility for macro-prudential oversight now resides with the newly-established **European Systemic Risk Board**, also based in Frankfurt (http://www.esrb.europa.eu/home/html/index.en.html).

The ESAs will create a "single European rule book" by drafting binding technical standards. Once adopted by the European Commission these technical standards will become European law with direct effect in Member States (i.e. no national implementation will be required). ESMA is already at work on drafting technical standards for MiFID II (see below) and the revision of the Market Abuse Directive. It will also draft technical standards for other legislation as and when it is adopted. For instance, it will be developing technical standards and detailed procedures for the controversial Alternative Investment Fund Managers Directive (AIFMD) .

ESAs have a power to investigate where they think that a competent authority is mis-applying European law (or failing to apply it at all), they will be able to impose bans on certain financial activities (albeit temporarily) and will have significant emergency powers which will allow them (subject to certain conditions) to make decisions that will be binding on national regulators and firms. ESMA has a direct supervisory role in relation to credit rating agencies.

***MiFID Review (MiFID II)***

The European Commission has now published a consultation paper on changes to MiFID. (http://ec.europa.eu/internal_market/consultations/2010/mifid_en.htm). This came out on 8 December 2010 and closes on **2 February 2011**. Given the intervening Christmas and New Year break, this gives very little time for firms and trade associations to digest an important paper, which is densely packed with a large number of significant (and sometimes controversial) proposals. We summarise a few below, but it is important that firms inform themselves about them and respond or assist their trade associations in responding. As the AIFMD has shown, drastic proposals can move fast and become embedded very quickly, whatever their merits or the difficulties that they raise.

Following the consultation process, the Commission will prepare a formal legislative proposal. The Commission says that this is scheduled for adoption **in mid-May 2011**.

The consultation document is divided into a number of sections, including the following:

- **Investor protection and provision of investment services**: there are a number of significant proposals under this heading, including:
    - removing or narrowing the exemption from the MiFID appropriateness obligation. Firms which arrange or execute transactions but who do not give investment advice are subject to the requirement that they assess whether the service or product is appropriate for the client. There is an exemption for execution and arranging services in relation to shares admitted to trading on EU regulated markets, bonds, UCITS and certain other "non-complex" instruments, which is particularly relevant for execution-only brokers with retail clients. The Commission is considering removing the exemption entirely or narrowing it so that:
        - "shares" excludes shares in collective investment undertakings, convertible shares and other shares embedding a derivative;
        - "bonds or other forms of securitised debt" excludes any instruments which embed a derivative or which incorporate a structure "which makes it difficult to understand the risk involved";
        - units in a UCITS scheme may not always be non-complex because of the adoption of complex portfolio management techniques in the management of some UCITS.

In addition the exemption would not apply at all if the firm is granting credit or loans to the client in order to allow the client to carry out the transaction.

- significant changes to the inducements regime (see COBS 2.3). These include:
  - abolishing the possibility of disclosing inducements in summary form and introducing an ex-post reporting obligation (e.g. where the prior disclosure referred to the method of calculating the amount of an inducement rather than the amount itself);
  - banning any third party inducements in the context of portfolio management, or investment advice given on an independent basis. This could mean that commission sharing and other similar arrangements will no longer be possible
- because the Commission considers that professional clients and eligible counterparties require more protection than they are currently given in certain circumstances, making the following amendments:
  - the 'fair, clear and not misleading requirement' will expressly extend to eligible counterparties;
  - as regards suitability and appropriateness requirements, the presumption that professional clients have the requisite level of experience and knowledge would be abolished;
  - the category of "eligible counterparty" will not be available in respect of complex products such as asset-backed securities and non-standard OTC derivatives;
  - "non-financial undertakings" and "certain financial undertakings" would be excluded from the eligible counterparty regime – there are few details behind this proposal, other than the suggestion that the exclusion could be based on size or on the nature of business;
  - it would no longer be possible to categorise municipalities as eligible counterparties or per se professionals.
- imposing an obligation on firms to make additional information available to their clients (possibly even eligible counterparties) in relation to complex products (such as OTC derivatives and structured products), i.e.: (a) prior to the transaction, a risk-gain and valuation profile of the relevant product in different market conditions, (b) quarterly valuations of the product (c) in the case of structured products, quarterly reporting on the evolution of the underlying assets and (d) a notification of any material changes to the product during its lifetime;
- extending the scope of MiFID to include structured deposits offered by credit institutions;
- amending MiFID should be amended to enshrine the principle that clients would have a right of action against firms for rule breaches – the Commission particularly refers to the following provisions of MiFID: information requirements, the suitability and appropriateness regimes, reporting requirements, best execution and client order handling. This may result in an extension of the current UK regime which extends certain civil law claims to "private persons" for breach of rules.
- prohibiting title transfer arrangements "at least when dealing with retail client assets".

- **Developments in market structures**: The Commission's proposals include the following changes to MiFID:
  - the expansion of MiFID to include a new service, the operation of an "organised trading facility". The concept of an "organised trading facility" would capture bilateral and/or discretionary facilities, and systems which are not within the definition of a multi-lateral trading facility ("MTF") but which the Commission believes are hybrids between client order execution facilities and multilateral systems. Accordingly, broker crossing systems and inter-dealer broker systems which bring together third party interests and orders (whether by voice or electronically) would be caught, whether equities or other financial instruments are being traded. Simple order execution and routing systems would not be caught.

    Operators of organised trading facilities would be subject to specific requirements, including the adoption and publication of rules, the monitoring of trading (i.e. with a view to identifying potential market abuse) and the obligation to suspend or remove financial instruments from trading on instructions from the competent authority. Operators of crossing systems would additionally be required to make public aggregated end-of-day information about the number, value and volume of trades executed on the system. Finally, the Commission suggests that any organised trading facility should be converted to an MTF after reaching "an asset-specific threshold", though quite how this would work is not clear.
  - the expansion of MiFID to provide that all trading in derivatives which are eligible for clearing and are "sufficiently liquid" (as decided by ESMA) should be on regulated markets, MTFs or a "specific sub-regime of operating trading facilities";

   - the introduction of controls over automated or algorithmic trading, including high frequency trading – for instance, all persons involved in high frequency trading over a "specified minimum quantitative threshold" (not yet defined), would need to be authorised as investment firms, even if they are currently relying on the "dealing on own account" exemption under Article 2.1(d) of MiFID. Additional organisation requirements would be imposed on firms involved in or offering automated trading.

- **Pre- and post-trade transparency**: the Commission suggests a tightening up of existing pre-trade and post-trade transparency requirements and a potential widening of their scope.

- **Commodity derivatives**: the Commission suggests some specific requirements for commodity derivative exchanges and proposes to widen the basis upon which a physically-settled OTC derivative on commodities can be regarded as within the scope of MiFID.

- **Transaction reporting**: the scope of the Market Abuse Directive is to be changed and so the Commission believes that the **scope** of the transaction reporting obligation in MiFID should be extended to catch transactions in a wider range of instruments including:

   - all financial instruments the value of which "correlates" with the value of an instrument traded on a regulated market, MTF or organised trading facility;

   - depositary receipts that are related to financial instruments admitted to trading or traded on a regulated market, an MTF or organised trading facility;

   - OTC commodity derivatives.

  The Commission also proposes other amendments which are likely to widen the scope of persons subject to transaction reporting, increase the information required in reports and place certain obligations on firms who receive and transmit orders.

- **Reinforcement of key supervisory powers**: this section includes a controversial proposal that the Commission should have the power to ban specific services, products or activities where there are significant and sustained investor protection concerns or the product or activity threatens the financial markets or financial stability. It also includes a proposal that competent authorities should be given a power to intervene in derivative contracts.

***Securities Law Directive***

This Directive concerns the rights of investors to "account held securities" i.e. securities held through intermediaries such as custodians, brokers and other investment firms. It is therefore relevant to both the providers of custody and settlement services and their clients, and will have very wide ranging effects including on the legal rights and obligations involved when securities are held indirectly.

The Commission's second consultation paper is at: (http://ec.europa.eu/internal_market/consultations/2010/securities_en.htm).

The deadline for responses to the paper has been extended to **21 January 2011**. The Commission's proposals are likely to form the basis of a new Securities Law Directive which is due to be introduced and made during 2011. The Directive is intended to adopt a "functional approach" to:

- enhance the ability of "account holders" to exercise the rights attached to account held securities;

- impose certain minimum duties and liabilities upon "account providers" in relation to their maintenance of "securities accounts";

- provide legal certainty as to the steps that must be undertaken to acquire or dispose of account-held securities or an interest in them;

- prohibit the attachment by creditors of an account holder of securities or interests which are "higher" in the chain of entitlements (the so-called "prohibition on upper-tier attachment");

- introduce an "innocent acquirer" rule to protect transferees from any defect of title in the transfer of account-held securities;

- ensure that securities or interests held for account holders are not available for distribution to the creditors of an insolvent account provider;

- minimise the issues created for account holders by any "shortfall" in the amount of the underlying securities held by an account provider;
- provide "priority" rules for the various interests that might arise in relation to account-held securities;
- establish a uniform "conflict-of-law" rule to determine the law which governs proprietary issues affecting account-held securities; and
- require all EU-based account providers to be authorised under MiFID for the "safeguarding and administration" of financial instruments (which will be upgraded to become a new investment service/activity under Annex 1 Section A of MiFID (instead of, as now, an ancillary activity under Annex 1 Section B)).

Particular issues that have concerned UK market participants include:

- "strict liability" is to be imposed on account providers in relation to the performance of their account maintenance functions. This might require account providers to assume full responsibility for the insolvency or other default of other intermediaries in the chain-for example if a UK firm holds assets in its nominee name with another custodian. The inability to control this liability through contract is likely to result in increased costs and potentially a reduction in the range of services available to investors;
- issuers and account providers may be required to recognise and facilitate the exercise of the rights of "ultimate account holders" with whom they have no contractual or other legal relationship, whom they may not be able easily to identify with certainty. This is contrary to the current position under English company law;
- the potential territorial scope of the proposals raises material concerns that EU account providers will be made subject to duties in relation to non-EU securities that conflict with the laws of the relevant non-EU state;
- the proposed "priority" rules conflict with existing English rules and potentially undermine the priority of floating charges supported by a "negative pledge" (as taken by CREST settlement banks); and
- the proposed "conflict-of-law" rule lacks the certainty required by the EU markets and fails to deliver the benefits that would be achieved through the adoption of the Hague Securities Convention.

### *AIFMD – the battle continues*

Now that the Directive itself is finalised, focus now shifts to the Level 2 process. On 2 December 2010 the European Commission sent to CESR (now ESMA) its provisional request for technical advice on the Level 2 measures for AIFMD (available on the Commission's AIFMD page at http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#level2). ESMA has until 16 September 2011 in which to deliver its advice.

On 3 December 2010, CESR issued its call for evidence
(http://www.esma.europa.eu/index.php?page=consultation_details&id=176).
The call for evidence consultation closed on 14 January 2011. Further consultation on ESMA's proposed advice to the Commission will take place over the coming months.

It is important for all in-scope firms to liaise with their appropriate trade association in order that considered responses and appropriate lobbying can be made at the European level. A great number of "devilish details" will fall to be fleshed out in the implementing measures.

Our full briefing on the Directive, as finalised, is here

For further information on these issues please contact one of the following partners in our Financial Services and Markets department or your usual contact at Travers Smith.


Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

**Margaret Chamberlain**
margaret.chamberlain@traverssmith.com
+44 (0)20 7295 3233

**Jane Tuckley**
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238

**Mark Evans**
mark.evans@traverssmith.com
+44 (0)20 7295 3351

**Tim Lewis**
tim.lewis@traverssmith.com
+44 (0)20 7295 3321



© **Travers Smith LLP - 14 January 2011**



Travers Smith LLP is a limited liability partnership registered in England and Wales under number OC 336962 and is regulated by the Solicitors Regulation Authority. The word "partner" is used to refer to a member of Travers Smith LLP. A list of the members of Travers Smith LLP is open to inspection at our registered office and principal place of business: 10 Snow Hill, London, EC1A 2AL. We are not authorised under the Financial Services and Markets Act 2000 but we are able, in certain circumstances, to offer a limited range of investment services because we are members of the Law Society of England and Wales and regulated by the Solicitors Regulation Authority. We can provide these investment services if they are an incidental part of the professional services we have been engaged to provide. The information in this document is intended to be of a general nature and is not a substitute for detailed legal advice.