

Regulatory Times

PwC Ireland
Asset Management
Regulatory News

Welcome to the latest edition of our quarterly PwC Ireland asset management newsletter. It covers both local and international regulatory topics affecting the Irish funds industry.

July 2011



What is hot this quarter?

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Irish Regulatory Updates

UCITS IV transposing legislation signed into Law

On the 29th June 2011, the Minister for Finance signed legislation that transposes UCITS IV into Irish law. The Statutory Instrument 352 of 2011 consolidates all previous UCITS legislation and includes the provisions of the UCITS IV Directive including: the management company passport, the Key Investor Information Document, simplified notification procedures for cross-border marketing, as well as provisions for cross-border mergers and master-feeder structures.

The Central Bank of Ireland has also issued revised Notices and Guidance Notes to reflect the UCITS IV legislation. The revised Notices and Guidance Notes complete the regulatory regime for UCITS IV funds in Ireland and include provisions for the corresponding changes to the Minimum Activities regime as proposed under CP 48. Additionally, the Central Bank has also revised and updated its NU Notices. The updated UCITS and non-UCITS Notices and Guidance Notes are available on the Central Bank's website - <http://www.centralbank.ie/regulation/industry-sectors/funds>.

Self-Managed Investment Company UCITS IV requirements for 1 July 2011

The Central Bank has confirmed that all Self Managed Investment Companies (SMICs), including those authorised from 1 July 2011, will not be required to comply with the full UCITS IV regime until 1 July 2013. It notes, however, that SMICs must comply with certain aspects of the new UCITS IV requirements by 1 July 2011, specifically those in UCITS Notice 10 and 16, as well as particular areas of UCITS Notice 2. Guidance Notes and updated UCITS Notices are available on the Central Bank's website www.centralbank.ie/regulation/industrysectors/funds.

Draft Industry Corporate Governance code published

On the 13th June 2011, the Irish Funds Industry Association (IFIA) in consultation with the Central Bank of Ireland issued a draft Corporate Governance code for funds and management companies - (the "code").

Post the financial crisis Corporate Governance has been high on the agenda for many authorities. The Central Bank has issued new Corporate Governance code for banks & insurance companies. Following on from this the Irish Funds Industry Association was asked to draft a Corporate Governance code for funds and management companies'. Statutory Instrument 450 implemented the 4th and 7th EU directives into Irish law in 2009. This requires the inclusion of corporate governance statement in the annual report of all Irish entities.

While many boards may feel that there will be no change to the status quo, there are some new recommendations introduced by the code, namely a requirement for an annual review of the Board's performance together with formal documentation of this process every three years.

Some of the key points of the draft IFIA Corporate Governance (the “code”):

- The proposed effective date for compliance with the Code is 1 September 2011.
- The code will be voluntary with a requirement to comply or explain detailed in the Annual Report.
- The code states that a board to have a minimum of three directors of which at least two must be Irish resident to ensure availability to the Central Bank.
- At least one director should represent the investment manager/promoter.
- Additionally the board should have at least one “independent” director.
- For UCITS funds there should be at least four board meetings a year.
- There should be a non-executive Chairman appointed.
- Directors must assess and document their time commitments required for each of their board appointments and to disclose their other commitments to Board of each fund. Where Board delegates tasks to third parties/service providers they have an obligation to monitor and receive reports and cannot abrogate responsibility.

The industry had until the 24th of June to give feedback on this draft. The IFIA and Central Bank will review this feedback and it is hoped that an agreed voluntary code will be available at the end of July 2011, to be then adopted by the industry on a comply or explain basis from September 2011.

Update to the Fitness and Probity Regime for directors

Directors and managers to Irish funds must pass a fit and proper test as outlined by the Central Bank. This is to ensure that the Directors and Managers have the proper skills to manage a firm.

“Fitness” requires that a person appointed as a Director or Manager has the necessary qualifications, skills and experience to perform the duties of that position.

“Probity” requires that a person is honest, fair and ethical.



The Central Bank has recently issued a draft consultation on revisions to the Fitness and Probity Regime, see outlined below.

- The new regime is expected to come into effect on 1 September 2011.
- Functions are now designated as either Pre-Approval Controlled Functions “PCF” or Controlled Functions “CF”.
- PCF and CF involve the exercise of significant influence on the conduct of a Regulated Financial Services Providers.
- PCFs must be deemed to be “Fit and Proper” before taking up role.
- CFs does not require pre-approval but may be removed if holder is not considered fit and proper by the Central Bank.
- Includes UCITS and Non-UCITS
- Self Managed Investment Companies and Management Companies PCF’s in respect of Self Managed Investment Companies/ UCITS or Management Companies include:
 - Directors
 - Designated persons to who a director may delegate the performance of the management function

Updated Central Bank procedures and QIF application

To improve efficiencies in the fund authorisation process, the Central bank has updated the procedures for comment letters and authorisation/approval letters to an electronic format rather than fax/hard copy as of 30th May 2011.

In relation to the QIF application and to aid the fund supervision process, since 1st June 2011 a Fund Profile sheet is to be submitted with a QIF application. It requires details such as the type of legal structure, names of the parties involved including promoter, administrator etc, investment policy and objectives etc. A copy of the Fund Profile sheet is available on the Central Bank’s website:

<http://www.centralbank.ie/regulation/industry-sectors/funds/non-ucits/Pages/forms.aspx>

Update to policy with regard to eligible assets and investment restrictions

As of the 2nd June 2011, the Central Bank has changed its policy with regard to eligible assets and investment restrictions (UCITS 9 and Non UCITS 13). The Central Bank will now accept, subject to certain conditions, that Irish authorised investment funds may invest up to 100% of their assets in securities issued or guaranteed by the Government of Brazil or the Government of India (provided the issues are of investment grade).

European Regulatory Updates

UCITS IV transposition delays

The UK, Germany, Ireland, Malta, Denmark and Luxembourg all implemented the UCITS IV directive by the July 1 deadline.

The majority of European countries failed to meet the deadline, the below table outlines the current status for a number of these countries.

Country	Status	Proposed Date for Transposition
Austria	Draft	September
Belgium	No official draft	Unknown
Cyprus	Draft	Unknown
Finland	Draft	Autumn 2011
France	Draft	Unknown
Italy	Draft	Unknown
Netherlands	Draft	September/October
Norway	Public consultation	Unknown
Poland	Draft	Not before end of 2011
Portugal	No draft	Unknown
Spain	Draft	Unknown
Sweden	Draft	1 August 2011
Switzerland	Changes adopted	15 July 2011
Romania	Draft	Autumn 2011

KIID ongoing charges figure

European regulators are engaged in talks over the representation of charges within the Key Investor Information Document (KIID) as of a result of complaints from French managers who say that the calculation of ongoing charges is different in France to other member states.

Although all countries are understood to have correctly applied UCITS IV legislation and EU guidelines, local accountancy rules mean the final figures for ongoing charges are different from one jurisdiction to the next.

France includes so-called “trading charges” in its figures, while they are left out in other Member States.

Luxembourg funds are impacted by charges that have the same economic effect as France’s trading charges but they do not need to appear within KIIDs for local accountancy reasons.



This has raised concerns that a French fund will appear more expensive than equivalents in other Member States.

French managers have said they would like the new European Securities and Markets Authority (ESMA) to give an exhaustive list of the charges that must be presented within the KIID.

Call for ‘Newcits’ term to be dropped

The European Fund and Asset Management Association (EFAMA) has called for misleading investment terms such as ‘Newcits’ to be scrapped as they distract investors, regulators and other stakeholders.

The term ‘Newcits’ was coined in the media to describe UCITS funds that employ hedge-like strategies in order to achieve absolute returns. EFAMA is a big defender of the UCITS brand and believes that the ‘Newcits’ term is detrimental to the brand due to its connections to sophisticated strategies and derivatives.

EFAMA established a working group in 2010 to examine reservations and concerns surrounding the rise in funds using techniques normally reserved for sophisticated hedge fund investors.

This working group released a report on 16 May 2011 titled *The Evolving Investment Strategies of UCITS* and the findings of the report claim that so-called ‘Newcits’ are in fact “neither new products nor a new category of funds” and describes the tag as “not helpful”. The EFAMA working group



adds that with wide variations in what constitutes 'Newcits', and with some providers simply using the name to describe an existing absolute return strategy, the label should be avoided altogether.

The report also says that all UCITS operate under one and the same regulatory framework and 'Newcits' funds were not a "specific and novel sub-category" of UCITS. Therefore, the labelling of these funds in such a way will only distract investors and other stakeholders from the real issues

An article published in Citywire on 17 May 2011 states that its readers disagreed with the findings of the report as they felt it was beneficial to distinguish between traditional, long only UCITS funds and hedge fund-like UCITS strategies such as managed futures, long short equities, currency funds, global macro funds. The article acknowledges that while the term 'Newcits' may not be the perfect name for these funds, it is not feasible to try to group all funds together under the umbrella term UCITS.

Delay on UCITS V draft publication

The European Commission EU has pushed back publication of the draft UCITS V directive to the latter part of 2011. The decision to delay publication, which was scheduled for July, was taken because the Commission wants to include a new section on sanctions. Brussels will launch a public consultation on UCITS sanctioning regimes in the near future. UCITSV will focus on investor protection. It is expected to introduce remuneration and depository measures in line with the alternative investment fund managers (AIFM) directive.

What can we expect to see in UCITS V?

Single depository requirement:

The new rules would require UCITS to appoint a single depository to be entrusted with safekeeping of all the fund's assets. The depository must be in a position to have oversight and responsibility for all assets and cash transactions for the fund.

Depository duties:

Definition of safekeeping: The EC proposes to define the activities and responsibilities related to safekeeping in a manner consistent with AIFMD. The regime would distinguish between safekeeping physical custody of financial instruments (e.g. securities) and asset monitoring duties relating to assets that are not physically held (i.e. financial instruments that may only be followed through a position-keeping book).

Alignment of oversight functions: Under the current framework oversight duties vary depending on the legal form of the UCITS, the location of the Depository and depositories of funds with a corporate form such as an investment company which have less onerous oversight duties than for funds which are unit trusts. The EC proposes to extend the current duties of depositories for UCITS with a corporate form to all forms of UCITS.

Delegation: The proposal aims to restrict delegation of depository tasks to safekeeping duties, and to align the conditions and requirements for such delegation with those of AIFMD.

Eligibility criteria:

An exhaustive list of entities eligible to act as UCITS depositories would be introduced, including credit institutions, MiFID firms which also provide the ancillary service of safe-keeping and administration of financial instruments, and existing UCITS depository institutions (by means of a grandfathering clause).

Certification requirements:

A requirement for an annual certification of the assets held in custody by the depository, which could be performed by the depository's auditors would be introduced.

Depository liability regime:

Liability: The proposal clarifies the difference between a depository's "unjustifiable" failures to perform duties

and circumstances in which a failure to perform may be justifiable, to address the depositary's liability in cases when a UCITS suffers a loss as a result of the depositary's negligence or intentional failure to perform its duties. A strict liability regime was debated in the AIFMD drafting process but ultimately rejected, and that is not being consulted on for UCITS. However, depositories are likely to face additional costs, due to increased potential liability for their own actions and those of their sub-custodians, which will need to be borne by the UCITS and their investors.

Replacement of lost assets: Depositories would be obliged to return the identical financial instruments or a corresponding amount of assets (where fungible) to the UCITS in case of loss.

Scope of depositary liability for assets lost by a sub custodian:

Depositories would remain liable for the loss of assets, even where part or all of its safekeeping tasks have been delegated to a third party.

Burden of proof: The depositary would bear the burden of proof in demonstrating that it has performed its duties to the required standard, in situations where negligence or intentional failure to perform its duties are alleged.

Investors' rights of action against the depositories:

The new proposal aims to give the same rights to all UCITS investors, allowing them to sue depositories, either directly or indirectly through the management company, depending on the legal nature of the relationship between the depositary, the management company and the investors.

Passporting:

The EC is not planning to introduce a depositary passport at this point but intends to assess the need for this a few years after the new UCITS depositary framework comes into force.

Remuneration:

The EC believes that remuneration for UCITS managers should be more clearly aligned to investors' interests and supported by robust policies and procedures. It intends to introduce measures similar to those under AIFMD.

Remuneration structures:

UCITS managers' remuneration structures would be required to include:

- Criteria for calculating compensation for different categories of staff where remuneration is performance related;
- Rules for guaranteed variable remuneration;
- Rules for fixed and variable components of total remuneration;
- Rules on pension benefits; and
- Rules for payments related to termination of employment.

Scope: Remuneration policies would apply to staff whose professional activities may have a material impact on the risk profile of the UCITS, specifically to senior management including the board of directors, persons carrying out supervisory functions or the permanent risk management function, and other employees in the same pay bracket as senior management.

Governance: The manager's board of directors (or equivalent) would be required to adopt the remuneration policy, and be responsible for the implementation and periodic review. Larger managers would be required to establish a remuneration committee to exercise independent judgement on remuneration policies and practices. Also, the compliance function would have to review how the policy operated in practice at least annually.

Effective risk taking and preventing conflict of interests: UCITS managers' remuneration policies should be designed to promote sound and effective risk management, discourage any risk-taking which is inconsistent with the funds' risk profiles and fund documentation, and prevent conflicts of interest.

Proportionate application: UCITS managers would be given flexibility to allow for the sound application of the remuneration policies in a manner proportionate to the size, internal organisation as well as the nature, scale and complexity of the activities carried out by the manager and the fund.



Council adopts EU rules for alternative investment fund managers

On 27 May 2011, the Council adopted a directive introducing harmonised EU rules for entities engaged in the management of alternative investment funds, such as hedge funds and private equity firms. Adoption of the text follows an agreement reached with the European Parliament at first reading.

The European Union's Directive on Alternative Investment Fund Managers will come into force on July 21 following its publication in the Official Journal of the European Union on July 1. EU member states will then have until July 22, 2013 to transpose the Directive into their national legislation.

EU-domiciled funds run by managers also based within the union will benefit from a 'passport' enabling them to be marketed to sophisticated investors throughout the union from July 2013. ESMA is due to advise the Commission on its extension to non-EU managers and funds by July 22, 2015.

On 14 July 2011, the European Securities and Monetary Authority (ESMA) issued the public consultation on Level II Implementing Acts for the AIFM Directive. This consultation is key to paving the way for the operating rules of AIFMD. The Implementing Acts will be the critical rules with which AIFMs will have to comply with when the Directive comes into force in 2013.

Key dates:

13th September 2011 - Consultation closes and industry responses considered

16th November 2011- Commission's own deadline for ESMA to finalise their advice

Jan / Feb 2012 - Commission complete drafting of Level II Text and forward to Parliament for approval as Implementing Directives

22nd July 2013 - Final Date of transposition of AIFMD into Member State national law

The level II Implementing Acts can be accessed at the below weblink -

http://www.esma.europa.eu/index.php?page=contenu_groups&id=28&docmore=1

The main features of the directive are as follows:

Authorisations: To operate in the EU, fund managers will be required under the directive to obtain authorisation from the competent authority of their home member state. Once authorised, an AIFM will be entitled to market funds established in the EU to professional investors in any member state. To obtain authorisation, AIFM will have to hold a minimum level of capital in the form of liquid or short-term assets.

Depositary: AIFM will be required to ensure that the funds they manage appoint an independent depositary responsible for overseeing the fund's activities and ensuring that the fund's assets are appropriately protected. The depositary will be liable to the investor and the manager. It should be located in the same country as the fund if the fund is established in the EU. If the fund is established in a third country, the depositary should be located in the EU, unless a cooperation and information exchange agreement exists between the supervisors ensuring that regulations are equivalent and supervision can be carried out in accordance with requirements in the EU.

Risk management and prudential oversight: AIFM will be required to satisfy the competent authority of the robustness of their internal arrangements with respect to risk management, including liquidity risks. To support macro-prudential oversight, they will be required to disclose on a regular basis the principal markets and instruments in which they trade, their principal exposures and concentrations of risk.

Treatment of investors: In order to encourage diligence amongst their investors, AIFM will be required to provide a clear description of their investment policy, including descriptions of the types of assets and the use of leverage.

Leveraged funds: The directive introduces specific requirements with regard to leverage, i.e. the use of debt to finance investment. Competent authorities will be empowered to set limits to leverage in order to ensure the stability of the financial system. AIFM employing leverage on a systematic basis will be required to disclose aggregate leverage and the main sources of leverage, and competent authorities will be required to share relevant information with other competent authorities.

AIFM acquiring controlling stakes in companies: The directive introduces specific requirements for AIFM acquiring controlling stakes in companies, in particular the disclosure of information to other shareholders and to representatives of employees of the portfolio company. It however avoids extending such requirements to acquisitions of SMEs, so as to avoid hampering start-up or venture capital.

Passport: The directive introduces a single market framework that will allow AIFM to “passport” their services in different member states on the basis of a single authorisation. Once an AIFM is authorised in one member state and complies with the rules of the directive, the fund manager will be entitled upon notification to manage or market funds to professional investors throughout the EU.

Funds and managers located in third countries: Following a two-year transition period and subject to conditions set out in the directive, the “passport” will be extended to the marketing of non-EU funds, managed either by EU AIFM or by AIFM based outside the EU. In accordance with the principle of “same rights, same obligations”, this approach will ensure a level playing field and a consistently high level of transparency and protection of European investors. The phased introduction of the third country passports will allow European supervisors to ensure that the appropriate controls and cooperation arrangements necessary for the effective supervision of non-EU AIFM are working effectively. Before the third country passport is introduced, and for a period of three years thereafter, national regimes will remain available subject to certain harmonised safeguards. Once this period has elapsed, and on the basis of conditions set out in the directive, a decision will be taken to eliminate the national regimes. At this point, all AIFM active in the EU will be subject to the same high standards and enjoy the same rights.

Optional exemptions for smaller funds: The directive gives member states the option not to apply the directive to smaller AIFM, namely funds with managed assets below EUR 100 million if they use leverage and with assets below EUR 500 million if they do not. Smaller funds will however be subject to minimum registration and reporting requirements.

The need for regulation and oversight of hedge funds is also the subject of ongoing discussion at international level within the G-20, the International Organisation of Securities Commissions and the Financial Stability Board.

Other Regulatory Updates



Solvency II - impact on asset managers

Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry. The directive has redefined the capital requirements imposed on all EU insurers and it is expected to be implemented across Europe by 1 January 2013.

Although the directive is primarily aimed at insurance firms, there is no doubt that its requirements will have implications for any asset management firm which does or plans to do business with insurance companies.

The exact details relating to the frequency and specific calibration of the capital requirement calculations and the reporting obligations imposed on insurers have still to be finalised and until these are finalised it is not possible to understand fully the detailed requirements being imposed on insurers and asset managers. However, the likely new requirements have been considered in recent publications in order to alert insurers and asset managers to the likely impacts of the directive.

Impact of Solvency II on asset managers

There are a number of ways in which asset managers will be impacted by Solvency II.

1. In the shorter term, the most significant implications will be the data requirements of Solvency II. The directive requires all insurers to calculate their Solvency Capital Requirements (SCR) on at least a quarterly basis in order to determine the overall capital requirement for all risks arising from assets and liabilities. The calculation will require the insurer to obtain extensive information from third parties, including relative asset managers. The calculation will be complex with a range of inputs which will require asset managers to provide detailed asset data. Given these requirements, the onus is being placed on asset managers to ensure they can provide accurate, timely and robust data to any insurance customer to enable it to comply with the new Solvency II obligations. Asset managers will need to understand the exact data needs of their insurance companies and develop an acceptable solution in each case.
2. Solvency II also requires insurers to provide annual disclosures to markets in order to increase transparency. Core information will also need to be reported to their regulatory supervisors on a quarterly basis which will necessitate that asset managers are able to facilitate the data provision required within short periods after the end of each quarter.
3. Solvency II will prompt insurers to review the mandates that they award to asset managers and bring asset managers under closer scrutiny. Solvency II makes asset-liability mismatches and investments in volatile assets both transparent and costly and thus, asset managers will need to be more active in all the steps of the product life cycle to ensure that these situations do not occur.
4. A desire to lower their SCR may lead insurers to focus on bonds over equities as this would reduce the volatility of their balance sheets

Solvency II will have significant effects on asset managers and service providers, especially in the area of asset data reporting. More than ever, asset managers will need to see themselves as a service provider for the actuarial practice. They will need to ensure that they can provide accurate, timely, suitable data to insurance clients. The nature of such data requested may vary from one insurer to another and will also vary from investment fund to fund. Therefore, in order to understand fully the likely data requirements of their customers, it is imperative that asset managers initiate engagement with all insurance companies in regard to their Solvency II requirements sooner rather than later in order to develop a practicable solution for all parties and to comply with the new legislation.

FATCA update

The Foreign Account Tax Compliance Act of 2009 (“FATCA”) was introduced into the U.S. House of Representatives and U.S. Senate in October 2009 and was signed into law in March 2010. FATCA impacts every foreign entity that has operations or affiliates generating U.S. source income and includes foreign affiliated entities of a US-based organization.

FATCA is a response to the continued perception that U.S. individuals are not reporting all of their U.S. income earned outside the U.S. either due to the lax standards or intentional actions of certain foreign entities. FATCA’s impact on the U.S. information reporting and withholding regime is sweeping, as it creates a new chapter to the Internal Revenue Code that is focused on strengthening information reporting and withholding compliance with respect to U.S. persons who invest through and/or in non-U.S. entities.

On 8 April, 2011, the Internal Revenue Service (IRS) issued Notice 2011-34 which provides supplemental guidance on the documentation, reporting and withholding requirements. It includes:

- Updated guidance for identifying U.S. accounts among pre-existing individual accounts;
- Initial guidance on passthru payments;
- Clarification of deemed compliant status for certain foreign financial institutions (FFIs);
- Further guidance on the reporting on U.S. accounts by FFIs;
- Clarification of the interaction between the existing QI regime and the new FATCA regime;
- Details of the application of FATCA to expanded affiliated groups; and
- Initial details of the certification procedures for participating FFIs.

Dodd Frank update

At its Open Meeting on the 22nd June 2011, the US Securities and Exchange Commission (SEC) adopted rules that will require investment advisers seeking to do business in the United States to register

with the Commission. Also adopted were rules that establish new reporting requirements for advisers and which impose reporting on certain advisers that will not be required to register.

The Commission also adopted a rule defining the term “Family Office” and exempting advisers who meet its requirements from registration. Historically, family offices have not been required to register with the SEC under the Advisers Act because of an exemption provided to investment advisers with fewer than 15 clients. The Dodd-Frank Act removed that exemption but included a new provision requiring the SEC to define family offices in order to exempt them from regulation under the Advisers Act. The new rule adopted at the Open Meeting on the 22nd of June enables those managing their own family’s financial portfolios to determine whether their “family offices” can continue to be excluded from the Investment Advisers Act.

Also at this meeting the SEC ratified the term “US person,” a distinction based on residence and not citizenship and which is a key element in the new exemptions.

As mentioned in our previous newsletter, there are two exemptions for non-US advisers. One is the Private Adviser Exemption - an investment adviser that solely advises “private funds” and has less than \$150 million in assets under management in the United States is exempt. The \$150 million test is based on the location from which the manager advises the private funds.

The other, the Foreign Private Advisers exemption- a foreign investment adviser is exempt as long as it meets all the below criteria:

- less than \$25 million in aggregate assets under management from U.S. clients and private fund investors; and
- fewer than 15 U.S. clients and private fund investors.

The compliance date for registration or claiming an exemption is 30 March 2012. This means that a Form ADV Part 1 to register or claim an exemption must be filed at least 45 days prior, or 14 February 2012.

Global Regulators question ETF risks

In recent years, Exchange Traded Funds (ETFs) have been very successful and the ETF market has experienced strong growth and rapid innovation. ETFs are highly valued by investors due to their features in particular their low investment costs and intra-day liquidity through exchange trading. Despite their success, a number of global regulators including the International Monetary Fund, Bank for International Settlements and UK’s Financial Services Authority (FSA) have highlighted the need for investors to consider the possible risks they face when investing in ETFs. The Financial Stability Board, the organisation set up after the financial crisis to oversee global regulators, has also raised concerns regarding the risks surrounding ETFs.

Potential Financial Stability Issues

On 12 April 2011, the Financial Stability Board, “FSB” published a note on the potential financial stability issues arising from recent trends in exchange-traded funds (ETFs). The purpose of this note is to improve understanding of possible emerging issues for financial stability by identifying potential vulnerable issues and the actions that may be needed to address them. The note claims that closer scrutiny of the ETF market is required due to a number of disquieting developments and encourages the financial industry to adapt risk management practices, disclosure and transparency early in the product cycle.

The FSB warns that both traditional and swap-based ETFs pose significant potential risks to investors.

Swap-based ETFs are those that do not own shares in the indices they track but pay a fee to the bank and, in return, the bank pays the returns of the specific index. The FSB has warned that these types of ETFs could pose more significant threats to investors than they may be aware of. The note explains their potential risks using an example of an ETF tracking the S&P500. The collateral basket for a S&P 500 synthetic ETF could be less liquid equities or low or unrated corporate bonds in an unrelated market. Consequently, the provider may face difficulties liquidating

the collateral if there was a sudden demand from ETF investors to sell their ETFs. This would then leave the provider with the difficult choice of either suspending redemptions or maintaining them and facing a liquidity shortfall at the bank level.

The FSB also provides warnings regarding traditional ETFs which do own the shares in indices they track like the FTSE 100 and the S&P 500. The note warns that these ETFs could run into similar problems to swap-based ETFs due to their tendency of lending out the shares they own. If an ETF has loaned some of its shares and investors exit the ETF in large numbers, there may be no underlying shares for the ETF to sell.

The FSB advises that in terms of collateral selection and arrangements, it is imperative that investors in ETFs exercise an adequate level of due diligence and scrutiny. This in turn requires a high level of transparency being made available by ETF providers

Response to the FSB note

EFAMA responded to the FSB note stating that a large proportion of ETFs are UCITS which are regulated by the UCITS directive and that this directive provides a robust regulatory framework for investment funds. Additionally, the UCITS regime will be further strengthened by UCITS IV Directive on 1 July 2011.

EFAMA also stated that while they support initiatives of regulators to increase understanding of ETFs, the areas of concern in the FSB note are not unique to ETFs and thus regulators need to consider other products when highlighting systematic risks.

Update on the EU short selling regulation

The European Parliament (EP), through its ECON Committee and the Council of Ministers (the Council) have adopted separate amendments to the Commission's proposal on Short Selling and since May 2011, these institutions, along with the Commission, have been engaged in a series of dialogue negotiations in order to find a compromise acceptable to all parties.

On 28 June 2011, the final trialogue scheduled by the outgoing Hungarian Presidency concluded with a number of significant issues still dividing the parties:

- *Uncovered sovereign CDS* - the Commission proposal contains no restrictions on entering into uncovered sovereign CDS positions. However, the EP's amendments introduces a ban on such behaviour;
- *The powers of ESMA* - the EP wishes to extend ESMA's powers, allowing ESMA to impose additional restrictions. The majority of Member States in the Council oppose this position and would seek to require, at worst, the consent of the Member State's national regulators before any proposed emergency action by ESMA were to become effective within a particular jurisdiction;
- *Uncovered short sales (shares and sovereign cash debt)* - the EP favours a definition which contains an obligation that the holder of a short position must, at very least, have a third party's prior agreement to reserve the relevant financial instrument, whereas the Council's preferred wording would allow for the position holder to have a 'reasonable expectation' that settlement can be effected when due; and
- *Public disclosure* - the EP text would permit significant short positions (i.e., those above an initial 0.5% threshold or an additional incremental band) to be made public on an anonymised basis. Council is pushing for the individual position holder to be named.

On 5 and 6 July 2011, the EP held a plenary session at which ECON's amendments to the Commission's draft proposal were adopted.

A meeting of the Council Working Group was held on 6 July 2011 to consider again the Council's position but the dialogues will now not resume until September.

At present, the aim remains for the Regulation on short selling to come into effect from 1 July 2012.

Update on the EC's proposal of the OTC derivatives Regulation

At an ECON committee meeting on 24 May 2011, agreement was reached on a set of amendments to the EC's proposal of the OTC Derivatives Regulation (EMIR). On 5 July 2011, the EP in plenary session voted on and approved these proposed amendments with only a small number of minor amendments.

The EP, Council and Commission will now need to agree a common position on the text. All institutions aim to finalise the agreement before the end of the year but negotiations may still continue into 2012 as there still seems to be a fairly high number of open issues. Some of the main issues still up for debate include;

- the powers of ESMA;
- whether the scope of EMIR should be extended to include exchange traded derivatives;
- the ability of Central Counterparties (CCPs) to access central bank liquidity;
- recognition of third country CCPs; and
- exemptions for intragroup transactions and pension schemes.

Contacts

The Regulatory Advisory Services team are happy to address any questions you might have on any of these regulatory news updates.

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