Financial Regulation

In the U.S., Europe and Asia, 2012 saw measured progress in the implementation of recent regulatory reforms, the Basel capital rules, the deleveraging of the financial services firms and deliberations about the role of financial supervision, in the midst of a halting recovery from the financial crisis. In Europe, the immediate financial crisis affecting certain EU member states has stabilized for the moment, while the debate continues regarding the shape and scope of EU-wide financial services regulation. At the same time, the U.S. and the U.K. are fundamentally restructuring their respective regulatory frameworks.

Despite the immense work left to be done, the regulatory progress to date offers the financial services industry at least the outlines of certainty in a number of important areas. This section reflects upon developments in financial regulation in 2012 and highlights important predictions for 2013.

President Obama's reelection and the retention of a Democratic majority in the U.S. Senate confirms that the Dodd-Frank Act is here for the foreseeable future. Two years after enactment, implementation of the act has been uneven, and much remains to be done. Many Dodd-Frank provisions took effect in 2012 without the benefit of implementing regulations. In addition, a number of the proposed rules generated a significant amount of substantive public comment and criticism — as well as legal challenges — leaving the industry with limited guidance on a number of important issues.

As the regulatory reform process has moved forward around the world, significant consequences and challenges for institutions operating across borders have emerged. Whether with respect to swaps regulation, short-selling, private fund restrictions or other opportunities for regulatory arbitrage, regulatory action in 2012 highlighted the continuing need for, and difficulty of, global coordination on financial regulation.

Last year also saw a renewed post-crisis focus by U.S. prosecutors and regulators on enforcement, with numerous ground-breaking and record-setting penalties. There were a large number of high-profile money laundering and sanctions-based settlements in 2012 — a trend that likely will continue to present a challenge to global financial services organizations throughout 2013 — as well as a record settlements with respect to practices in setting LIBOR. Large settlements regarding mortgage lending and servicing practices, coupled with the newly organized Consumer Financial Protection Bureau's proving to be a robust regulator with a series of large consumer lending settlements, also indicate that 2013 likely will see continued enforcement activity.

Excerpted from *2013 Insights*. The complete publication is available at www.skadden.com.

(Click on a title below to read the article.)

Swap Regulation: The CFTC and SEC Chart the Road Ahead

CONTRIBUTING PARTNER

Mark D. Young / Washington, D.C.

OF COUNSEL

Maureen A. Donley / Washington, D.C.

ASSOCIATE

Theodore M. Kneller / Washington, D.C.

The Dodd-Frank Act authorized the CFTC and the SEC to develop comprehensive regulations for swap transactions and security-based swaps, respectively. Considering swaps generally were unregulated before Dodd-Frank, the CFTC and the SEC have been writing for two years on a blank slate. In 2012, the agencies began to fill in many of the blanks, but much work remains for 2013 and beyond.

In 2012, the CFTC and the SEC finished the specific joint Dodd-Frank Act assignments Congress gave them: The agencies finalized the product definitions (rules defining "swaps" and "security-based swaps") and the entity definitions (rules defining "swap dealer" and "major swap participant"). These were seminal steps in the creation of a regulatory structure for swaps. In the bulk of the Dodd-Frank rulemaking areas, which Congress left to each agency to address separately, the SEC and CFTC approaches diverged, with the SEC taking a step back and concentrating on its other regulatory responsibilities, putting off the development of regulation for security-based swaps.

The CFTC, on the other hand, pushed forward in 2012 to adopt rules in many of the major areas Dodd-Frank required. The agency finalized rules setting out requirements for, among other things:

- swap reporting and recordkeeping;
- swap dealer registration and business conduct standards, including special customer protections and disclosures;
- swap documentation;
- special protections for swap customer margin funds (called legally segregated operationally commingled, or LSOC);
- the types of interest rate and credit default swaps that must be cleared by derivatives clearing organizations to prevent systemic risk; and
- the scope of the exemption from that mandate available to "commercial end users."

All of these new rules required fine-tuning; CFTC staff also issued a stream of more than 70 no-actions and interpretations to try to address the unintended direct and indirect consequences of many of the agency's new regulations.

These CFTC final rules were major, resource-intensive undertakings, but constituted at best only half of the major issues the agency must tackle in fashioning a swap regulatory structure. In 2013, the CFTC is expected to take final action on:

- required pre-trade price transparency for swaps;
- registration and regulation of swap execution facilities;
- the swap trading mandate;
- block trading standards for swaps;
- cross-border application of its new swap regulations;
- margin rules for uncleared swaps; and
- the scope of the clearing mandate for currency, equity and commodity swaps.

In addition, the CFTC will reconsider the issue of speculative position limits at the same time it pursues an appeal from a district court decision invalidating the physical commodity position limits the CFTC adopted in 2011.[1]

Trends to Watch

Some big-picture trends developed in 2012 that will necessarily permeate the CFTC's consideration of the yet-to-be-finalized rules and the implementation of the rules it already has adopted.

Cross-Border Issues. The CFTC's 2012 proposals for cross-border application of its rules have resulted in the expression of serious concerns from non-U.S. market regulators that the CFTC's swap rules exceed the agency's authority and superimpose rules on market participants outside of its jurisdiction. These proposals have had real consequences, with some market participants deciding to eschew transacting with U.S. entities to avoid becoming subject to CFTC swap regulation. These actions already have closed off some sources of liquidity to U.S. market participants.

The CFTC and its foreign counterparts can be expected to discuss how to achieve the coordinated international regulation of a global marketplace. Without this kind of cooperation, regulatory disparities and asymmetrical application of derivatives rules could lead to losses in liquidity and increased costs that could harm many market participants. The December 2012 announcement by the CFTC and its fellow international regulators pledging a harmonious and cooperative approach in the future seems like a solid step in the right direction.[2]

> "Without international cooperation, regulatory disparities and asymmetrical application of derivatives rules could lead to losses in liquidity."

Swap "Futurization." The CFTC also will need to adapt to market evidence that its new swap regulations (based on somewhat different statutory provisions and structures from futures) have caused exchanges and other market participants to try to achieve their trading and hedging goals through futures products rather than swaps. The Intercontinental Exchange's (ICE) October 2012 decision to shift its energy swap business to futures to take advantage of the decades of regulatory certainty that futures have experienced was the first evidence of this phenomenon, which some have dubbed the "futurization of swaps." This trend is widely viewed as a response to customers that feared the cost and uncertainty of many of the swap regulations the CFTC promulgated, a fear that as of yet is unabated.

These cross-border and futurization forces suggest that the CFTC's still-to-come final rules will need to focus more on, and be more attentive to, the expected costs of new regulations on market participants. Otherwise, in spite of more than two resource-intensive years developing swap regulations, the CFTC may find that the swap markets its rules were designed to cover are much less robust and have fewer market participants than the agency expected when it began this process. More practical attention to the cost of regulation also will allow the CFTC (and the SEC) to be more confident that the final rules it adopts are defensible in court should parties decide to challenge those rules, as we have seen in the past.

---

[1] *See ISDA v. CFTC*, No. 11-cv-2146 (D.D.C. Sept. 28, 2012), *appeal docketed*, (D.C. Cir. Nov. 15, 2012).

[2] Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market, CFTC Press Release (Dec. 4, 2012), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6439-12.

The JOBS Act: Important Questions for Private Funds

CONTRIBUTING PARTNERS

Heather Cruz / New York

Phillip H. Harris / New York

ASSOCIATE

Michael D. Saarinen / New York

On August 29, 2012, the SEC proposed amendments to Rule 506 of Regulation D of the Securities Act of 1933 (Securities Act) that would eliminate its long-standing ban on general solicitation and general advertising for certain securities offerings. The proposal, which implements certain components of the Jumpstart Our Business Startups Act (JOBS Act), would require (1) all purchasers of securities sold in such offerings to be accredited investors and (2) that issuers take reasonable steps to verify that their purchasers are accredited investors.

The proposed amendments remain subject to further change prior to being finalized. In comment letters regarding JOBS Act rulemaking submitted in May and October 2012, the Investment Company Institute (ICI) recommended, among other things, that the SEC investigate the feasibility of crafting a rule similar to Rule 482 under the Securities Act for private fund advertisements. Rule 482 governs any registered fund advertisement containing performance advertising. It prescribes specific calculation methodologies for current yield, tax-equivalent yield, average annual total return and after-tax return, as well as requirements for the disclosures that must accompany performance data.

Recently, an SEC representative, speaking unofficially, indicated that the staff was seeking industry input on the ICI's recommendation, but that it was plausible to expect that certain standardized requirements for private fund performance advertising in the context of general solicitations will be established at the time the final Rule 506 amendments take effect. The SEC representative also confirmed that such standardized performance requirements would not apply to the content of materials presented in one-on-one meetings, whether a fund relies on the old or new provisions of Regulation D (Rule 506(b) and Rule 506(c), respectively). The scope and character of the standardized requirements remain unknown at this time, although the ICI is continuing to press for requirements that are similar to those of registered fund advertisements.

Regardless of the nature of the standardized requirements, private fund advertisements will remain subject to the Investment Advisers Act of 1940 (Advisers Act), specifically the anti-fraud provisions set forth in Section 206 and the rules promulgated thereunder. It should be noted that the definition of advertisement under the Advisers Act includes information communicated "by radio or television." Advisers that avail themselves of the opportunity to conduct radio or television interviews in connection with a general solicitation should be careful to ensure that such communications do not run afoul of the existing advertising rules or the new standardized requirements.

Important Questions

It is expected that a number of private funds will want to make prophylactic 506(c) filings to give themselves the flexibility to speak to the media and engage in other related activities. However, many unresolved questions remain surrounding 506(c) general solicitations by private funds, including:

- **Will a 506(c) election by an issuer that previously relied on 506(b) require the issuer to perform due diligence regarding the accredited investor status of its pre-existing investors?** The SEC has not yet provided guidance on this question. In the event that the SEC requires due diligence, we expect that many private funds will break their existing offerings under 506(b) and, after a certain period of time has elapsed, commence new offerings under 506(c).
- **Will an adviser be permitted to make separate concurrent offerings of similar products under 506(b) and 506(c)?** Logically, two issuers should not be integrated, but the matter is not free from doubt.
- **Will the CFTC harmonize its existing prohibition on advertising by certain commodity pools, including exempt commodity pools under CFTC Rule 4.13(a)(3)?** Given the expansion of the commodity pool definition to include entities using swaps and the removal of the primary exemptions historically used by hedge funds and private equity funds, CFTC regulations present significant open issues. Since the JOBS Act does not mention private funds in its text or the legislative history, the CFTC could conclude that commodity pool rules do not need to be addressed, although this extreme outcome seems unlikely. However, the pace is slow, and the impediment is real.
- **How will issuers resolve the "world sky" requirements related to prohibitions on public offerings that exist in virtually all non-U.S. jurisdictions?** Such prohibitions will need to be analyzed on a country-by-country basis to ensure that a U.S. general solicitation does not taint the offshore offering.
- **How will the states respond?** Several states also have raised concerns regarding general solicitations. Given the federal override in Section 18 of the Securities Act regarding Regulation D offerings, such concerns may seem moot. However, in view of the recent activity of the states to prosecute fraud, great care needs to be taken with respect to the content of advertisements to avoid state law issues in addition to Section 206 anti-fraud requirements.
- **How will private funds verify accredited investor status?** The SEC has stated that it is a facts-and-circumstances determination, and standards are evolving. We anticipate that every adviser will ask each new investor to affirm that its subscription was funded without the use of financing.

"Great care needs to be taken with respect to the content of private fund advertisements to avoid state law issues."

Responses to these questions will emerge over the next year or two. We expect that standard practices will be established in due course for private fund offerings in the context of general solicitations.

What Lies Ahead for US Economic Sanctions Against Iran

CONTRIBUTING COUNSEL

Sean M. Thornton / Washington, D.C.

Economic sanctions appear to be having a dramatic impact on Iran's economy, with both the value of the rial and the volume of Iran's petroleum exports falling dramatically during 2012. Many observers credit the aggressive expansion of U.S. economic sanctions in recent years, and key U.S. policymakers maintain that such sanctions continue to be a promising method of pressuring Iran to abandon its nuclear program. Expect more of the same in 2013: more new sanctions focused on non-U.S. entities that trade with Iran and continued aggressive enforcement of existing U.S. sanctions against Iran, including more large penalty settlements.

Sanctions

Because U.S. persons have been prohibited from most business with Iran since 1995, there is relatively little more that the U.S. government could impose. Instead, the recent expansion of economic sanctions has consisted mainly of secondary sanctions against third-country (*i.e.*, non-U.S., non-Iranian) persons who engage in certain business with Iran. This trend shows every sign of continuing.

President Obama signed nine executive orders imposing new economic sanctions during 2012 alone, six of which related to Iran; the impact of these recent Iran-related orders has fallen primarily on non-U.S. persons. The year ahead undoubtedly will provide occasion for even more executive orders. In late November 2012, the U.S. government called for a deadline of March 2013 for Iran to show "substantive cooperation with" the International Atomic Energy Agency in the agency's efforts to investigate Iran's nuclear program. Assuming the Iranian government does not meet such a deadline to the satisfaction of U.S. leaders, new executive orders imposing more types of sanctions on third-country entities would be a relatively quick way for President Obama to respond.

New statutes also need to be implemented. On January 2, 2013, President Obama signed into law the Iran Freedom and Counter-Proliferation Act, which authorizes additional sanctions on persons doing certain business with Iran's energy, port, shipping and ship-building sectors — each of which already is the subject of wide-ranging U.S. sanctions, but the new law provides cumulative or incrementally broader authorities. As the sanctions pile on, the legal framework becomes increasingly complex, and it can be quite difficult for non-U.S. entities to understand what conduct risks the imposition of U.S. sanctions.

Despite the new authorities to impose sanctions on third-country entities, the U.S. government has been relatively restrained in exercising them. During 2012, the U.S. Treasury Department first applied a 2010 statute to prohibit U.S. financial institutions from opening or maintaining correspondent or payable-through accounts for a non-U.S. financial institution that has engaged in or conducted a significant transaction with a designated Iranian bank. Almost every major Iranian bank has been designated for sanctions, and there likely are some large third-country institutions that meet these criteria. The Treasury Department, however, chose to impose the sanctions against two banks, one based in Iraq and the other based in China, whose names were unfamiliar to many Westerners. Similarly, despite several expansions of the Iran Sanctions Act in recent years, the U.S. State Department has imposed sanctions against relatively few

companies for their involvement in Iran's energy sector. Perhaps that will change in the year ahead, as U.S. policymakers test their expansive and growing authorities in this area.

> "Despite the new authorities to impose sanctions on third-country entities, the U.S. government has been relatively restrained in exercising them."

Sanctioned persons should remember that U.S. government decisions involving economic sanctions are reversible. Although it rarely publicizes these decisions, the U.S. government has lifted such sanctions against hundreds of individuals or entities, including some individuals it previously had branded as terrorists or narcotics traffickers, over the past several years. These decisions usually are made after the sanctioned person petitions for administrative reconsideration to the agency responsible for implementing the sanctions (usually the Treasury Department). The government rarely will admit it made a mistake, but it appears willing to reconsider the imposition of sanctions based on a credible demonstration that circumstances have changed — for example, that the sanctioned person has stopped engaging in the activities that were the basis for sanctions and will never engage in such conduct again.

Enforcement

In addition to enacting new types of economic sanctions, U.S. authorities likely will continue to aggressively enforce existing sanctions against Iran through civil and criminal processes. We should expect continued steep fines against non-U.S. banks that have conducted business for Iranian and other sanctioned clients using U.S. accounts, particularly as regulatory and prosecutorial agencies at the federal and state levels continue to compete with one another for perceived leadership in sanctions enforcement. HSBC and Standard Chartered recently resolved U.S. enforcement actions relating to Iran by agreeing to make steep penalty payments, and similar investigations into non-U.S. banks continue.

Western European banks have been the focus of U.S. sanctions enforcement efforts in recent years, but it seems unlikely that banks from that part of the world are the only ones to have engaged in the conduct. A Japanese bank recently paid a settlement for processing funds transfers through the United States in violation of existing sanctions against Iran and other countries, and press reports have suggested that U.S. authorities are beginning to turn their attention to banks in China. In the year ahead, we may see more U.S. sanctions settlements involving banks from other parts of the world. These sanctions do not apply solely to banks, and perhaps there also will be penalties in new sectors, such as securities or energy.

Of course, it remains to be seen whether or how this continued wave of sanctions and penalties ultimately will persuade Iranian leaders to abandon their nuclear program. Long-standing U.S. economic sanctions against Burma were relaxed significantly during 2012 in response to perceived progress in Burma's transition to democracy, and perhaps 2013 will bring similar good news in another U.S. economic sanctions regime. More likely, however, U.S. economic sanctions with respect to Iran will continue to follow the unmistakable trends seen in recent years: an ever-widening net of new sanctions and continued high-profile enforcement cases.

Year One at the Consumer Financial Protection Bureau

CONTRIBUTING PARTNERS

Joseph L. Barloon / Washington, D.C.

Anand S. Raman / Washington, D.C.

COUNSEL

Darren M. Welch / Washington, D.C.

Since becoming fully empowered with the appointment of Richard Cordray as its director on January 4, 2012, the Consumer Financial Protection Bureau (CFPB or Bureau) has exercised its authority aggressively through the issuance of several groundbreaking enforcement actions, numerous intensive examinations of both banks and nonbanks, and the issuance of a number of proposed and final rules that will affect all consumer financial services providers. 2013 promises to be an even busier year.

The CFPB issued several enforcement orders in the latter half of 2012 that are notable for the high remediation and penalty amounts involved as well as for the specificity of the Bureau's findings. Three high-profile cases involved credit card "add-on" products:

- **Capital One (July 18, 2012).** The CFPB found that Capital One engaged in deceptive marketing and sales practices in connection with credit monitoring and payment protection products offered to its credit card customers. The CFPB alleged that the company's call center employees deviated from sales scripts and misled consumers about the optional nature of the product and whether they had agreed to purchase the service. The consent order required $140 million to be paid in restitution to an estimated two million customers, along with a $25 million civil penalty.
- **Discover Bank (September 24, 2012).** The CFPB found that Discover engaged in deceptive marketing and sales practices in connection with the offering of credit monitoring, identity theft protection and payment protection products. In the Discover order, the CFPB found that the customer service scripts themselves misled consumers by not making it clear that the consumers were purchasing a product, or that the product had a separate fee, as well as with respect to certain other product terms and pricing. The consent order required Discover to pay restitution of $200 million and a $14 million civil penalty.
- **American Express (October 1, 2012).** The CFPB found that American Express engaged in: (1) deceptive debt collection practices regarding waiving or forgiving debt in exchange for settlement; (2) deceptive marketing of a rewards program; (3) charging impermissible late fees; (4) failing to report accurate credit history information; and (5) improperly considering the age of applicants as part of a credit scoring system. The order required remediation payments of $85 million and a $27.5 million penalty.

Notably, each of these enforcement actions was paired with an action by the institution's prudential regulator, indicating that the CFPB and traditional bank regulators likely will work together closely in enforcement actions.

The CFPB has devoted tremendous resources to the exercise of its supervisory duties. The CFPB's depository examination program is in full swing, and the Bureau has commenced on-site examinations of certain nondepository financial institutions, including nonbank mortgage lenders. Examinations to date have proved to be both comprehensive and intensive. The Bureau recently finalized the rules to identify nondepository "larger participants" in the consumer reporting and debt collection markets for supervision by the CFPB. In 2013, the CFPB will continue with larger-participant rulemakings in other nondepository markets, which will subject a wider range of financial services companies to supervisory examinations.

Finally, the CFPB has exercised its rulemaking and guidance functions. In 2012, the CFPB issued proposals regarding loan servicing standards, TILA and RESPA disclosures, and loan originator compensation. In addition, it issued guidance regarding fair lending, marketing of ancillary credit card products and other topics. The Bureau also has conducted a number of consumer market studies, indicating it intends to engage in "data-driven" enforcement and rulemaking.

Looking Ahead

The Bureau will issue a number of important rulemakings in 2013, including mortgage origination rules addressing the "ability to repay" and "qualified mortgage" safe harbor. We expect that the Bureau will then turn to developing rules for new mortgage and small business data reporting requirements. The Bureau also may take action to limit the use of mandatory pre-dispute arbitration provisions in loan agreements and to limit overdraft fees and prepaid card fees.

The EU's Short-Selling Regulation: Notable Requirements and Restrictions

CONTRIBUTING COUNSEL

Patrick Brandt / London

The European Union's regulation on short-selling and certain aspects of credit default swaps (Regulation (EU) No 236/2012) (the Regulation) came into effect across the EU in November 2012. The Regulation is designed to remove the panoply of short-selling requirements previously in place in different EU member states. However, there are two main exceptions. First, the Austrian short-selling regime will remain in place until the end of a transitional period that expires on July 1, 2013. Second, EU countries can introduce separate, emergency short-selling measures in liaison with the European Securities and Markets Authority (ESMA), the EU securities regulator, which Spain did in November 2012.

The Regulation also gives ESMA power to ban or restrict short-selling and impose additional disclosure requirements, which is part of a tentative trend toward EU regulation. It is supplemented by a number of delegated acts that apply across the EU and were introduced after very short consultation periods. The new regime is highly technical and has raised a large number of issues. It is possible that the regime will be amended after its review by the European Commission in 2013.

The Regulation focuses primarily on short positions taken in EU shares and EU sovereign debt, and on EU sovereign credit default swaps (CDS).

Notification and Disclosure

Holders of net-short positions in EU shares and EU sovereign debt that cross certain thresholds will trigger a number of regulatory notification and public disclosure obligations:

- Net-short positions in EU shares must be notified to the local regulator where the net-short position reaches/falls below 0.2 percent of the issued share capital of the company concerned (and in increments of 0.1 percent above that initial threshold).

Public disclosure must be made for net-short positions of 0.5 percent (and again, of increments of 0.1 percent above that initial threshold); and

- Net-short positions of EU sovereign debt and uncovered CDS positions that cross specific thresholds published by ESMA for each member state must be notified to the local regulator. There is no public disclosure obligation.

Calculating Net-Short Positions

The rules on calculating net-short positions contain complex underlying detail, but broadly:

- The net-short position in EU shares is the position remaining after deducting any long position held in the company's issued share capital from any short position held in relation to that capital; and
- The net-short position in EU sovereign debt is the position remaining after deducting (1) any long position in relation to issued EU sovereign debt and any long position in highly correlated debt instruments of a sovereign issuer from (2) any short position held in relation to the same EU sovereign debt.

There also are special rules for how fund managers and groups calculate and report net-short positions:

- A fund manager must aggregate the net-short positions of the funds and portfolios under its management for which the same investment strategy is pursued in relation to a particular issuer. This includes the positions of funds and portfolios that have been delegated to it by a third party but excludes net-short positions taken by its own delegates; and
- A group must aggregate the net-short and long positions held by the entities within that group, excluding the positions of fund management entities, and report any group net-short position.

Restrictions on Short-Selling and Uncovered CDS

Uncovered short-selling of EU shares or EU sovereign debt is banned. Therefore, short-sellers need to put arrangements in place to ensure that the relevant financial instrument is available for settlement. There are further restrictions as to what type of arrangements will be sufficient. For example, borrowing or location agreements only can be entered into with certain third parties.

CDS transactions only can be entered into for legitimate hedging purposes, which include:

- a long position in the EU sovereign debt of the relevant issuer;
- any position or portfolio used in the context of hedging exposures to the sovereign issuer referenced in the CDS;
- any assets or liabilities that refer to public sector entities in the member state whose EU sovereign debt is referenced in the CDS, such as exposures to central, regional and local administration, public sector entities or guaranteed exposures;

- exposures (such as loans, counterparty credit risk, receivables and guarantees) to private sector entities established in the member state that is referenced in the EU sovereign CDS; and
- indirect exposures to any of the above entities through indices, funds or special purpose vehicles.

> "The regulation is designed to remove the panoply of short-selling requirements previously in place in different EU member states."

Exemptions

The Regulation contains a number of exemptions that can be used by market makers, authorized primary dealers on sovereign debt markets, and firms that enter into short sales or have net-short positions in relation to stabilization programs.

Extraterritoriality

The European Commission and ESMA have asserted that the Regulation has extraterritorial effect outside the EU. Therefore, non-EU persons contracting outside the EU are subject to the same reporting requirements and restrictions as EU-based persons. This is controversial, but we expect any non-EU financial services group with EU places of business will look to comply with the Regulation on a global basis. Those entities with no EU place of business or EU subsidiary will need to consider the legal and practical issues of whether to comply with foreign laws, which we expect may include an assessment of enforcement risk.

Restructuring the UK Regulatory Framework: What the Financial Services Industry Can Expect

CONTRIBUTING COUNSEL

Patrick Brandt / London

An operational split of the U.K.'s Financial Services Authority (FSA), abolishing the agency and dividing its functions and staff between two new regulators,[3] began earlier this year. The formal handover will become effective in April 2013, when the two new regulators formally assume their roles.

The new financial services regulators will be:

- The Prudential Regulation Authority (PRA), which will be the prudential regulator of banks, building societies, insurance companies and systemically important investment firms with permission to deal as principal. The PRA will be a subsidiary of the Bank of England and will implement the macroprudential policies of the bank's Financial Policy Committee, which is charged with maintaining U.K. financial stability;
- The Financial Conduct Authority (FCA), a self-standing body that will oversee the conduct of business by all regulated firms, including those regulated by the PRA. It also will be the prudential regulator of any financial services firm that is not PRA-regulated. The FCA will inherit the FSA's role as listing authority and also will be responsible for regulation of U.K. wholesale financial markets, including investment

[3] The FSA's current regulatory responsibilities for settlement systems and recognized clearing houses will be transferred to the Bank of England and not to either of the new regulators.

exchanges. Finally, the FCA also may be given the Office of Fair Trading's current authority to regulate consumer credit.

The move to a new "twin peaks" model of regulation comes with implementing laws that require both regulators to consult with each other on a number of issues, including applications made by U.K.-regulated firms. Although not expressly stated — or even admitted — it appears that the PRA will have the upper hand, as it has been given, in certain circumstances, a right of veto and direction concerning certain FCA-regulated matters.

Impact on Firms

- Firms already regulated by the FSA will be grandfathered into the new regime — they will not need to reapply to the PRA or FCA to continue carrying out U.K.-regulated financial services business.
- Both regulators will, in time, have their own separate rulebooks. Initially, each regulator will adopt the relevant parts of the existing FSA Rulebook. Both, however, have indicated that they will review these rules with a view toward adopting separate rulebooks in the future. These separate rulebooks likely will increase the compliance burden for groups that contain both PRA- and FCA-regulated businesses.
- There will be a change in supervisory approach, which already is starting to be felt in the U.K. Both the PRA and FCA will take a more judgment-based and interventionist approach to regulation. Each regulator expects to challenge senior management business decisions that conflict with regulatory objectives, although they acknowledge that their own decisions may be proven wrong in time. In short, U.K. regulators will aim to prevent what they see as the flawed decision-making that led to the financial crisis.

> "The new U.K. regulatory model represents a toughening of standards and approaches in line with trends in other OECD countries."

- The effects of this new approach also will be felt in the wholesale and institutional markets. Recent FCA senior staff speeches make clear that there will be no *caveat emptor* assumption for entities operating in those markets. The FCA likely will judge whether counterparties are in fact equal and whether the treatment of a counterparty could have adverse effects on end investors, such as fund unitholders for example.
- At an operational level, the application process will be more complex, especially where the firm concerned is a PRA-regulated bank, insurer or investment firm. For example, entities looking to acquire threshold stakes in PRA-regulated firms that trigger U.K. change-of-control approval laws will find that their applications need to be vetted by both the PRA and FCA.
- The FCA will have the authority to block product launches and ban the sale of existing products. FSA staff have prepared for use of these new powers by announcing a ban on the sale of senior life-settlement products and other alternative funds to most U.K. retail investors. The FCA also will be able to order firms to withdraw and amend misleading marketing material, with immediate effect.
- Enforcement procedures will be tightened. Currently in the U.K., an entity or individual subject to enforcement action receives a warning notice setting out the regulator's case and providing a formal opportunity to rebut the allegations. These warning

notices normally are kept private and, if the entity or individual shows that there is no case to answer, there should be no reputational damage. Under the new regime, however, the regulator will be entitled to publish the warning notice allegations. This may not be particularly inconvenient for entities. For individuals who are charged, however, this could unnecessarily damage their reputations, particularly where the regulator subsequently agrees that there is no case to answer.

The new U.K. regulatory model represents a toughening of regulatory standards and approaches in line with trends in other Organisation for Economic Co-operation and Development countries. Given the importance of financial services to the U.K. economy, however, the industry hopes that the new regulators will use their new powers and approaches effectively — but proportionately.

English Limited Partnerships: Liability Definition Remains Elusive

CONTRIBUTING PARTNER

Stephen G. Sims / London

In November 2012, investors in an English limited partnership, Henderson PFI Secondary Fund II LP, lost their claim against the fund's manager and general partner for an alleged breach of the fund's investment policy.[4] While the investment policy claims were defeated, the case has highlighted a number of important issues for fund managers and investors who use English limited partnerships as fund vehicles.

Background

The limited partnership is the pre-eminent vehicle for private equity and related private investment funds throughout the Western world. Investors become limited partners and, provided they do not participate in the partnership's management activities, benefit from limited liability for the partnership's debts.

However, in England the vehicle's appeal comes with an opaque definition of limited liability, which has presented challenges over the years. Despite a 2003 Law Commission Report proposing reforms, the Limited Partnerships Act of 1907 (1907 Act) has gone virtually unchanged for a century. There also has been a dearth of relevant case law, but the *Henderson* decision highlights several factors that underscore the need for clarification of the 1907 Act.

Involvement in Management

Section 6(1) of the 1907 Act provides that "a limited partner shall not take part in the management of the partnership business, and shall not have power to bind the firm. … If a limited partner takes part in the management of the partnership business he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner."

[4] Certain Limited Partners in Henderson PFI Secondary Fund II LP (a firm) and Henderson PFI Secondary Fund II LP (a firm) and others, [2012] EWHC 3259 (Comm).

This was relevant to the *Henderson* proceedings because the limited partners sought a declaration that they would not lose their limited liability by bringing a derivative action in the name of the partnership against its manager. In England, a derivative action is permitted where special circumstances justify it. Henderson's general partner, who has responsibility for managing the partnership, refused to do so on the basis that it did not consider the manager guilty of wrongdoing. Henderson also was conflicted due to its relationship with the manager.

In his decision, Mr. Justice Cooke held that a derivative action was available to the limited partners but that they would clearly be participating in management, noting that "there are potentially grey areas no doubt but the conducting of litigation on the part of the Partnership is not one of them."

Loss of Limited Liability

While the judge's view regarding participation in management through a derivative action is unsurprising, Mr. Justice Cooke went on to state that the liability wording in Section 6 has a temporal, rather than purposive, meaning. A limited partner will be liable for all debts and obligations incurred while he takes part in management, whether or not they are connected to the management activities undertaken by him. The judge also raised the possibility that the limited partner could be liable in place of the general partner, stating that "he supplants the general partner and becomes liable as if he were the general partner."

The suggestion that the general partner could be relieved of liability does not appear to be supported by the legislation and would put the general partner in a better position than an ordinary partner in a general partnership.

Importance of the Manager's Opinion

The Henderson fund manager's powers included the ability "to do all or any other acts as are required of the Managers by this Agreement or as are necessary or desirable in the reasonable opinion of the Manager in furtherance of the foregoing powers and consistent with the terms of this Agreement."

> "The *Henderson* decision highlights several factors that underscore the need for clarification of the 1907 Act."

Mr. Justice Cooke cited case law relating to the existence of a similar clause in the objects of a company's memorandum of association, which made the bona fide opinion of the directors sufficient to decide whether an activity of the company was *intra vires*. In doing so, the judge held that this clause makes "the reasonable opinion of the Manager the touchstone for its powers." He concluded that if, contrary to the judge's view, the investments were in fact outside of the restrictions in the limited partnership agreement's investment policy, but the fund manager "reasonably takes the view that the activities on which they embark are necessary or desirable in furtherance of the powers given to them and set out earlier in the clause, and are consistent with the terms of the Agreement," then the manager's actions are authorized.

Indemnification

In a similar line of reasoning, the judge held that the inclusion of an indemnity for acts (other than negligent or other culpable ones) "arising out of or in connection" with circumstances relating to or resulting from the provision of services to, or in respect of, the partnership, extended to making unauthorized investments where the manager reasonably believed them to be authorized. This was despite the manager's obligation to cause the partnership to make investments only in accordance with the investment policy. In this context, the manager was entitled to be indemnified if not negligent (or otherwise culpable).

The judge refused to apply the *contra preferentem* rule whereby a clause will be construed against the draftsman, on the basis that the parties were of equal bargaining power and were sophisticated commercial entities.

* * *

The years following the onset of the financial crisis have seen a number of disputes involving English limited partnerships and the rights and obligations of general and limited partners. Investors and managers should consider whether changes are required in light of *Henderson* and other cases.