

Investment matters

KEY ISSUES

for life assurers and fund managers



- Pension scheme buy-outs – fad or fixture?
- “Wrapping” – from first principles
- A new retail investment landscape
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- Feeling the crunch
- Talent wars: are you at risk?

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This newsletter is intended for clients and professional contacts of CMS Cameron McKenna LLP. It is not an exhaustive review of recent developments and must not be relied upon as giving definitive advice. The newsletter is intended to simplify and summarise the issues which it covers.



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IN BRIEF

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Welcome to the first edition of 'Investment Matters', our quarterly newsletter for the investment community which covers a wide variety of legal and regulatory issues.



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The current investment market is often described as “challenging”, and firms face a wide variety of threats from all sides as they battle to recover investment losses and to retain clients, funds under management and their top performers. We look at some of these challenges in this edition, assessing the prospect of litigation arising out of the credit crunch and offering some tips on how firms can minimise their risk in the talent wars.

To add to firms’ workloads, the UK’s Financial Services Authority continues to issue its constant stream of discussion papers, consultation papers and policy statements, whether in response to market developments or developments at a European level (e.g. MiFID or UCITS) or, seemingly, just to keep its policy team occupied. Selecting just two topics for this edition was quite difficult, but we have chosen wrap platforms and the Retail Distribution Review as these complement each other and threaten to alter the retail investment landscape in the UK quite dramatically.

Despite the current challenges facing the industry, there remain a few opportunities, two of which we look at in this edition. One of these is the booming pensions buy-out market, which continues to expand and innovate at a brisk pace with stiffer competition. The other is climate-related and environmental investments, such as those involving sustainable building and regeneration schemes, are becoming increasingly popular both with retail and institutional investors. Some of our clients have developed and marketed funds focusing on a range of such “green” investments, whilst others are simply looking to improve their CSR ratings and reduce the environmental impact of their existing investments and activities.

We hope you find the articles in Investment Matters interesting and thought-provoking. If you would like to discuss any of the topics covered, please do give one of us a call.

Pension scheme buy-outs

fad or fixture?

You only have to open the pages of the business press these days to find another company offloading its defined benefit pension scheme. The pensions buy-out market, which was struggling to take off this time last year, is suddenly flying.

After a bumper fourth quarter in 2007, estimates suggest that almost £2 billion of new business has been done in the first quarter of 2008; and the market is expected to more than double this year.

In fact, so much has changed over the past 12 months that the pensions buy-out market is perhaps no longer an appropriate term: there are now a large number of solutions other than the traditional annuity buy-out with an insurance company all of which aim to transfer responsibility for pension liabilities away from a company and, crucially, away from its balance sheet.

Key drivers of activity

The rationale for companies to offload their pension liabilities has become more compelling in the past three years. First, there was a strengthening in company accounting requirements; second, a new Pensions Regulator was appointed; and, third, a new regime for pension scheme funding was introduced. This has generally required significant increases in companies' cash contributions into their schemes, not only draining precious corporate resources but also improving schemes' funding levels to such an extent that buy-outs are no longer totally out of reach.

And, as buy-outs have come within range, the buy-out market itself has become more competitive. Many new providers have emerged, all keen to do business, with the result that some people believe the market is currently undervalued and presents a unique window of opportunity for companies interested in this option.

But these conditions have been in place for twelve months now. What has triggered the explosion in activity since then?

The first change is that someone else has now taken the plunge. Many companies did not want to be first in case it upset staff and unions or was viewed as a desperate step by the market. Now that the likes of Rank and Emap have completed significant pension liability transfers, others are now more relaxed about following suit. Similarly, the new providers have now completed a few deals and no longer need to stare at their shoes when asked about their track record.

The second change, which will sustain the market through 2008 and beyond, is in the financial climate. In the carefree days of last summer, many pension schemes were fully funded on an accounting basis, while their cash funding positions had been strengthened by stock market rises.



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Finance directors quickly forgot the lessons of previous years – that defined benefit schemes carry an inherent risk – and were unwilling to commit the funds required to buy out such a docile liability. Recent stock market falls have changed all that.

The third change was the proposal by the Pensions Regulator that schemes should significantly strengthen their mortality assumptions. The use of strong mortality assumptions by insurers is a key reason why buy-outs are so expensive. The Regulator’s proposal will increase actuarial valuations of liabilities for ongoing schemes, which will in turn increase the cash contributions required from companies and so bring the buy-out cost even more into range.

And the clincher, if these were not enough to make every finance director think about buy-out, was proposed changes to accounting requirements which might substantially increase the size of the deficit being carried on the balance sheet.

Key requirements

The three most important issues when considering a pension liability buy-out are the same today as they were ten years ago: security of member benefits, administrative capability to pay the benefits and price. However, their relative importance has changed and there are now other issues to be taken into account.

This is partly because the client has changed. A few years ago, nearly all pension buy-outs were by schemes in wind-up. As most were under-funded, the only solution was often to cut back members’ benefits as companies were not obliged to fully fund the scheme even if they could afford to. In those cases, the process was led by the scheme trustees with little or no involvement from the company. Price was the overriding factor as the better the price, the more benefits members would receive.

Today, companies are required by law to fully fund their pension scheme. Where

the company is insolvent and scheme funding falls below a certain level, the Pension Protection Fund will step in. As a result, most new buy-out activity is from ongoing schemes with ongoing sponsoring employers. This means that both the company and the trustees are involved, with the company usually in the driving seat.

For companies, price is still the primary focus but their concerns about reputation mean that security and administration are important too. For trustees, whose agreement is needed for nearly all pension liability transfer exercises, priorities have begun to change from price to security of member benefits and administrative capability. They now know that the company must fund the benefits and so price can be given less prominence. However, in some cases, security is still not given the level of attention it requires.

Today’s client is also more demanding: they want to transfer their pension liabilities, but in the way which suits them best. The market has recognised this as a call for innovation and responded, just as the domestic mortgage market developed different ways to obtain a secured loan.

“Now that the likes of Rank and Emap have completed significant pension liability transfers, others are now more relaxed about following suit.”



But retaining a trust structure can bring its own issues. Both the provider and the company have less control over the future running of the arrangement. The trustees may change over time and wish to take the scheme in a different direction. The Pensions Regulator is very keen to ensure that trustees in this situation comply fully with their fiduciary duties to scheme members, and is currently being granted greater powers by Parliament to replace trustees who it thinks are not adequately protecting members' interests.

Timing is everything

Another big area of innovation is in the timing of the buy-out. Partial and staged buy-outs are becoming much more common. These suit companies who want certainty about the buy-out terms but need to clear up a few issues or accumulate more funds before they complete the process.

Partial buy-outs involve buying out part of a scheme's liabilities (eg just pensioners), usually because they cannot afford to buy out everyone. Staged buy-outs enable the scheme liabilities to be bought out in stages, triggered by agreed events or dates. This usually transfers mortality risk to the provider at the outset and allows market risk to be matched. All liabilities are transferred over time, the price mechanism is agreed in advance and the company has less cash to pay up front and more time to find the remainder.

Staged buy-outs can be used to give a scheme time to clean itself up in the knowledge that, when it is ready, the buy-out terms are pre-agreed. It might simply want to cleanse membership data so that everyone knows what liabilities are actually being transferred to the provider.

Alternatively, it might want to reduce the liabilities being transferred by first encouraging deferred members to transfer their benefits elsewhere, although there is an obvious risk that members may select against the scheme during such an exercise. Inducements offered might be an enhanced transfer value or a cash inducement or a mixture of the two. The buy-out pricing mechanism should then automatically reflect a cost reduction for each member who transfers.

Companies can offer a significant enhancement to a standard transfer value before it reaches the cost of a deferred annuity, so it makes good commercial sense for them to do so. However, it is currently difficult for financial advisers to recommend that members accept enhanced transfers, partly because there are no products which offer to reduce or insure any of the risks taken on by the member when leaving a defined benefit pension scheme. This unexploited segment of the market represents a significant opportunity for retail product providers as the market for deferred member enhanced transfers is vast.

The future

The combined effect of competition and the credit crunch means that not all new providers will establish themselves in the pensions buy-out market (or whatever name it should be known by). Some will consolidate in an attempt to build market presence but others will walk away and reinsure themselves off-risk for existing clients. However, enough free capital is already committed to the market for it to cope with expected demand, and for innovative products and attractive pricing to continue. The outlook is rosy, at least for now.

When is a buy-out not a buy-out?

A number of buy-out clients want to offload their pension liabilities but do not want to do a full buy-out. The trust structure is seen as a source of comfort for many pension scheme members. Retaining a board of trustees to look after the members' interests keeps a barrier between the members and the buy-out provider and avoids the appearance that the company is dumping its pension liabilities.

Some companies therefore want to retain the trust structure whilst removing their liability to fund it. Some would like to transfer their funding liability to a third party without informing the scheme members. This can be achieved by the trustees holding a bulk annuity policy as an investment within the existing scheme, instead of buying individual policies for each member outside the scheme. Alternatively, instead of turning to an insurance provider, they might arrange for a bank or other provider to back the scheme in their place.

“Another big area of innovation is in the timing of the buy-out. Partial and staged buy-outs are becoming much more common.”

“Wrapping” –

from first principles



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An increasing number of online platforms or “wraps” are now being used within the financial services industry to purchase investments and to monitor and manage clients’ asset allocations and risk exposures.

These platforms allow comparison and purchase of products such as ISAs, SIPPs, life products and collective investment schemes. Most are used by intermediaries only but some can be accessed directly by consumers. The majority are accessed via the internet and many can be integrated into an intermediary’s back office process.

According to a recent Personal Finance Society survey, 84% of intermediary respondents already use a platform. Providers have reported that intermediaries now use platforms for between 30-70% of new business, while Datamonitor has suggested that around €2.8 trillion worth of assets can now theoretically be ‘wrapped’. Certainly the number of platform providers is steadily increasing

as insurers look for less capital-intensive ways to make money and “independent” platforms enter the market to compete with the provider-owned offerings.

While the platform market is the subject of much debate and research, there is still no obvious consensus about the range or combination of services likely to be offered through them in the longer term. Until now, the term “wrap” has tended to denote platforms which provide access to a broad range of asset types and tools, whereas “fund supermarket” has been used to describe those with a narrower focus. However, in many cases this distinction is blurring as fund supermarkets expand their service range.



In an ever more crowded market place, platform providers need to define their offerings and advisers need to decide what service they want from their platform provider. If an adviser provides a relationship-driven service to its clients, the full range of tools available in a wrap may be most appropriate.

However, for sales-driven commission-remunerated advisers a more basic fund supermarket may be perfectly adequate. The re-polarisation proposed by the FSA in its interim report on the retail distribution review (where advisers must give advice on the whole market and everybody else is simply a salesman) may polarise the platform market as well as the intermediary market.

The FSA's approach to platform regulation

The FSA has stated that it does not want to inadvertently restrict the platform market, as the market is very dynamic at this stage of its development. The FSA's preferred approach is to follow its initiative of more principles-based regulation and not set out prescriptive rules for platforms. It considers its existing Principles for Businesses will be sufficient to address the risks associated with platforms. This offers flexibility for the market to follow its own growth path.

The FSA will, however, pay close attention to whether and how all firms are meeting the Principles for Businesses and Treating Customers Fairly obligations. If the FSA finds platforms or advisers are not

satisfying these regulatory obligations it may decide to introduce detailed requirements.

From our work with different platforms and in light of what the FSA has said in this area, we discuss below some of the key issues for platforms and intermediaries.

Intermediary responsibilities

Intermediaries must conduct due diligence on the potential platforms they will be using or recommending to clients. They must decide on the scope of the service they wish to offer to customers and then find a platform that properly supports that service. Intermediaries have complained that information about certain platforms and their owners is difficult to obtain. However, the FSA expects platforms to meet requests for information from both large and small intermediaries unless the request is for commercially sensitive information.

Intermediaries providing advice from the whole of the market must be able to demonstrate that they are considering a sufficient number of products and that their choice(s) of platforms are beneficial to each customer. In many cases it may be a prudent approach to use more than one platform. Although the FSA has stated that intermediaries can use a single platform provided they fulfil their regulatory obligations, much will depend on the scope of the service offered by the particular intermediary and the particular platform. Additional care is needed when advising on pensions and life products.

“Clarity about charges is a priority for the FSA, which recognises the challenges faced by platform providers in communicating features and costs effectively.”

Disclosure of costs

Clarity about charges is a priority for the FSA, which recognises the challenges faced by platform providers in communicating features and costs effectively. The FSA is keen to work with the industry to make progress in this area but recognises that firms themselves are best placed to understand their own offerings, and to identify the important messages customers need to understand. There is no clear consensus in the industry on how this can best be achieved and there is a concern in some areas that costs are being deliberately hidden.

The FSA emphasises the need for platforms to make it clear exactly what products and services are on offer, and for information about complex charging structures to be arranged so that the overall picture is clear, rather than being scattered in different places or across different documents. The information provided should cover both the cost of accessing the services and the costs of

individual transactions. In some cases, showing these separately could make a transaction appear cheaper than it is.

Re-registration of assets

The FSA and most of the market wants the platform industry to move towards a position where consumers can transfer assets into and out of a platform quickly and efficiently, without having to convert them into cash. It is recognised that this can be difficult or impossible for certain products (mostly life policies) which cannot easily be transferred. At present, re-registration can be a time consuming, manual process. In addition, the FSA has stated that platforms should aim towards allowing *in specie* transfers wherever possible without unreasonable barriers. Where it is possible to facilitate *in specie* transfers, consumers should be able to transfer their investments out of a platform or to another platform in a swift and efficient manner. There is a concern in some sections of the industry that providers are being deliberately obstructive in order to retain assets under management and this will not be acceptable to the FSA as it is a clear breach of TCF obligations.

Next steps

As the market expands and new entrants into the platform market increase competition, further innovation will be seen in relation to the products and services offered by platforms and the products they offer. In particular, platforms

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aimed at employers, designed to promote worksite marketing of products are likely to arise. More generally, we would anticipate further growth in the number of platform providers followed by consolidation to a core number of large providers. Some may say this has already started with the merger of Selestia and Skandia but there is a long way to go before we reach the position in the USA of two main platform providers.

The FSA will be keeping a watchful eye to ensure that customers continue to be treated fairly. First, the FSA intends to engage with the platform providers with the intention of improving standards in costs and services disclosure across the industry; second, the FSA intends to undertake thematic work with intermediaries on the adoption and use of platforms; third, the

use of platforms will be an important consideration in the FSA's retail distribution review (please see page 10 for a review of the FSA's most recent thinking on this issue). In summary, detailed rules on the use and operation of platforms may not be forthcoming, but greater regulatory scrutiny and guidance seems inevitable.



A new retail investment landscape

The FSA's Retail Distribution Review is intended to revive the retail financial products market so that consumers get a fair deal, have confidence to buy more products and forgive the consumer mis-selling scandals of recent years.

The FSA attributes past failings to poor quality advice from retail distribution firms and bias resulting from commission-based selling.

In June 2007, proposals were put forward by five industry focus groups formed at the invitation of the FSA. The FSA has now published its interim review, following extensive consultation on those proposals.

The review proposes a simpler landscape comprising advisers who must be independent – first proposed upheaval – sellers who cannot advise, and generic money guidance advice catering for lack of financial awareness among potential consumers.

The FSA also wants the industry to develop a common standard for professional qualifications and to work out what rule regime is required for non-advised sales. It also wants – second earthquake – product providers to have no input into advisers' pay.

The FSA acknowledges that its proposals require considerable further work, and has invited the industry to come up with workable solutions. It also wants to review their implications in greater detail, including EU, legal and competition issues. It will then publish a statement in October 2008 covering industry responses, any proposed rules changes and a timetable.

The advisory role

The FSA wants advisers to give independent advice based on the whole of the market (WOM). The FSA proposes this tentatively 'as a basis for further consideration', recognising that this is likely to be unpopular with providers.

It also wants retail advice to distinguish between full in-depth advice offered to those able to pay a fee, and straightforward non-advised sales for those who cannot, and below that there is to be generic financial advice to assist the financially excluded.

The segregation of tied and independent advice ended in 2004 when the FSA abolished polarisation. Since then, firms have been able to adopt tied, limited panel or WOM status for different products and different customers, a move which has been broadly successful.

The market has been operating without evident problems, with tied and independent advisers distinguishing themselves by mandatory status disclosure. The proposal that tied advisers must either upgrade to WOM advice or downgrade to advice-free sales not only goes against the grain of the market and is at odds with EU practice, but is also likely to increase the numbers of people who are excluded from receiving advice for reasons of cost.

The argument that this change is necessary so that customers can distinguish between advice and selling is unsupported by any clear reasoning. There is no correlation between the size of a firm's panel and the degree of independence that it offers, especially if remuneration is agreed at arm's length.

Equally, the provision of tied advice is not inconsistent with fair treatment as the interim review seems to imply. Given that the FSA calls for market-led solutions, firms should argue that they can achieve the goal of treating



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customers fairly without needing to offer WOM advice.

However, the industry will need to give considerable thought over the next few months to designing bias-free distributor remuneration. Possibilities include 'factory gate' pricing (where the provider sets the product cost and the distributor adds its own sales costs to the total price), customer-agreed remuneration (where the adviser sets its own fees), or perhaps even a form of commission which is expressly agreed by the customer.

The sales role

The separation of sales and advisory roles is a logical development of the primary advice proposal made in 2007, recognising that investors cannot be properly advised without going fully into their needs and demands.

The FSA wants consumers to be able to make simple, straightforward choices. It recognises that guidance may be needed to help firms find a sales model which both is economically viable and meets minimum regulatory criteria.

The FSA suggests that rule changes will not be made unless there is a 'solid case' for doing so but has nonetheless invited the industry to propose new rules as they

"The FSA suggests that rule changes will not be made unless there is a 'solid case' for doing so but has nonetheless invited the industry to propose new rules as they think appropriate."

think appropriate. These should regulate who may sell, and the training and competence standards they must meet.

There may also need to be rules setting out the required sales process, including any disclosure required to enable customers to understand that they are not being advised.

Finally, the rules may need to define which products may be sold, as it is a fundamental aspect of Treating Customers Fairly that products are suitable for their target market, although another point of view is that this is best left to the market to determine.

Winners and losers

The clear potential winners, apart from investors themselves, are the private

client wealth managers, who are already operating at the proposed advice level and offer WOM advice. The proposals may also work in favour of banks and building societies, which can offer mass-market sales through their existing branch networks.

By contrast, there will be many mid-market IFAs and networks who will feel threatened because they cannot meet the higher criteria for advice, and many providers whose sales cannot survive the loss of a direct sales force, if that proposal ever sees the light of day.

Firms should study the review carefully, assess how they might adapt to the evolving model and consider how best to respond to the invitation to propose new rules. The interim review represents a remarkable opportunity to contribute to the design of the retail distribution system, and firms would be well advised to press this to maximum advantage.

CMS Cameron McKenna runs tailored RDR workshops for clients and contacts. If you are interested in discussing the latest FSA proposals with us in more detail, then please contact Simon Morris.



How green

As sustainability of buildings reaches the top of investors' agenda, can the green lease improve fund performance?

The introduction of Energy Performance Certificates for commercial buildings and Display Energy Certificates for public buildings has already helped to bring green issues to the fore. Soon, air-conditioning systems will have to be inspected every five years, while tenants who are large commercial and public sector organisations will want their landlords to help them achieve government targets to meet its Carbon Reduction Commitment. The momentum for change is gathering.

But there is still a long way to go. EPCs only rate a building's energy efficiency and CO2 emissions when it is built, sold or let. They do not address possible changes during the tenant's fitting out, which often make the building less energy efficient. They may last for 10 years but will need to be renewed if the building

undergoes significant modification. And there are further question marks about their continuing validity in situations such as where a certificate is obtained for part of a building following an earlier one for the whole building.

Moving forward

EPCs can include the assessor's recommendations for improving energy performance but there is no compulsion to implement them. Taking the idea a step further and including energy performance requirements into leases would be a leap in the dark, and unlikely to appeal to either landlords or tenants until they are able to assess the implications for rent review and dilapidations.

Furthermore, there are still no standard or industry-approved ways of measuring a building's continuing energy performance. The only initiative of note so far has been IPD Occupiers' publication of its Environment Code, which aims to set a UK standard for measuring corporate property's environmental impact.

This contrasts with the position in Australia, where there is already an industry-recognised method for monitoring and improving energy performance. This is found in the Australian Building Greenhouse Rating system which contains

targets providing a benchmark for the assessment and comparison of building efficiency. This has enabled the government to produce a series of green lease schedules which can easily be added to a normal lease contract.

In the UK, the Centre for Research in the Built Environment has produced model lease clauses and recommendations as part of a good practice guide aimed at helping landlords and tenants improve the environmental and energy performance of their buildings by reducing both waste and consumption. It was prompted to make this move by research suggesting that commercial lease agreements are considered a systemic barrier to improving environmental and energy efficiency, particularly in multi-tenanted buildings.

And there are also signs that some institutional landlords and property companies are starting to consider 'greening' their leases. Public authorities are being encouraged to do likewise by central Government. It is also likely that Display Energy Certificates will bring pressure on public bodies to make more efficient use of energy in their buildings.

But green clauses will not arrive under their own steam. Unless legislation makes them compulsory, they may be viewed unfavourably as a potential white elephant.



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is your lease?

Rewards

But there are reasons for landlords to seize the initiative, perhaps to demonstrate their own commitment to corporate social responsibility; alternatively as a means of future-proofing their leases against increased taxes, financial penalties and higher insurance costs which may be the consequences of legislation down the line.

There is also the possibility that greener leases may help to differentiate buildings from the competition, not merely for socially responsible tenants but also for those attracted by the promise of reduced energy costs, or the thought that a shared environmental commitment may lead to better landlord-tenant relations.

But the best and most obvious driver of change will be financial, if improved energy and environmental performance should help to make their buildings not just more attractive but more valuable in terms of rent and overall returns.

Most commentators advocate green provisions that are relatively simple and standardised, preferably used and endorsed by recognised industry bodies. But two major issues must first be resolved. The first is how the costs will be funded or shared between landlord

Benefits of going green

- ✓ CSR for landlords and tenants
- ✓ Improved rent and investment value
- ✓ Better quality tenants
- ✓ Future-proof against legislative/tax changes
- ✓ Competitive differentiation
- ✓ Reduced energy use

and tenant. The second issue is how green they should go.

How green?

Possible measures range from encouragement to prescription. To start with, there may be provisions encouraging the recycling of office waste and the use of environmentally-friendly cleaning equipment. A bolder step might be to require both landlord and tenant to implement energy-saving initiatives. These might include turning off PCs, air-conditioning, lighting and hot water during agreed hours, and using natural daylight where possible.

In turn, this might require changes such as the introduction of separate metering for each tenant in a multi-let building, and also changes to the service charge provisions so that the landlord can recover his costs of 'greening' the building. The landlord might also wish to implement any recommendations made by energy assessors, and recover them via the service charge.

Going further still, the landlord may seek to control tenants' fit outs and alterations by reference to their impact on the building's energy performance, require them to observe pre-agreed environmental policies, such as reporting performance data, and hold regular landlord and tenant meetings to discuss and encourage adherence to a shared environmental commitment.

But neither landlords nor tenants are likely to favour heavily prescriptive provisions or penalties for failure to meet carbon reduction targets. Clauses will need to be fair and cost effective, providing known and ascertainable advantages to both landlord and tenant.

One way or another, green leases will start to feature in the UK commercial leasing market but it is not clear yet what form they will take. What is clear, however, is that they are firmly on the agenda and whether through Government regulation or through a recognised industry standard, they will arrive.



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Feeling the crunch

What do the next 12 months hold in store for fund managers given the current challenging market conditions?

The key issues for fund managers at the start of 2007 were the challenges of retaining top performing managers in a buoyant market and the regulatory implications of MiFID and UCTIS III. What a difference a year makes. Few predicted or could have foreseen the significant deterioration in financial markets and erosion of market confidence brought about by the US sub-prime mortgage crisis and the ensuing credit crunch.

As the credit crunch has taken hold and firms are now operating in what FSA euphemistically describes as “less benign” market conditions, asset managers face new challenges and increased risks. There is a general recognition that in 2008 financial markets could be more vulnerable to external shocks and the impact on firms of those shocks could be bigger than in previous years.

Firms and FSA have had to adapt to the new economic climate. FSA has increased its surveillance of firms and markets to ensure firms have robust risk management and adequate capital and liquidity in place. For asset managers the market turmoil has demonstrated the importance of understanding how their portfolios and products might behave under stressed scenarios. FSA expects firms to ensure that they have adequately stress tested their business models to account for both firm-specific and market-wide conditions, to ensure that they can deal with the impact of market movements on potential mandate breaches, forced sales or sudden and significant redemptions.

Valuation

The market turmoil has highlighted the difficulties of valuing illiquid and complex instruments, particularly asset backed vehicles and securities, but similar issues could also emerge with other assets, such as property and private equity. Firms need to be confident they are placing a true and fair value on their positions not only on those marked to market but also on those marked to model. This means that firms need to review their valuation procedures and processes (particularly the ability of their middle and back

office to deal with complex instruments) and ensure that the values also reflect the reduced possibility in the current environment of selling particular instruments to third parties. Firms will also need to adapt to the heightened expectations of investors and regulators for greater transparency about the risks and how the instruments are valued. A failure to value fairly not only risks regulatory action but could also lead to claims being made against the firm by disadvantaged investors.

Market abuse

Market turbulence and volatility also provide an incentive and opportunity for market abuse and FSA had made the prevention and detection of market abuse a key priority even before the events of last summer. In support of its tough stance it points to the recent “trashing and cashing” of HBOS shares and its recently published market cleanliness survey which shows that nearly a quarter of takeover deals may have been preceded by insider dealing.

FSA’s agenda

FSA has made it clear that it expects firms to have robust and effective systems in place to deter and detect market abuse. This means regular, good



quality training for all staff, clear personal account dealing rules, effective supervision and monitoring of trades, effective controls around inside information, and clear escalation procedures to senior management where suspicious activity is detected.

Firms that abide by these requirements will not find themselves the subject of regulatory action should abuse be detected. FSA has not got an impressive record on bringing action for market abuse either under its civil or criminal powers. It has clearly signalled that this will change and that it is determined to do more to send the right deterrent message, which includes bringing a “steady stream of insider dealing prosecutions”.

Whether these words will translate into action remains to be seen, but FSA is certainly seeking to ensure it has all the powers it believes it needs to achieve its aim. For example, it has significantly improved its transaction monitoring system “Sabre 2” and committed itself to increased thematic visits in this area as hedge fund managers have noted. The introduction of floor calls, telephone taping requirements on firms and the acquisition of powers to offer immunity from prosecution are all seen by FSA as a way of improving its record on bringing

market conduct cases and cleaning up the market. Firms need to prepare for increased investigations and scrutiny of their systems and controls.

Increase in litigation

It is well known that in difficult times disputes and litigation tend to increase and when investors suffer loss they look to the deep pockets of the banks and fund managers to recoup these losses. Firms should therefore brace themselves for an increase in claims and, those operating in the retail sector, for an increase in FOS complaints. The credit crunch has seen a significant increase in the amount of investment litigation in the US and to a certain extent firms need to be prepared for similar claims to cross the sea, although copycat litigation is unlikely, given the substantial procedural and cultural differences.

The types of claims that firms are likely to see include claims for (i) mismanagement (for breach of mandate or negligent management of the risks);

(ii) misrepresentation (particularly where the firm produced promotional literature); and (iii) misvaluation (negligent valuation of the assets to the detriment of some investors). While some of these claims may have little merit and simply be based on a lack of investment performance, reduced liquidity and/or suspended redemption, others will raise difficult issues as to the relevant contractual relationships. As well as claims aimed at the fund management sector, we are also likely to see claims brought by fund managers against the credit rating agencies, borrower claims for mis-selling, fraud claims and an increase in employee litigation.

Firms will need to be alert to these new risks as the difficult market conditions continue, whilst at the same time ensuring that they continue to focus on conduct of business requirements and maintaining a business as usual approach. It is hoped that 2008 will end on a more positive note than on which it began.

“The credit crunch has seen a significant increase in the amount of investment litigation in the US and to a certain extent firms need to be prepared for similar claims to cross the sea.”

Talent wars: are you at risk?

Markets rise and markets fall but the one commodity that never seems to lose its lustre is talent. Even as the spectre of recession haunts the City, a number of highly successful and well remunerated individuals and teams are being lured to join rival organisations or set up on their own. The key for firms is to minimise the impact on their businesses.

It goes without saying that losing talent can have a devastating effect on the jilted firm: the departing star may soon be followed by clients and their business, while the combined effect of this exodus may undermine market confidence in the firm and harm its prospects of replacing what it has lost.

To retrieve the situation, firms often pin their hopes on restrictive covenants, garden leave and other contractual rights. This, they hope, will give them time to persuade the employee to reconsider, failing which to convince clients to stay. But there are many practical as well as legal measures which can help firms retain a measure of control over the situation and protect their business.

Practical measures

First, be certain of the ground you stand on: whatever contracts were signed initially will provide a good start but will rarely encapsulate the up-to-date position. Look for documents with signatures – salary letters, bonus arrangements, confidentiality agreements – as well as the latest versions of your staff handbook, policies and procedures.

If the employee has restrictive covenants or garden leave provisions, ask your lawyers whether they are likely to be enforceable. Enforceability depends partly on the wording, and partly on the

business interests over which it is legitimate to seek protection. These generally arise where the employee manages client relationships or has access to current confidential information.

If he manages client relationships there are a number of issues to be addressed. Is he the only person in your business who has contact with the client or are there others? Does he deal with decision-makers, or only with those who act on someone else's authority? How long has he known the client? Did he know them before he joined? The answers to these questions will help you evaluate your exposure to potential loss of business.

Security and IT

As for confidential information, what security measures are in place, such as locked cupboards, password protection and non-disclosure agreements? If none, in what sense is the information confidential, as opposed to merely important? How can employees tell the difference?

Next, examine your IT policy. Does it give you the right to monitor emails? If you don't know what to look for, confine your search to key words, limited date periods and content authored by specific individuals. You never know what it might turn up.

Consider also reminding your directors that they have a fiduciary duty to report their



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suspicions about employees planning to leave and take business with them. Evidence from colleagues can be crucial if you are to succeed in establishing wrongdoing. Ask them to check whether anyone has tried to divert or defer business opportunities due to be concluded around the time of their departure.

Collusion

Where whole teams jump ship, look for collusion between individuals. Often, it will be the most junior person in the team who leaves a trail. Examine emails between team members with nothing in the subject field; unusual patterns of emails and phone calls; and large attachments sent to personal email accounts.

There may be circumstantial evidence too: perhaps they all resigned in the same week, or their resignation letters follow a similar format. Look also for unusual behaviour patterns: staying unusually late to do photocopying or being absent for unspecified private appointments at the same time.

Then look outside your business: search Companies House to see if any of them has recently become shareholders or directors of a new company.

And don't forget to ask for their version of events: while they remain your employees, they owe duties of fidelity

and good faith and are therefore obliged to cooperate with any investigation you conduct into their activities.

Beware, however, of making unfounded allegations against them or behaving aggressively when questioning them: this may hand them the perfect opportunity to claim constructive dismissal and walk away free from any further obligations to you.

Contractual duty

For as long as they are your employees, they are bound to obey any lawful and reasonable instruction, which includes being required not to inform clients of the fact that they are leaving or where they will be going. Check their voicemail message and "out of office" email notification to ensure that these are compliant with your instruction. For a "belt and braces" approach, require all staff to say nothing on these topics.

Consider also instructing them to hand over all their company data and documents, to stop it being destroyed, copied or stolen. This will prevent them from working during their notice period but only rarely will they have a right to do so (only where they would lose key skills if prevented from using them).

You may wish to put them on garden leave during their notice period, to keep them out of the market while you

concentrate on shoring up your client relationships. If there are restrictive covenants to follow, it will impact on their enforceability. There are other pitfalls too. Before you do anything, pay close attention to the detail of their contract.

If you give them nothing to do while on garden leave, it will be more difficult to exercise control over their activities. If you assign them special projects, they may need to have contact with colleagues or customers and access to company systems and information. Assigning duties which are incompatible with their seniority or position, or which affect their ability to achieve a bonus or commission, may amount to constructive dismissal.

The end game

In the final analysis, even star employees cannot be prevented from leaving. Legal action is generally a last resort, when all other avenues have been explored. Perhaps the most obvious and often overlooked avenue is that they will be leaving for a reason – perhaps for money, promotion, a change of direction or to escape from personal conflict – and most of these are motivations you can influence in your favour. But, when you are sure there is nothing more you could have done, the only remaining action is to protect your business.

In brief

Withering profits

The FSA is consulting on proposed changes to COBS 20.2 on payments from the inherited estates of with-profits fund and invites comments by 3 September 2008. The FSA rules currently allow proprietary firms running with-profits funds to charge payments for compensation and redress in relation to their past and present policies in these funds to their inherited estates. The FSA considers that there is insufficient incentive for proprietary firms to address failures of systems and controls and this may jeopardise the intended outcome of COBS 20.2, which is that firms treat with-profits policyholders fairly.

However, the Treasury Committee inquiry report on inherited estates (just published on 19 June 2008) is critical of the FSA's approach generally in this area. The Committee was not satisfied that the FSA has provided a "robust enough framework" to manage the conflicts of interest arising in inherited estate. The report sets out a number of recommendations for the FSA and the industry covering issues such as smoothing, funding of new business, mis-selling compensation costs, shareholder tax, phasing of special distribution payments and with-profits committees. This paves the way for a wider debate about the future of inherited estates and how with-profits companies deal with them.

On a more positive note, the OFT has just published its response paper to the Treasury Committee inquiry, which considers that inherited estates and the various uses that with-profits companies make of them do not significantly distort competition in the relevant market.

Market abuse

On 5 June, the FSA published **Market Watch 27**, an update of the thematic review of controls over inside information. It includes a set of voluntary Principles of Good Practice for the handling of inside information, which were drawn up by industry practitioners representing different areas involved in M&A activity, such as issuers, corporate finance houses, lawyers, accountants, public relations firms and financial printers.

Caught short

On 13 June 2008 the FSA published new disclosure rules in relation to persons taking short positions in a company during the period of a rights issue. These rules came into force on 20 June 2008. Controversially the FSA did not undertake its usual consultation process with the market and the rules caught a number of firms, and hedge fund managers in particular, by surprise.

In effect the new rules require public disclosure of any significant (0.25% or above) short positions in securities admitted to trading on prescribed markets where the company to which they relate is undertaking a rights issue.

In the case of short positions held by fund managers on behalf of non-discretionary clients, the disclosure obligation applies to the client. In the case of short positions held by fund managers on behalf of discretionary clients, the fund manager itself should make the disclosure, although the underlying clients need not be named.

Given that failure to make the required disclosures could amount to market abuse, firms would be well advised to check the robustness and accuracy of the processes that they have been forced to put in place so quickly.

Transparency (or name and shame?)

On 27 May, the FSA published a discussion paper that explores the creation of a framework for determining what further information the regulator might publish about firms and industry sectors. The paper seeks to initiate debate on how the FSA can better utilise transparency to achieve its regulatory aims, and in particular proposes a code of practice. The FSA invites comments on the proposals by 29 August 2008.

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