

Investment matters

KEY ISSUES

for life assurers and fund managers



Madoff: the recovery position

Lessons from Lehmans

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- where are we now?

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Investment matters is prepared by the Investment Businesses group of CMS Cameron McKenna. It should not be treated as a comprehensive review of all developments in this area of law nor of the topics it covers. Also, while we aim for it to be as up-to-date as possible, some recent developments may miss our printing deadline.

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.



Welcome to the latest edition of 'Investment Matters', our regular update on legal and regulatory issues affecting the investment community.



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After reading any of the articles in this issue, the question that may be running through your mind is "Where's the money?" That was most certainly the question that investors in any of Bernie Madoff's funds were asking themselves. In their lead article, Omar Qureshi and Alison McHaffie look at the prospects of recovering any money from the wreckage left by Madoff and consider how this may just be the tip of the iceberg.

On a similar theme, Rob Hickmott and Will Dibble give their thoughts on the lessons that can be learned from the collapse of Lehman Brothers and what you should do if you suddenly find that your counterparty or broker has gone bust.

On the grounds that prevention is better than cure, Gawain Hughes and Melville Rodrigues consider the implications of

recent events on funds and outline the protections that investors (and regulators) will be looking for to make sure their money is safe. And Simon Morris and Paul Edmondson review the FSA's latest proposals on the future of retail distribution – firms may well be asking themselves where the money is to pay for all these changes...

Finally, our Funds team is running a series of seminars – details of which are included in the seminar programme at the back of this issue – and we hope you can make at least one of them.

We are sure you will find our articles of interest and if you would like to discuss any of the topics in this or either of the previous Investment Matters in further detail, please do give one of us a call.



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Madoff:

the recovery position

In the months since Bernard Madoff revealed to US authorities that his investment advisory business was a fraud, there have been plenty of headlines but little progress in locating the remaining assets. Investors and other creditors still don't know if or when they might see any of their money, nor do they know how far the web of fraudulent behaviour spread or where the blame will fall. .

What is clear is that the vast majority of the cash handed over to Mr Madoff has been lost and liquidation of the business will only deliver a fraction of what investors and other creditors thought their investments were worth. But there are other avenues to explore to increase the pot available to creditors.

Bad luck if you invested direct

Those who invested direct are in the least enviable position. There isn't really anyone to blame (or claim from) – such as advisers or other fund managers who on-invested the money and there isn't likely to be much scope for recovery from Madoff's auditors, a three-man band based in up-State New York. It is unlikely their pockets are deep or that they had adequate insurance – assuming a claim in negligence or fraud against them succeeded.

Direct investors may be better off waiting to see what happens in any US class action claim for civil recovery, as they will automatically be included in the class, unless they choose to opt out.

One glimmer of hope for “direct” investors is that if they invested via Madoff's brokerage house they may be covered under the Securities Investor Protection Corporation. However, here compensation is limited to \$500,000, with only \$100,000 likely to be payable in cash (the rest in securities). But if, as reported, there are at least 8,000 potential claimants, SIPC's compensation pot of \$1.7bn isn't going to be enough.

It gets worse

US bankruptcy laws allow the liquidator to seek to claw-back money paid out to investors in the two years before the

fund collapsed under federal law, or even six years under New York state law. The effect of these laws, coupled with recent judicial precedent on their interpretation (arising from the Bayou Ponzi fraud uncovered in 2005), is that the possible claw-back would include recovery of profits (i.e. anything above an investor's principal investment) on a no fault basis – it doesn't matter that the beneficiary did not know there was anything wrong or improper about Madoff and his activities, because he did not give value for the transfer. The trustee could even claw-back redemptions and repayments of the principal investment before the balloon went up, but only if fault – i.e. some knowledge of wrongdoing - can be found against the investor.

The key point here is the level of knowledge that triggers claw-back.

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New York counsel have been arguing over this point since the fraud was uncovered and some have suggested that, based on the judgments in the Bayou case, it would be enough for the liquidator to show that the investor withdrew because he thought the scheme was too good to be true (without any specific knowledge of wrongdoing). That may be an overly cautious view, but the losses here are large enough to make a claim on that basis worth trying.

There is precedent for this – in the Bayou Ponzi fraud referred to above the trustee successfully clawed back monies from investors for distribution among all the scheme’s creditors. Those judgments have been criticised in some quarters and may effectively be re-litigated in the Madoff fall-out. Nevertheless, this strategy sets investor against investor and may have implications for law firms and conflict of interest issues, as it may be difficult for the same firm to represent clients who employed different investment strategies.

Not all the money need go into the pot

It is also possible that the US government may try to recover funds from abroad, such as from the British

Virgin or Cayman Islands where many of the offshore hedge funds are based. If successful, the government does not have to distribute these funds to investors on a pro-rata basis and could instead reward whistle-blowers or those who helped recover the money.

The claim game

For those who invested indirectly via a “feeder” fund or through some other form of bank-created security, claims may exist against those funds or banks. It may be possible to claim against the fund’s accountants for not confirming that Madoff held the assets and these cases may be more straightforward if

“Claims against advisers who recommended investment in Madoff will involve allegations of negligent advice.”

brought in the US where they are likely to be part of a class action.

There is also the risk of worldwide

freezing injunctions being sought to preserve assets held by banks or funds who removed monies from Madoff before the balloon went up (under section 25 of the Civil Jurisdiction and Judgments Act 1982). Indeed, the recent case of *SEC v Manterfield* shows just how potent interim relief can be in support of foreign proceedings involving allegations of fraud.

Claims against advisers who recommended investment in Madoff will involve allegations of negligent advice, unsuitability and other breaches of duty relating to perceived failures in due diligence conducted on Madoff and his brokerage house. Exclusion and limitation clauses will come under scrutiny and the Courts will look at their reasonableness in light of all the surrounding circumstances, including what services the adviser claimed to provide and what fees or commissions he earned on the advice.

Advisers and other professionals should not assume last year’s Springwell decision provides definitive protection from claims by investors, even sophisticated investors, if their agreements are sufficiently tightly drawn. Just as important will be whether the adviser provided the services he purported to provide and charged fees



commensurate with that sort of advice. There may also be allegations of conflicts of interest on the basis of fee structures that gave incentive to the adviser to recommend the investment regardless of the risks. Springwell may turn out to be the high-watermark in pro-bank judgments by the English court.

For funds of funds, there will be particular concern where the investor paid a premium to the fund manager in the expectation of benefiting from additional due diligence. If some of the reports of the size of fees and commissions charged by the “feeder” funds are true, there may be some very difficult questions for them to answer where claims are brought. This sort of allegation will go hand in hand with questions as to whether the investments were within the terms of the mandate and whether the manager properly monitored the investments.

There could also be claims to FOS by retail investors if firms providing products in which retail investors have invested are not already taking steps to protect and recover any assets affected by Madoff.

For some banks the situation could be costly – those that have significant exposure to Madoff and provided a guarantee of no losses to clients must now be regretting it.

Another possible avenue for investors may be the deep pockets of the big audit firms who audited the feeder funds and who failed to detect the fraud in the underlying investments. However, investors may struggle to show that the auditors owed them a duty of care and that they relied on the auditors’ statements in making their investment decisions. The funds themselves may have a better chance of claiming against their own auditors in this regard, under negligence principles or for breach of contract.

In turn, the auditors may be covered by their professional indemnity insurance for any negligent failings. Indeed, many of the other categories of potential defendant are likely to have some form of insurance that may answer claims arising from Madoff. Even the “feeder” funds may have some recourse under their policies if they have suitably worded “extension of crime” cover. Conversely, the insurers may find themselves litigating the extent of coverage provided by such clauses and whether it is wide enough to allow a fund to claim for client losses arising from the Madoff fraud. In any event, anyone hoping to gain the protection of insurance coverage needs to notify their insurer promptly and in as much detail as possible to protect their rights.

These sorts of claims are likely to be more successful than one already started against the Securities and Exchange Commission in the US, relating to its failure to properly oversee the Madoff funds. This is because a US government body cannot be held liable for discretionary actions and in this case the complaint concerns its failure to decide to take particular actions or conduct investigations of Madoff’s business – which would appear to be a complaint as to the exercise of its discretionary powers - and so the claim is likely to fail.

If similar circumstances were to arise in the UK, any action against FSA would also be very difficult as it has statutory immunity from an action in damages unless it can be shown to have acted in bad faith.

As for the oversight bodies pursuing Madoff or other funds that invested in his funds for regulatory failings, the path is not clear. It could be argued that had the watchdogs identified the fraud themselves they would have saved investors billions of dollars. It’s not as if they didn’t receive warning – in 1999 and again in 2005, US analyst Harry Markopolis spotted

irregularities and reported his suspicions to the SEC in detailed dossiers that suggested Madoff was operating a fraudulent scheme. Given the likely criticism SEC would face in any action it took against regulated entities who invested in Madoff, it may have little stomach for taking that course.

New laws

The messy fall-out from the Madoff affair has fuelled expectations that the US government may pass new legislation, but there is little hard evidence as to what that may be. Rumours abound that the new laws may prevent claw-backs, or allow them, or clarify how they may work. Whatever happens, the situation is complex and plenty of issues need to be considered. Some investors are very elderly – does the government want to help them? Some may die before the affair is resolved. Should the government look to benefit those who inherit the claims? Should the government pass legislation that effectively lets off the hook funds of funds who failed to carry out adequate due diligence – the moral hazard argument?

But regardless of the possibility of new legislation, regulatory regimes in the US and throughout Europe will doubtless be tightened up. We might also see far tighter audit and custody rules to protect investors and the British Government may need to consider a U-turn on recent legislation allowing auditors to limit their liability.

Another “casualty” of the current climate is likely to be the “light touch” regulation that hedge funds have enjoyed to date internationally, but given that many of the issues relevant to hedge funds apply to all market participants (e.g. market abuse issues) any regulatory focus on the hedge fund market is likely to affect all regulated businesses in a similar way.

“The messy fall out from the Madoff affair has fuelled expectations that the US government may pass new legislation.”

Lessons from Lehmans

better protection...

For much of recent history the relationship between banks and counterparties has been unequal, proceeding on the assumption that the bank will always remain solvent whilst the counterparty is the party at risk of failing.

Although this assumption is fundamental to the traditional banker-customer relationship, it also applies to the contractual arrangements surrounding more sophisticated financial products where the logic is harder to justify. For example, derivatives contracts where both parties may have obligations to post monies have often been negotiated by banks on the basis that the bank will never default. Similarly, prime brokerage agreements (where commonly under English law the counterparty essentially takes net credit risk on its prime broker) have been negotiated by prime brokers on the assumption that they will always be solvent and able to honour their contractual commitments.

The collapse of US investment bank Lehman Brothers last September changed all that forever. The market had simply not expected a bank the size of Lehmans to go under and was ill-prepared for the fall-out. Reaction was instant and counterparties including large corporates and hedge funds immediately started re-examining their documentation and preparing for the previously unthinkable scenario where banks go bust.

In derivative contracts, many parties (both banks and non-banks) are now

ensuring that any exposure to their counterparties is collateralised. This is normally agreed on the basis that the amount of collateral support being posted is tied into a party's credit rating at any given time as well as its actual exposure under such derivative contracts. It should be noted that this can practically cause problems for counterparties in times of distress because, as a party's rating fails, it is required to tie up more capital or other assets as collateral.

Non-bank counterparties who have not previously been concerned with the risk of their banking counterparties becoming insolvent are now examining their derivative contracts to ensure that if a default were to occur they would be able to serve the requisite notices correctly and in a timely manner.

One issue that arose out of the unique circumstances of Lehmans' insolvency was that whilst parties wanted to serve default notices in respect of derivatives contracts on the day of the insolvency to crystallise their positions, often delivery of the requisite notices was made after close of business on that day. This opens up the possibility of a technical argument (depending on the precise wording of the default notice) that such notices have not been validly served.



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“...the unquestioning trust in the integrity of the banking system looks distinctly cavalier...”

With hindsight, the unquestioning trust in the integrity of the banking system looks distinctly cavalier and many bank customers and counterparties are paying the price for their blind faith. One group that was shown to be particularly vulnerable are the funds that used investment banks as their prime brokers.

Some funds were alarmed to discover that the administrators of Lehmans would not answer their demands for the return of their assets, and that it did no good applying to the English court for assistance. Their inability to recover and manage their assets at a time of extreme market volatility was financially damaging (potentially fatally so) to many funds and one consequence has been that many are starting to look to migrate their prime broker arrangements to US banks. Here the contracts will be subject to US law, and the US courts have already shown a greater willingness to order the return of securities in this type of situation.

The Lehman collapse also raised a particular concern in the debt market.

Where Lehmans held debt which they then sold on the debt market, they (and the rest of the market) customarily did this either by way of a straight debt transfer (where the buyer becomes the legal holder of the debt with a right to be repaid directly by the borrower), or else by a sub-participation of the debt. In a sub-participation structure, the debt would continue to be held by Lehmans but the bank would agree to account for any repayments of that debt to the buyer. So although the buyer would have paid for the debt, and would hold the entire economic interest in any repayments, he does not “own” it, so the repayments must “flow” through the seller (here the Lehman entity) on their way to the buyer.

This structure is fine as long as the institution which sub-participated the debt remains solvent, but if it goes bust, the repayments still arrive with the seller but no longer “flow” through to the buyer. As the relationship between the buyer and the seller is that of debtor/creditor, the buyer is merely left with an unsecured claim for breach of

contract against the insolvent institution and cannot claim any proprietary interest to the underlying facility. The buyer is also in the unfortunate position of taking on a double credit risk - on the default of either the borrower or the seller. Needless to say, a breach of contract claim against an insolvent company is generally not worth very much.

If the trade is subject to the standard US debt trading terms and the sub-participation is documented under New York law the position may be different. The structure is not that of a limited recourse back-to-back funding arrangement, but is deemed to be a “true sale”, where the buyer is in a much stronger position to assert “ownership” of the repayments. And as buyers become more alert to the dangers, we are starting to see them looking to implement ever-more ingenious mechanisms to protect against the credit risk of the seller, such as declarations of trust by the seller, the granting of security and use of bankruptcy and remote SPVs.

Finally and on a purely practical level, when Lehmans collapsed some 140,000 trades were left open across Europe, leaving trade counterparties in an uncertain position. Hopefully the collapse of Lehmans was a one-off but



should something similar happen again firms should carefully collate and maintain details of all the open positions and check the administrator's website and press releases for information on how it is dealing with the situation.

Problems can also arise where the buyer is the insolvent counterparty, particularly if the price of the underlying asset has changed substantially since the time of trade. Not all exchange rules provide for contracts to be terminated on insolvency, so this also needs to be checked. If they do, the correct procedure must be adhered to. If not and the date for performance has passed "time is of the essence" can be invoked and the contracts can be closed out. But before closing it is worth discussing with lawyers the best mechanism for calculating the close-out value of each trade and then agree this with the administrators, who will need to be informed of the final result.

"We are starting to see ever-more ingenious mechanisms to protect against the credit risk of the seller."

While another bank the size of Lehmans is unlikely to be left to fail, no one can be certain and the risk remains. What is certain is that the age of unquestioning trust in the banking system is over and corporates would do well to be prepared.



Funds - universally challenged



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The recent market turmoil has created challenges for funds across all asset classes and has exposed perceived inadequate protections provided by fund structures - and the need for greater investor scrutiny

Institutional and private investors considering commitments in unregulated funds are increasingly risk-averse and are asking more questions of and imposing heavier obligations on managers and the terms they are being offered. This is reflected in greater investor activism and a number of new trends including a move towards stricter regulatory jurisdictions, demands for improved corporate governance, and greater scrutiny of valuation procedures.

Tax and Regulatory Flight to Safety

For the past few years, funds have been operating within a globalised competitive network, jurisdiction-shopping for tax efficiency and regulatory flexibility. But today investors have a greater focus on tax risks, such as transfer pricing as well as management and control, recognising that tax leakage on returns can be significant. Investors' due diligence may now extend to

checking tax-related issues - rather than relying on representations from the managers.

It is also likely there will be a reversal of the recent trend for fund managers to operate in "cheap and cheerful" offshore destinations with a light touch approach to regulation. Instead, we expect investors will prefer the UK and other regulatory regimes which demand stricter compliance requirements.

Greater Corporate Governance

Investors invariably represent pension funds and other stakeholders. These stakeholders will expect the investors - perhaps through an advisory committee - to monitor or exercise control over the fund's key decision-making and potential conflicts of interest. This means the fund's constitution should articulate corporate governance principles, which the fund should apply.



“...we expect investors will prefer the UK and other regulatory regimes which demand stricter compliance requirements.”

Such principles have already been adopted for certain asset classes – for example in real estate the European Association for Investors in Non-listed Real Estate Vehicles (INREV) launched late last year its integrated guidelines which include the following requirements :

- That funds are managed with due skill, care, diligence and integrity and with adequate levels of financial, operational and human resources. The latter is often reinforced with key personnel provisions.
- Accountability as well as transparency ie fund information communicated clearly, is fair, complete, timely and not misleading. Transparency includes identifying fund-level and property-specific expenses, as well as explaining side letters and similar investor agreements.
- That funds are run in the interests of investors, and any conflicts of interest managed fairly amongst investors as a group and between investors and managers.
- That non-public information regarding funds and investors’ interests in funds be treated confidentially.

Similarly, the EU recently launched a consultation process on the regulation of hedge funds on which the UK government responded noting: " A regulatory response to ... risks which focused on hedge funds alone would not be effective and would create opportunities for regulatory arbitrage. So while we agree that a re-examination of the EU regulatory framework that applies both to hedge funds and hedge fund managers is appropriate, we do not believe that EU legislation aimed at hedge fund activity alone is likely to be the right means to deliver the necessary improvements."

But following a meeting at the end of February to thrash out the bones of a common EU policy the region’s heads endorsed a plan to create a comprehensive regulatory framework that covers “all financial markets, products and participants – including hedge funds and other private pools of capital which may pose a systemic risk”.

The full details of the accord will not be published until all EU states have reviewed the proposals, which are clearly more radical than the UK Treasury’s plan.

Valuation Issues

Many unregulated funds experience a continuing conundrum in that their underlying investments are relatively - and during the recent turmoil actually – illiquid. Yet they need to put a valuation on these assets as they not only determine redemption prices (where available) but also drive fund performance and management and carried fees are often linked to these valuations.

Managers need to explain the basis on which they calculate valuations and also whether these are related to realised and/or unrealised assets. There is also pressure particularly in the hedge fund industry for valuations and carry interest payments to follow the private equity model and only be paid out once realisations are achieved above the carried interest hurdle rate.

The issue of valuations is also affecting funds in terms of their loan to value covenants with their debt financiers.

Finally, when the markets stabilise and fund returns become more attractive, investors may be encouraged to consider fund commitments and support their entrepreneurial managers. However, for many investors, commitments will only be formalised once they are satisfied about investor protections within the fund structure itself.



Retail Distribution Review - where are we now?



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As the first phase of the on-going Retail Distribution Review draws to a close, we're starting to get some useful insight into how the revised landscape will look for selling advice and investment products.

The consultation process appears to have worked relatively well so far - nearly 900 firms, industry bodies and consumer groups submitted responses to the original Retail Distribution Review Discussion Paper. Further effective industry lobbying against the proposal that all advice be whole of market all contributed to the FSA issuing revised proposals for further consultation at the end of last year.

These revised proposals include other important changes, too. Besides dropping the controversial whole of market idea, the watchdog also replaced the proposal for customer agreed remuneration with one on adviser charging and downplayed the introduction of primary advice or guided sales, instead recommending that firms consider targeted advice.

Clearly, FSA has recognised that a simpler and less controversial set of proposals can still be consistent with its

aim of increasing professional standards and its policy of working with rather than against the market. It has also tacitly recognised that there is no longer a binary distinction between tied and independent advice, with the growth of platform and wrap services shifting the emphasis from product selection towards asset allocation. As a result its revised proposals, published in November 2008, now cover four key areas.

The first is central to the RDR - raising professional standards. The second is defining the requirements for independent advice to address some residual areas of potential conflict or bias. Next comes requiring advisers with a restricted product range to make this restriction clearer, and finally the FSA proposes to remove provider input from distributor remuneration while still allowing payment by commission.

It is also likely to consult on consumer



“The driving force behind RDR is FSA’s desire to ensure retail investors get a fair deal...”

perceptions of independence; the mechanics of adviser charging; operations of the professional standards board; and whether firms require guidance on targeting advice. In June, FSA expects to deliver a Consultation Paper on detailed Handbook changes.

At this point, the watchdog may extend the RDR regime to pure protection insurance, but it probably will not include mortgages.

The driving force behind the RDR is FSA’s desire to ensure that retail investors get a fair deal and the outcome will affect all areas of the advice sector. When it comes to independent advice it is focusing on two elements – codifying independence, whereby an independent advice firm adheres to two key principles, and adviser charging.

For codifying independence, a firm must be able to show how it gives comprehensive and fair analysis of the relevant markets. Processes should be robust and prices competitive and firms that use platforms and portals must be aware of their limitations. But that’s not all. Firms must provide unbiased and unrestricted advice, a requirement that should ring alarm bells for wealth managers that only offer their own collective investment schemes as a portal to underlying investments as FSA has suggested they may not meet this principle.

As for adviser charging, the FSA’s long-term aim is banning commission. This is impracticable for the foreseeable future so in the interim it proposes that product providers will no longer be able to set the levels of commission and instead the adviser devises a pre-determined set of charges.

The ban on provider firms determining commission terms and the requirement that they price products net of adviser

charges means firms are likely to have to redesign their products and administration systems. It also seems likely that FSA will not allow providers to recommend caps or norms on charging levels, although how this squares with the Treating Customers Fairly campaign is yet to be seen. Equally, payment of indemnity commission is unlikely to be allowed and any enhancements paid to an advisory firm must explicitly enhance the service provided.

When it comes to non-independent advice, FSA has concluded that most consumers need help to identify their needs and it sees three different types of non-independent advice.

The first is full advice given to the same standard as independent advice but does not meet the two new principles. In this case, FSA states that it will not require existing advice services, such as tied or multi-tied firms, to change their business models and that a firm may provide both independent and non-independent services. This suggests that the post-depolarisation landscape will not alter.

For non-independent sales, the new proposals are likely to include a few new elements: that advisers are clear about the limits of their client propositions; compulsory separate disclosure of costs of advice from the costs of the product – a point FSA is keen to consult on to ensure easy comparison; that charges are consistent with giving impartial advice; and that advisers have the same qualifications as their independent peers when performing equivalent roles.

In line with FSA’s drive to increase standards, it is throwing its weight behind a new Professional Standards Board to provide a common framework for advisory professional qualifications. While there will be no requirement to join, advisers will be subject to its standards, code of ethics and must

obtain annual practising certificates. The board will also set out a benchmark qualification of at least QCA level 4 and both independent and non-independent advisers will be expected to reach the same competency levels. Finally in this area, it seems grandfathering won't be permitted, although on-the-job assessment may be acceptable.

One of the areas where FSA has given a lot of ground is guided sales or primary advice. Primary advice was intended as a way of filling the gap between full advice and direct offer sales, possibly with less qualified advisers selling straightforward products to a lower standard. But consumer groups saw the makings of the next mis-selling scandal and providers and advisers were concerned about uncertain liability. As a result, the idea has been recast as targeted advice.

It looks as if FSA will issue guidance on how a firm can offer targeted advice that is subject to the full standard of fact-finding and suitability but is less onerous because the scope of the firm's enquiries is restricted to a single issue or a single product. If this can be coupled with lower qualified advisers then a high-street branch network could successfully offer this service to the lower income groups at present facing financial exclusion.

Although the RDR has come a long way, many issues remain firmly unresolved. These include whether firms will in fact be able to redesign their products and administration systems to cope with adviser charging; whether a non-independent adviser may simply state that its range is restricted to advising on the products of XYZ or whether FSA requires a more negative statement of the implicit limitations; how FSA will compare charges between the different

advice channels; whether a tied firm will have to operate in all circumstances to the same qualification standards as an independent firm; and whether a Qualifications Standards Board is necessary if the same objective could be better achieved by a revised Training & Competence Sourcebook.

While there are important elements yet to be resolved, it is already clear there will be winners and losers. It seems likely that private wealth managers already operating at the requisite level will make it to the winners' enclosure, although those that use a house-funds model may no longer be able to call themselves independent. They will be joined by providers able to adapt to adviser charging and by Bancassurers who bring their teams up to the QCA level 4 for full advice.

The losers are likely to include independent advisers who rely on portals or provider support that fail the new tests for independence along with the mid-market independents who cannot reach the requisite standard and whose cost base is too high to offer targeted advice. Providers who are reliant on tied sales forces will also lose out, unless they can be raised to QCA level 4, and finally, the proposals do nothing for the financially excluded – unless targeted advice is cost effective in the mass market.

There is still real scope to influence these proposals and firms concerned about the possible outcomes should be prepared to continue to lobby until policy is finalised in each area, expected to be March 2010. After that, firms have just two and a half years to prepare for target implementation in December 2012.

“Although the RDR has come a long way, many issues remain firmly unresolved.”



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The Madoff affair may turn out to be the biggest fraud in history, but it is not the only one to have been thrown up by the credit crisis.

The allegations involving Allen Stanford and, on a smaller scale, the investigation of Ponzi-scheme allegations against GTX are just further recent examples. The receding tide of easy credit, coupled with increased withdrawals and redemptions from funds, have exposed a growing number of cases, leaving all sorts of parties with tarnished reputations and open to losses, or even prosecution. So what can they do to protect themselves in similar situations?

The National Bank of Kuwait has reportedly reimbursed about \$50m to private banking clients who invested in Madoff through its Swiss bank. The clients have reportedly been reimbursed both the principal and the gains they thought they had made. This may be an option available to those who are cash-

rich and have exposed their customers or clients to relatively small losses - but what about institutions with much bigger exposures?

As a pre-emptive strike to avoid having to deal with massive claims and US class actions, Banco Santander has promised to compensate all private clients who lost money as a result of their investment in its Optimal fund (but only up to the amount they originally invested – not for the fictitious profits generated by the fraud), which has a reported £2.14bn of exposure to Madoff. The bank plans to issue £1.28bn in preference shares, with an annual coupon of 2 per cent to compensate clients. Not only is the cost to the bank of this move - at £466m – a fraction of full reimbursement, it could also mean the bank avoids defending damaging and expensive legal actions. Nevertheless, US lawyers representing some of the victims have commenced a class action claim in Florida looking for a better recovery. Meanwhile, French investment house Meeschaert Gestion Privé has also said it will reimburse clients' original investments in an effort to restore investor trust.

If these moves are successful, they can be filed under the heading of "what to do after the horse has bolted". But risk

management and corporate governance issues need to be looked at now as failures could lead to worse consequences down the line, particularly if, as expected, the authorities get much tougher at enforcement and more draconian oversight and regulation is enacted. This should be high on the agenda of senior management, who can be held personally liable for internal mistakes even if they are not directly involved.

In tough times, fraud and its detection are more common so vigilance is key. When businesses start to review past behaviour they might uncover fraudulent/wrongful actions that may otherwise have gone undiscovered. If internal failings do come to light, regulated clients will need to consider their duties to disclose the failings to regulators and may wish to seek advice on how best to present these issues in the hope of a more sympathetic hearing.

Still, operating in accordance with best practice provides the best protection and the check-list is simple. Identify the risks and look for red flags, ensure that everyone has risk management and fraud awareness training and that there are proper processes and oversight arrangements to prevent or detect problems early. One rogue employee is

Protect and survive

Limit your exposure to fraud

“One rogue employee is all it takes.”

all it takes and the sums a firm could become liable for quickly reach eye-watering amounts. For example, we are currently advising a broker client on the hook for claims exceeding \$100m due to the actions of a single employee acting well outside the scope of what he should have been able to do.

Beyond large fines and freezing injunctions, extradition is also a possibility where the wrongdoings took place abroad. Turning this on its head – don’t assume that if the actions took place abroad, the English authorities and courts will not have jurisdiction and will not assist the foreign courts. They might. Our experience of extradition requests is not limited to the US and the case above concerns extradition applications from Eastern Europe.

In cases of professional failings that fall short of “fraud” and where companies have professional indemnity insurance, the insurance companies may end up footing much of the bill. However, some policies may provide even wider protection – we are already advising on financial institutions notifying insurers of client losses from Madoff in reliance on extension of crime cover in their

insurance policies. This may lead to future test cases on the scope of such provisions and the protection they were intended to provide. Again, vigilance remains the best protection and insurers need to make sure their contracts are tightly drafted to avoid being told they were providing wider protection than intended.

Finally, claims in fraud and the court processes, procedures and tactics they involve are complex and specialised. Firms involved in fraud claims – on either side – must look for experienced advisers who know how to use the available procedures to maximum advantage.

In brief

Short selling

After months of seemingly off the cuff measures, the FSA finally published its discussion paper on UK regulation of short selling on 6 February 2009. The latest proposal suggests a permanent regime in respect of stocks from all UK incorporated issuers. It seeks to balance legitimate business aims from short selling with FSA's objectives of maintaining orderly markets and reducing financial crime through an enhanced disclosure regime. FSA invites comments by 8 May 2009. The proposals may not be entirely welcome. Fund managers will probably be caught by more regulation and may see the measures as excessive, given the problems triggering the initial restrictions arose only in relation to a relatively discrete class of issuers. FSA is eager that consensus should be reached and will liaise with IOSCO (internationally) and CESR (Europe) on achieving this. FSA is working to a deadline of 30 June 2009, when its current temporary measures expire. It may have to consider extending these if it genuinely seeks an international consensus.

A response to the EC consultation on hedge funds

HM Treasury and FSA have made a joint response to the EC's consultation on hedge funds. They believe fundamental issues might be obscured by heated political debate and finger pointing involving hedge funds. They observe, rightly in our view, that many risks associated with hedge funds are not unique. "So while [HMT and FSA] agree that a re-examination of the EU regulatory framework that applies both to hedge funds and hedge fund managers is appropriate, we do not believe that EU legislation aimed at hedge fund activity alone is likely to be the right means to deliver the necessary improvements". Change will be coming; its scope remains to be seen.

Pensions Regulator makes further statement on current economic conditions

The Pensions Regulator has issued a statement to trustees and a similar statement to sponsoring employers addressing concerns arising from the recession. The shortfall in company pension schemes hit a record high in February according to the Pension Protection Fund – and this is expected to get worse. Only around 9% of schemes are in surplus. Broadly, the Pension Protection Fund insures 100% of promised benefits for pensioners and 90% of promised pension benefits (up to a cap of £28,000) for others.

The Regulator believes that the current scheme-funding regime is flexible enough to cope with the economic downturn. For example, there is potential to renegotiate existing recovery

plans (the period over which scheme deficits should be rectified) where an employer is under pressure. Additionally, the Regulator will apply the flexibilities in the scheme funding regime pragmatically. It will consider what is in the best interests of both schemes and sponsoring employers. Trustees may need to revise their thoughts as to what is reasonably affordable for sponsoring employers. All concerned need to be balanced in their approach; pension schemes should not be at a disadvantage to other unsecured creditors or against shareholders. All of this would have been good news for the pensions liability buy-out market, but everyone is finding it increasingly difficult to manage asset-liability ratios at the moment.

Litigation trends

The former Northern Rock shareholders who challenged the bank's nationalisation have suffered a serious setback in their efforts to receive compensation for the loss of their shares. The High Court dismissed their application for judicial review brought against the Treasury; they have been granted leave to appeal. The shareholders challenged the basis on which compensation is to be calculated under a statutory scheme, in particular the assumptions that the independent valuer was required to make in valuing the shares. These had the effect of the shares being worthless. The shareholders claim the compensation scheme breached human rights laws (concerning the deprivation of private property).

In making its damning findings against the shareholders, the court was affected by the actions of the major hedge fund shareholder claimants. They had speculated by purchasing further shares in the bank after the Treasury had announced how compensation would be calculated if the bank were nationalised. The court was unable to make findings based on the different categories of shareholders, as the claims had not been

run on that basis. The outcome might have been different if the claims had been separated out between the different affected shareholders. This is interesting given the unequivocal signals being made about the future of collective actions.

In the UK, there are moves afoot to increase access to justice through modifying laws on collective actions. Internationally, the EU has issued its Collective Redress Green Paper. There is a growing trend for outside investors to finance the cost of litigation, in return for a guaranteed share of the compensation. Hedge funds, private equity firms and high net worth individuals are attracted by the potentially high returns litigation funding offers them - at a time of generally compressed returns from traditional markets. The Financial Ombudsman Service expects to resolve a record 165,000 consumer complaints in 2009/10. The spectre of collective actions, alternative sources of litigation funding and the upswing in complaints and claims needs thought.

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