CLYDE&CO

International review

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Keeping you in touch with international developments

Contents

Overview

James Cooper, Partner, London

The failure of subprime mortgage loans in the US was a catalyst for the last and truly global financial crisis, and, in the opening article of our international review, we examine whether the growth in US subprime auto loans is a cause for concern. Michael Lewis's *Flash Boys* did more than hit the bestseller lists; it was the touch paper for a raft of regulatory activity and civil suits in the US relating to High Frequency Trading.

Whilst there is no doubt that enhanced regulatory oversight continues apace in a number of jurisdictions (the UK's Small Business, Enterprise and Employment Bill, the FCA's first use of its product intervention powers in relation to CoCos and Hong Kong's Stock Exchange consultation on changes to the Listing Rules intended to increase transparency and accountability are three examples covered in this review), care must be taken not to oversimplify at the expense of understanding local complexities. The contrast between the approach taken by regulators in the US and UK in relation to LIBOR and by MAS in dealing with SIBOR in Singapore is just one example.

However, there remains much to learn from the experience of other jurisdictions, and the lack of clarity in how to apply proportionate liability in claims against financial services professionals in Australia will no doubt be instructive elsewhere.

Likewise, in this review, we also take a look at the current status of the RBS and Lloyd's shareholder actions in the UK and at a number of decisions impacting on the collective actions landscape in Canada. In Canada, the Courts were influenced by US and UK jurisprudence in deciding whether to assert jurisdiction over a class action brought against a UK company in relation to securities purchased on an exchange outside of Canada.

We close with a review of China (developments in the Shanghai Free Trade Zone), the Middle East (where the DIFC showed a willingness to look beyond formal legal structures and exercise jurisdiction over a non DIFC regulated entity in a mis-selling claim) and Africa (where long tail liabilities related to silicosis may catch D&O insurers unawares).

Subprime auto loans – is it a real bubble or overblown?

Kim West, Partner, San Francisco
Jully Yoon Rojas, Associate, San Francisco

A recent wave of articles suggests that the next subprime crisis will ensue in the form of auto loans[1]. The fundamental issue is whether subprime auto loans are a real basis for concern or much ado about nothing.

Just as the securitisation of home mortgage loans was not previously widely known outside those operating in the financial markets, many today may not realise that auto loans are also securitised. Investors seeking a higher rate of return are turning to securities backed by subprime auto loans, which are offered to less creditworthy borrowers at higher interest rates (often 20 percent or higher as compared to 5 percent for prime borrowers).

According to the financial press, the major concern is that "[t]he explosive growth [in subprime auto loans] is being driven by some of the same dynamics that were at work in subprime mortgages."[2] A recent New York Times article noted that "[m]any subprime auto lenders are loosening credit standards and focusing on the riskiest borrowers" and that "lending practices in the subprime auto market … demonstrate that Wall Street is again taking on very risky investments just six years after the financial crisis."[3] For example, during the second quarter of 2014, US borrowers obtained USD 101 billion in new auto loans.[4] Total outstanding auto loan balances rose to USD 905 billion. Subprime auto loans – defined as loans to borrowers with credit scores below 620 – made up 22 percent of new auto lending in the second quarter.[5]

Other commentators are not so alarmed. They note that the percentage of subprime auto loans make up a smaller proportion of total auto loans than before the "Great Recession" (i.e., the period from 2000 to 2004) and that overall lending to subprime borrowers is still below normal levels from before 2008.[6] Moreover, some contend that subprime auto loans are not as risk-laden as subprime mortgage lending because automobile loan payments are smaller and more manageable for borrowers than mortgage payments. Auto loans are scheduled to be repaid faster, and, as noted, loan collateral is more easily seized and recouped than houses.[7]

Notwithstanding the debate in the press, regulators have taken notice. To date, two institutions, GM Financial and Santander Consumer USA, have received subpoenas from the US Department of Justice requesting certain documents relating to their subprime auto loan contracts.[8] The subpoenas were issued in contemplation of a civil proceeding for potential violations of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), which served as the government's main weapon against thrifts during the S&L crisis over two decades ago.

Even with the increased securitisation of subprime auto loans and heightened regulatory attention, we concur with the commentators who are not alarmed. As many of them note, automobile loan payments are smaller and somewhat more manageable. Additionally, defaults are less likely because people scrimp to make their car payments so they have a means to commute to work. Finally, unlike houses, cars rarely appreciate; conversely, a "bubble" in the car market is unheard of.

For all of these reasons, subprime auto loans are more likely to be a bump in the road than a disaster.

1 *See, e.g.*, Silver-Greenberg, Jessica et al. *In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates*, The New York Times, Jul. 19, 2014.
2 *Id.*
3 *Id.*
4 *Quarterly Report on Household Debt and Credit*, Federal Reserve Bank of New York (Aug. 2014).
5 *Id. See also*, Rugaber, Christopher S. *New York Fed: US auto loans rise to highest level since 2006*, U.S. News & World Report, Aug. 14, 2014.
6 Weise, Karen. *Three Charts on America's Not-So-Bubbly Subprime Auto Loans*, http://mobile.businesweek.com/articles/2014-08-14.
7 *Ally Financial Bets on Risky Car Loans*, Reuters, May 31, 2011.
8 *U.S. Auto Loans Soar to Highest in 8 years*, http://newyork.cbslocal.com/2014/08/18, Aug. 20, 2014; Corkery, Michael, et al. *Santander Consumer Gets Subpoena in Subprime Car Loan Inquiry*, The New York Times, Aug. 20, 2014.

Flash claims; financial institutions

Targeted for High Frequency Trading

Ned Kirk, Partner, New York

Following the March 31, 2014 release of *Flash Boys* by Michael Lewis, an all-too-familiar story is playing out on Wall Street, this time focusing on high frequency trading ("HFT"). As in past financial scandals, the publicity surrounding HFT has fueled a growing wave of regulatory activity followed by investor lawsuits, and could result in significant claims under financial institution insurance policies. To date, these matters have arisen in the US, but similar investigations and lawsuits may eventually spread to other jurisdictions.

This article discusses HFT practices, the regulatory response, investor lawsuits and the potential impact on financial institution insurers.

High Frequency Trading practices

HFT involves the use of technological tools and computer algorithms to rapidly trade securities. In order to capture small profits on a large volume of trades, traders utilise trading models and computer programs to move in and out of positions in fractions of a second. This allows HFT firms to make enormous profits with virtually no risk.

Proponents contend that HFT benefits securities markets by increasing liquidity and leveling the playing field. Regulators and investors, however, allege that HFT firms often employ HFT with other strategies to electronically manipulate securities markets and obtain improper gains, including "front-running", "trading ahead", "latency and rebate arbitrage", "co-location", "pinging", "spoofing" or "layering", and "contemporaneous trading." While not all of these practices are illegal, they may constitute violations if used to manipulate the markets.

Regulatory investigations and actions

Long before *Flash Boys*, HFT was the subject of regulatory scrutiny. In early-2009, analysts questioned whether HFT firms had an unfair advantage, and the SEC considered the need for tighter controls on HFT.

On May 6, 2010, US stock markets lost and then recovered hundreds of points, all within a few minutes. Regulators later determined that HFT firms exacerbated the price declines and some commentators blamed HFT as the cause. This so-called "flash crash" further increased regulators' interest in HFT.

Following *Flash Boys*, authorities further increased their scrutiny of HFT and particularly the use of privately-owned alternative stock trading platforms called "dark pools." In March 2014, New York Attorney General Eric Schneiderman (the "NYAG") announced an investigation into HFT practices as part of his "insider trading 2.0" initiative, and shortly after issued subpoenas to HFT firms regarding dark pools. The FBI and CFTC are also examining HFT practices, and the SEC has disclosed that it has multiple ongoing investigations into dark pools. Congress has held a number of hearings on HFT, and new HFT regulations are expected.

On June 25, 2014, the NYAG announced that he had filed fraud charges against Barclays for alleged misrepresentations it made to clients trading in its dark pool. The NYAG contends that Barclays reassured those clients that it would protect them from predatory HFT while it actively sought to attract such traders to its dark pool.

At least three other European banks, UBS, Deutsche Banc and Credit Suisse, have reported that the NYAG is examining their dark pools.

Private civil lawsuits

Predictably, HFT quickly caught the attention of the plaintiffs bar in the spring of 2014. Investors have already filed an increasing number of lawsuits across the US against exchanges, brokerage firms and HFT firms.

On April 18, 2014, the City of Providence filed an ambitious lawsuit (the "*Providence Action*") on behalf of a massive plaintiff class against 16 stock exchanges, 14 brokerage firms and 12 HFT firms in the Southern District of New York ("SDNY"). The court later consolidated three similar lawsuits with the Providence Action.

Many of the allegations in the initial complaints closely tracked *Flash Boys*. The plaintiffs essentially alleged that by utilising non-public information and manipulating the securities markets through HFT, the defendants diverted billions of dollars from investors. The complaint described various types of manipulative, self-dealing and deceptive conduct, and alleged that the defendants paid each other kick-backs.

On September 2, 2014, five lead plaintiff institutional investors filed an amended complaint in the Providence Action. The amended complaint dropped many of the defendants, but named Barclays and seven stock exchanges. The allegations focus on the exchanges and Barclays' operation of its dark pool. According to the amended complaint, the defendants "paved the way" and incentivised the illicit activity of high frequency traders, allowing them to "prey on less sophisticated investors." The lead plaintiffs seek to represent a broad class of investors who traded on the defendant exchanges or in Barclay's dark pool between April 18, 2009 and the present.

The amended complaint asserts causes of action for violations of §§10(b) and 6(b) of the Exchange Act and SEC Rule 10b-5, and seeks, among other things, unspecified compensatory damages, restitution, disgorgement and forfeiture of illicit fees.

At the pleading stage of the Providence Action, the plaintiffs will need to overcome significant hurdles. Motions to dismiss are due on October 31, 2014, and the defendants will likely argue for dismissal on a number of grounds. For example, the defendants may argue that the amended complaint does not allege actionable misrepresentations or omissions as many of the practices were disclosed or otherwise known to investors. Also, the defendants may argue that their conduct was not manipulative and the plaintiffs have not sufficiently pled fraudulent intent as many of the alleged practices are not prohibited under applicable regulations, have been approved by the SEC, and benefit the markets and investors. Further, statute of limitation defences may apply as much of the alleged conduct occurred at an early date and may have been known to investors. With respect to the §6(b) claim, the defendants may argue that there is no private right of action under that provision.

If the amended complaint survives a motion to dismiss, the plaintiffs will have other significant challenges before trial, including class certification and the defendants' summary judgment motions. In particular, the plaintiffs may not be able to demonstrate that common class-wide issues predominate over individual issues with respect to the broad plaintiff class. Also, it may be difficult for the plaintiffs to prove causation and damages.

Investors have filed additional securities class actions against Barclays, as well as separate lawsuits against stock exchanges for securities law violations, breach of contract, common law fraud, aiding and abetting, constructive trust, unjust enrichment and violations of the Sherman Antitrust Act and the Commodity Exchange Act.

Plaintiffs will likely file new lawsuits in the wake of regulatory actions and further disclosures about HFT practices, and continue to test different theories of liability and damages in various courts across the US.

Potential impact on insurers

Financial institutions and exchanges targeted by HFT regulatory investigations and investor lawsuits may seek insurance coverage under D&O, Professional Indemnity and other policies. While these matters are in their preliminary stages and the ultimate exposure is difficult to predict, those entities might seek reimbursement of significant defence costs and sizeable settlements or judgments.

Depending, of course, on the particular circumstances and contract terms, a number of coverage defences may arise. For example, in view of the early regulatory activity, coverage defences may arise relating to the timing of the conduct and the insured's prior knowledge, including whether the claim was first made in the policy period, whether notice was timely and whether the insured disclosed HFT risks in the underwriting of the policy. As many of the lawsuits seek disgorgement or restitution and allege fraud, whether the claims allege insurable "Loss" or are barred by public policy may be significant issues.

Further, the HFT matters may trigger a number of policy exclusions, including with respect to, among other things, dishonest or fraudulent acts, improper personal gain or advantage, professional services, regulatory claims, notice to prior insurers and prior wrongful acts. Finally, additional coverage issues may arise with respect to other insurance clauses and allocation of costs between covered and uncovered loss or parties.

In view of the potential exposure and related coverage claims, financial institution insurers should closely track developments with respect to HFT litigation, regulatory actions and new regulations.

Canada and class action developments?

Rod McLauchlan, Partner, Toronto
Catherine Tyndale, Senior Counsel, Montreal

There are several important issues that bear watching in the Canadian courts in connection with class actions.

1. Limitation period under the Ontario *Securities Act*

On August 7, 2014, the Supreme Court of Canada granted leave to appeal in three Ontario securities class action cases: *Green v Canadian Imperial Bank of Commerce, Silver v IMAX* and *Celestica v Trustees of the Millwright Regional Council of Ontario Pension Trust Fund*.

These cases address how the three year limitation period under the Ontario *Securities Act* applicable to secondary market class actions should be applied. To bring a secondary market class action under the Ontario *Securities Act*, leave of the court is required. Pursuant to section 138.14, the action must be commenced within three years. Securities legislation in the other provinces contain similar provisions.

On February 16, 2012, in *Sharma v Timminco*, the Ontario Court of Appeal interpreted this provision to mean that plaintiffs must obtain leave from the court within the three year period to commence the action. This was a surprising and, for many securities class action plaintiffs, an unfortunate decision, as in many pending cases the plaintiffs not obtained leave within the three years, but had simply applied for leave, and the three year period had already expired.

In the wake of *Timminco*, there were several diverging decisions. On February 3, 2014, in *Green v Canadian Imperial Bank of Commerce*, a rare five judge panel of the Ontario Court of Appeal reversed its own decision in *Timminco* (with companion decisions in *Silver v IMAX and Celestica v Millwright*). The Court of Appeal found that articulating an intention to seek leave to commence the secondary market claim under the *Securities Act* was sufficient to suspend the limitation period, even though leave had not yet been granted to commence such an action.

It is now down to the Supreme Court for the final say on how this three year limitation period is to be applied. The Supreme Court's decision will have a significant impact on numerous securities class actions already before the courts and those to come.

2. Bank faces liability for breach of privacy

On June 6, 2014, in *Evans v Bank of Nova Scotia*, the Ontario Superior Court at first instance has certified a class action against the Bank of Nova Scotia for vicarious liability for, among other claims, the tort of intrusion upon seclusion: in effect, for the breach of privacy rights of customers of the bank whose personal financial information had been disclosed illegally to hackers by an employee of the bank.

This is the first time such a class action has been brought against a financial institution in connection with this tort. The tort of intrusion upon seclusion is relatively new, having been recognized by the Ontario Court of Appeal in 2012 in *Jones v Tsige*. A necessary element of the tort is that the underlying conduct must be intentional, which includes reckless conduct. The plaintiffs did not allege that the bank acted intentionally but instead alleged that the bank was vicariously liable for its employee's intentional and wrongful actions against over 600 customers. Vicarious liability per se would attach due to the relationship of the bank to the wrongdoer not due to its own conduct. The bank has vigourously contested whether it can be vicariously liable for the employees actions.

If the claim is maintained, it opens up an additional exposure for banks and other entities which possess and control financial and personal information. While the non-pecuniary damages for breach of this tort are capped at $20,000 per person, this can be signigficant when hundreds of people are affected.

3. Court of Appeal closes door on Canadian claims involving foreign investors

The decision of the United States Supreme Court in *Morrison v National Australia Bank* was a landmark in securities class litigation, in that it ruled that foreign investors in foreign companies who purchased their securities on foreign exchanges had no right of action under US securities laws.

Until recently, some Canadian courts had agreed to accept jurisdiction in similar situations, where they found that there was a "real and substantial connection" between the action and the jurisdiction, and had certified "global" classes – although not all agreed (e.g. *McKenna v Gammon Gold*). In the wake of *Morrison*, some wondered whether Canada would become the go-to jurisdiction for foreign investors whose own jurisdictions did not have similar remedies or the means of bringing class actions.

On August 14, 2014 the Ontario Court of Appeal rendered its decision in *Kaynes v BP, plc*. The representative plaintiff, an Ontario resident who purchased his BP American Depositary Shares ("ADS") on the New York Stock Exchange ("NYSE"), sought to certify a class of all Canadian BP shareholders who purchased their shares between May 2007 and May 2010 regardless of which stock exchange was involved. He asserted a statutory right of action for misrepresentation under the Ontario *Securities Act*, arguing that BP, as a "reporting issuer", was subject to Ontario securities legislation. BP, a UK corporation headquartered in London, sought to have the action of those plaintiffs who purchased their securities on an exchange outside Canada dismissed for lack of jurisdiction.

The trial court had dismissed BP's motion. However, the Court of Appeal reversed that decision, finding that while the Ontario courts did have jurisdiction *simpliciter*, they should decline that jurisdiction on grounds of *forum non conveniens*. It examined the remedies available to security holders under US and UK law, noting that there was a parallel shareholder class action by BP shareholders in the US. It also noted the relative volume of shares traded in the three jurisdictions, and found that 0.0005% of BP shares had traded on the TSX. Remarking that the US and the UK assert jurisdiction on the basis of the exchange where the securities are traded, the Court ruled that "[a]sserting Ontario jurisdiction over the plaintiff's claim would be inconsistent with the approach taken under both US and UK law …" and that "the principle of comity requires the court to consider the implications of departing from the prevailing international norm or practice, particularly in an area such as the securities market where cross-border transactions are routine and the maintenance of an orderly and predictable regime for the resolution of claims is imperative". As for the consequences to the plaintiffs, the Court stated that "[i]t would surely come as no surprise to purchasers who used foreign exchanges that they should look to the foreign court to litigate their claims".

Given BP's concession that the Ontario court did have jurisdiction over the claims of those members of the class who had purchased their shares on the TSX, the Court granted leave to amend the claim accordingly. It seems unlikely, however, that those plaintiffs will pursue the claim, given that of the total of 83,945 ADS which had traded on the TSX, the number held through the end of the proposed class period was somewhere between 14 and 7,477.

Nothing new under the sun: Class Actions and Group Litigation Orders

Laura Cooke, Partner, London
Francesca Morley, Associate, London

It is often said that there is nothing new under the sun: sooner or later, everything is recycled, re-packaged and re-presented to a new and enthusiastic audience. This is true even for legal concepts. Class actions, which enable one or more parties to act in a representative capacity to bring an action on behalf of a larger class of litigants, are seen here as a very "American" idea, having long been used to resolve disputes in the United States.

The origin of the class action, however, is English – a holdover of medieval law which clung on long enough to be exported to the colonies before withering on the home vine in the 19th century. Now, however, they have returned, albeit in an updated form, to their ancestral lands, and, in the fallout from the recession, they are once again staking out territory in the Courts of England & Wales.

The current incarnation of the class action in England & Wales is the Group Litigation Order ("**GLO**"), which permits multiple claims against a defendant to be grouped into a single action, provided the Court is satisfied that the claims give rise to common or related issues of fact or law.

GLOs remain relatively uncommon, with only 80 orders having been granted since 2000. However, they are gaining ground and while many of the GLO actions involve personal injury claims (most commonly in relation to pharmaceutical product liability), there is an increasing trend for GLO actions in the financial services arena. We are currently seeing GLO actions being commenced against single institutions which have allegedly caused loss to a vast group of investors, which may be the product of the recent economic crisis. Such actions provide claimants who on their own would otherwise have been unable to bring a claim, the opportunity to seek redress collectively. Given the initial financial outlay that is required in GLO actions, these large, complex, commercial actions involving financial institutions are becoming an attractive opportunity. The existence of various action groups looking to bring collective actions in this area have been reported on the press in recent years, but in this article we focus on two particularly substantial, and prominent, collective actions which are making their way through the Courts at the moment.

RBS rights issue litigation

This case concerns a rights issue of shares in RBS which took place between May and June 2008. Shortly thereafter, Lehman Brothers collapsed in September 2008 and the recession began in earnest. RBS was effectively nationalised a year later, and many of the rights issue subscribers (mostly retail and institutional investors) saw the value of their investments largely disappear, thereby suffering substantial losses.

Now, some of the claimant shareholders are seeking recovery of their losses on the grounds that the rights issue prospectus was neither accurate nor complete. Some claimants are additionally seeking recovery from the directors responsible for the prospectus pursuant to section 90 of the Financial Service and Markets Act 2000.

There are four claimant action groups consisting of significant numbers of both retail and institutional investors. It is thought that more investors are likely to join the proceedings in the future and that the total value of potential claims could run into billions.

A GLO was granted in September 2013. It has subsequently been ordered that any adverse costs should be shared by all claimants (regardless of the relevant action group to which they belong) on a several basis, pro-rated to the acquisition cost of each claimant's shares. This departs from the general rule that all claimants bear the costs equally amongst them). A further CMC is listed for October 2014 in order to determine directions for trial.

Lloyds Banking Group litigation

This case, issued on 6 August 2014, is being brought by a group of over 200 investors in relation to Lloyds' acquisition of HBOS in 2009. It is alleged that Lloyds' directors breached

tortious and fiduciary duties owed to the shareholders by (a) telling them the merger was in shareholders' best interests and thereafter (b) persuading shareholders to approve the merger on the basis of misleading information. The claimant group has applied for a GLO; it remains to be seen whether such an order will be granted.

As with the RBS rights issue litigation, the potential claim figure could be very high. The loss in value of the shares caused by the HBOS acquisition has been estimated at as much as GBP 6 billion, although the loss attributed to the investor group who are pursuing this litigation is estimated to be worth considerably less (approximately GBP 2.5 million). It should be noted that this figure will increase if more claimants are joined as parties to the litigation, or, if a GLO is approved, as members of the group.

Both claims raise interesting issues around prospectus liability and directors' duties, and, should they proceed further, will inevitably draw considerable attention from the financial services market. We will be keeping a close eye on the proceedings, and on any further developments in the GLO field generally, and further updates will be provided as matters progress.

What's the buzz? Transparency, accountability and the SBEE Bill

Laura Cooke, Partner, London
Sara Larmour, Associate, London

The numerous and much-publicised banking and corporate financial scandals of the last five or so years have led to, amongst other things, increased scrutiny of corporate governance by both regulators and governments. In the UK, there has been a strong focus on enhancing corporate transparency and accountability, culminating in the publication, on 25 June 2014, of the Small Business, Enterprise and Employment Bill (the 'Bill'). The Bill is currently progressing through Parliament, with the expectation that it will become law in advance of the next General Election, which is scheduled to take place in May 2015.

The Bill was born out of a discussion paper published by the Department for Business Innovation & Skills ("BIS") in 2013. We reviewed that paper in our October 2013 edition of the FI and D&O International Review. In fact, very little has changed between the paper and the Bill, and the fundamental purpose of the changes set out in the Bill remains to ensure that the UK is regarded as a trusted and fair place for business. The Bill covers a variety of topics; however, for the purposes of this article we consider the wording and impact of the Bill in relation to the new provisions on corporate transparency, the role and accountability of directors generally and the powers of liquidators and administrators to assign causes of action.

Introduction of a "Person with Significant Control" register

The Bill, if made law, will introduce a requirement for UK companies to keep a register of people who exercise '*significant control*' (see Part 7, Schedule 3).

Broadly speaking, the statutory definition of a 'person with significant control' is an individual who owns more than 25% of a company's shares or voting rights, or exercises control over a company or its management. Companies will be required to take reasonable steps to identify people they know or suspect to have significant control and those persons with significant control will be obliged to supply information or face sanctions.

This reform is intended to increase transparency around who ultimately owns and controls UK companies and will help deter, identify and sanction those who hide their interests in UK companies to facilitate illegal activities. These provisions do not, however, apply to LLPs.

Corporate and shadow directors

A major change proposed in Part 7 of the Bill is the requirement that company directors must be '*natural persons*' in order to increase accountability, breach of which will be an offence. Consequently, the use of corporate directors, which is not that prevalent in UK companies in any event, will be prohibited save for a number of limited exceptions.

Section 78 of the Bill will also extend the application of the codified general duties of directors under sections 170-177 of the Companies Act 2006 to shadow directors.

Directors' disqualification & compensation orders

Part 9 of the Bill introduces amendments to the Company Directors Disqualification Act 1986 ('CDDA'). The main change is the increase in the matters to which a court must have regard when determining whether a person is unfit to act as a director of a company.

It is widely felt that the current legislation (Schedule 1 CDDA) is outdated, particularly in light of today's globalised economy. The Bill proposes that a director's overseas misconduct be taken into account in disqualification proceedings, and introduces disqualification for persons who are not directors but who exert requisite influence over a director.

The Bill also proposes giving the court a new power to make a compensation order against a director, on the application of the Secretary of State, where the conduct for which that director has been disqualified has caused loss to one or more creditors of an insolvent company of which they have at any time been a director. Such orders may therefore substantially increase D&O exposures.

Compensating creditors

The Bill permits the assignment, by liquidators and administrators, of actions for wrongful and fraudulent trading, preferences, and transactions at undervalue to creditors. Whilst this may help creditors seeking redress from unscrupulous directors, the inherent risks of such claims will remain and it is unclear whether the changes will result in more litigation. Furthermore, creditors will not be able to utilise the detailed investigative powers of administrators and liquidators under the Insolvency Act 1986 prior to issuing any proceedings. Notwithstanding this, there will be certain instances where it is attractive for both the office holder and creditors to agree to an assignment of claims. Office holders will have to consider the terms of any assignment and whether to accept a lump sum for the assignment or a percentage of the fruits of litigation.

Administrators will also be afforded the same rights as liquidators to commence fraudulent trading and wrongful trading actions (thereby bypassing the need for, and saving the costs of, first placing the company into insolvent liquidation).

Conclusion

The expectation is that the Bill will become law before May 2015, and D&O insurers should therefore not delay too long in reviewing policy conduct exclusions to assess whether they adequately address the making of compensation orders against a director. Equally, D&O insurers may wish to consider whether further information on a director's history, both in the UK and abroad, is required upon renewal of a policy in light of the expansion of matters a court will take into consideration when determining director disqualification proceedings.

FCA restrictions: I should(n't) CoCo…

James Cooper, Partner, London
Rupert Saville, Associate, London

When, in years to come, the academics and economists look back on the current recession, there will undoubtedly be common factors that will draw the interest – the rise of sub-prime markets, the fall of Lehman Brothers, the bankruptcies of entire cities in the United States. For those operating in the financial services arena, however, we think that it is the rise of the regulator, on the back of public and governmental outrage at the behaviour of the financial institutions blamed for the crisis, which will resonate most strongly. Given a remit of "never again", regulators across the world have sat up, gripped their freshly-bestowed powers firmly, and waded into battle.

These newly aggressive regulators have already left many casualties in their wake, and, later this year, when the UK's Financial Conduct Authority ("FCA") will for the first time utilise its product intervention powers, contingent convertible instruments ("CoCos") will be added to the roster of the fallen.

What are CoCos?

CoCos are hybrid capital securities which feature both debt and equity elements. Issued as a bond paying a coupon, they convert into an equity security when a certain trigger event occurs. This trigger point is normally linked to the issuer's regulatory capital ratio. CoCos were originally designed for purchase by institutional investors, principally asset managers and banks and their popularity has increased dramatically in recent years given the high yields offered.

The FCA has reported that the value of CoCos issued between 2009 and 2013 is estimated to have reached GBP 40 billion (USD 70 billion), 20.7% of which was issued by UK banks. Indeed, Bank of America Merrill Lynch predicts that the market value for European Additional Tier 1 capital CoCos could exceed EUR 150 billion by 2020.

With expected rapid short-term growth in issuance, the FCA has decided to implement measures to mitigate the potential harm caused to investors by CoCos' complex and unusual characteristics, and in October 2014, it will restrict the distribution of CoCos to retail investors.

Risky business?

While financial institutions continue to increase their issuance of CoCos to fulfill prudential capital requirements, the FCA fears that their proliferation, and the returns offered, could see the investor market expand to incorporate ordinary retail investors. This is particularly likely at a time such as this of low interest rates when inexperienced and unsophisticated investors are tempted by high headline returns.

The FCA set out its principal concerns over CoCos in August 2014. Essentially, the fear is that the risks and unpredictability of CoCos renders them unsuitable for the mass retail market. For example:

- One particular class of CoCos, called "Additional Tier 1", features an equity conversion or writing-down trigger, which corresponds to the capital position of the issuer. Should an issuer's capital position fall to a certain trigger point, the issuer has the ability to write-off (partially or entirely), or convert into equity, the instrument, meaning that some investors could be left with little or no return
- Additional Tier 1 CoCos also feature entirely discretionary coupon payments, meaning that they could be cancelled indefinitely at any point and for any reason
- CoCos are also particularly difficult to price, and the factoring of risks into their valuation can be complex – for higher-rated instruments, although some characteristics, such as trigger levels and the credit spread of an issuer, are reasonably transparent, others, including an issuer's future capital position and the likelihood of coupon payments, are more difficult to predict, and at the sub-investment grade, CoCos are even more difficult to value

The FCA's announcement coincided with a statement from the European Securities and Markets Authority on the risks associated with CoCos.

FCA's product intervention powers

The Financial Services Act 2012 introduced amendments to the Financial Services and Markets Act 2000 ("FSMA") which, from 1 April 2013, have provided a framework of product intervention powers available to the FCA, including the ability to make temporary product intervention rules relating to certain types of investment and concerning specific persons. The FCA can intervene if it identifies products that could cause detriment to consumers either because of their characteristics or issuer distribution strategies. Intervention effectively prohibits firms from carrying out certain activities, for example entering into specified agreements with any person.

Temporary restriction of CoCos

As mentioned above, from 1 October 2014, the FCA will impose one of these temporary restrictions in relation to CoCos'. The restriction, set out in the "*Temporary Marketing Restriction (Contingent Convertible Securities) Instrument 2014*", imposes a 12 month prohibition on firms selling or otherwise doing anything that would result in retail investors buying or holding a beneficial interest in CoCos. The restriction does not apply to professional or institutional clients or to exempt persons, and there are exceptions for some activities – for example, MiFID business relating to the sale (but not the promotion) of CoCos will be permitted.

Whilst the temporary restriction is in place, the FCA will carry out a consultation on CoCos, and a policy paper is expected in the second quarter of 2015, which, it is anticipated, will set out the permanent rules which will come into force on lapse of the temporary restriction on 1 October 2015. Given the increasingly aggressive stance of all regulators, not just the FCA, we consider it likely that the permanent rules will, at least, mirror the temporary restrictions. In any event, we shall report again following publication of the policy paper.

LIBOR update

James Cooper, Partner, London
Francesca Morley, Associate, London

The fallout from the LIBOR manipulation scandal continues to attract headlines across the globe, particularly as the LIBOR investigations themselves appear to have triggered separate enquiries into the alleged manipulation of other benchmark rates. Investigations into various financial institutions are continuing and further eye-catching fines, along the lines of the USD 370 million paid by Lloyds Banking Group in July 2014 (see below) are anticipated. In the meantime, regulatory focus is now shifting towards individuals, and we therefore consider it likely that LIBOR will remain in the news for the foreseeable future. In this article, we look at recent developments in LIBOR actions internationally.

Regulatory investigations

Lloyds Banking Group is the latest financial institution to be fined by US and UK regulators for its participation in the manipulation of benchmark rates, which include, amongst others, LIBOR. In July 2014, Lloyds Banking Group agreed to pay fines totalling USD 370 million, which comprised fines imposed by the Financial Conduct Authority ("FCA") (GBP 105 million), the US Commodity Trading Commission (USD 105 million) and the US Department of Justice (USD 86 million). The Bank of England Governor, Mark Carney, described the manipulation by Lloyds Banking Group as "*highly reprehensible*" and "*clearly unlawful*". In the wake of the fine, at least four traders at Lloyds Banking Group have been suspended and, according to press reports, the financial institution is investigating the involvement in the scandal of approximately twenty individuals.

In June 2014, the European Commission issued a Statement of Objections to interdealer broker ICAP, which alleged that ICAP "*may have breached EU antitrust rules by facilitating several cartel infringements in the market for interest rate*

derivatives denominated in the yen currency". ICAP has denied such allegations and has confirmed that it will "*defend itself against these allegations vigorously*". ICAP will now respond to the Statement both in writing and at a hearing before representatives of the European Commission and national competition authorities. This course of action follows the imposition of a EUR 669.9 million fine by the Commission on six financial institutions in December 2013 for their participation in cartels relating to interest rate derivatives which derive their value from LIBOR.

Martin Wheatley, head of the FCA, confirmed in July 2014 that while investigations were still ongoing into the manipulation of LIBOR, such investigations were not as serious as those which have now concluded. However, at least some of the on-going LIBOR investigations appear to have been delayed on the grounds that the allegations in issue extend beyond the manipulation of LIBOR, and therefore the mere fact that the LIBOR allegations may be less serious should not be taken as meaning that substantial fines will not follow.

According to press reports, BaFin, Germany's financial regulator, is expanding its investigation into Deutsche Bank's alleged participation in the manipulation of LIBOR and other benchmark rates. BaFin's initial intention was to conclude its investigations by Summer 2014, but the expansion of the investigation is now likely to delay the publication of its findings.

Regulatory fines imposed to date

Institution	Date	Regulator & Fine					
		FSA/FCA (UK)	CFTC (US)	DoJ (US)	EC	Swiss FMSA	Dutch Prosecutor's Office
Barclays	27.06.2012	GBP 59.5m	USD 200m	USD 160m			
	04.12.2013				EUR 690m (100% reduced)		
UBS	19.12.2012	GBP 160m	USD 700m	USD 500m		60m CHF	
	04.12.2013				EUR 2.5bn (100% reduced)		
RBS	06.02.2013	GBP 87.5m	USD 325m	USD 150m			
	04.12.2013				EUR 391m		
Rabobank	29.10.2013	GBP 105m	USD 475m	USD 325m			EUR 70m
Deutsche Bank	04.12.2013				EUR 725m		
Société Générale	04.12.2013				EUR 446m		
Citigroup	04.12.2013				EUR 70m		
JP Morgan	04.12.2013				EUR 80m		
Lloyds Banking Group	28.07.2014	GBP 105m	USD 105m	USD 86m			
ICAP	25.09.2013	GBP 14m	USD 65m				
RP Martin Brokers	04.12.2013				EUR 247,000		
	15.05.2014	GBP 630,000	USD 1.2m				

Criminal prosecution of individuals

In June and August 2014 respectively, two former Rabobank traders, Takayuki Yagami and Paul Robson, pleaded guilty to one count of conspiring to commit wire fraud and bank fraud before US District Judge Rakoff. These two individuals are the first to plead guilty to charges involving the manipulating of benchmark rates, and another two former Rabobank traders, Paul Thompson and Tetsuya Motomura, continue to plead not guilty to the same allegations. Rabobank has previously paid fines totalling USD 325 million to US regulators in relation to manipulation charges.

The SFO's investigations into the involvement of individuals in the manipulation of LIBOR continue. To date, criminal charges have been brought by the Serious Fraud Office against twelve former traders (from UBS, Barclays, RP Martin and ICAP) for the manipulation of LIBOR, with the first trial listed for January 2015.

Litigation against institutions

Numerous lawsuits have been filed in the United States relating to LIBOR manipulation. Of particular interest is the suit filed by Jeffery Laydon, against a number of financial institutions, in the US District Court., Southern District of New York (*Jeffrey Laydon et al v Mizuho Bank Ltd et al*). Mr Laydon alleges that he suffered losses on futures contracts that were manipulated by various international banks.

In March 2014, US District Judge Daniels granted the defendants' motion to dismiss antitrust, vicarious liability and unjust enrichment claims brought by Mr Laydon. However, the judge also granted Mr Laydon leave to amend his complaint, to include allegations that the banks violated the Commodity Exchange Act by manipulating yen-denominated interest rate benchmarks between 2006 and 2010. The lawsuit seeks to rely on information taken from the various notices accompanying the regulatory fines imposed on financial institutions over the past two years.

In the UK, there have so far been two key cases concerning claims in respect of LIBOR-based products – *Graiseley Properties Limited & Ors v Barclays Bank plc* (2012) and *Deutsche Bank AG v Unitech Limited* (2013). The *Graiseley* claim was brought by various parties within the Guardian Care Homes Group, which entered into agreements with Barclays for an interest rate swap and an interest rate collar, as hedges to loans of GBP 41 million and GBP 29 million. The *Deutsche Bank* claim is in fact two actions being heard together. In the first, a syndicate of banks seeks repayment of a USD 150 million loan made to Unitech Global Limited, and in the second, Deutsche Bank seeks to recover around USD 11 million allegedly due from Unitech Global under an interest rate swap purportedly entered into as a hedge of its interest liabilities under the loan agreement.

Following protracted interlocutory skirmishes regarding pleading amendments, in November 2013, the Court of Appeal allowed both sets of claimants to amend their particulars of claim to include allegations of misrepresentation in connection with LIBOR and/or the swaps/collars. The *Graiseley* case settled earlier this year before it was due to go to trial, but the *Deutsche Bank* claim continues and will be monitored closely by others considering LIBOR-related claims.

Comment

While the focus of the litigation and investigations appears to have shifted to individuals it would seem that the height of the LIBOR scandal has now passed. Even once LIBOR passes, however, its legacy will cast long shadows over financial institutions for years to come. The LIBOR scandal has spurred on global investigations into the manipulation of numerous other benchmarks, including foreign exchange rates, oil and precious metals, and as yet there is no end in sight. We expect to see rate-fixing investigations, and the consequent 9 and 10 figure fines, hitting the headlines for the foreseeable future.

Proportionate liability: A decade of clarity or confusion

Jenni Priestley, Partner, Sydney
Janette McLennan, Senior Associate, Sydney
Kate Benjamin, Associate, Sydney

In mid-2004 proportionate liability reform became effective in Australia, removing joint and several liability for certain causes of action. Under the old system, the insolvency risk associated with other wrongdoers fell on the defendant against whom the plaintiff successfully sued and elected to recover judgment, which unfairly meant a single defendant could bear 100% of a loss notwithstanding that the acts of another wrongdoer caused the same damage.

It was hoped by many that reform would address the crisis of high claim costs associated with liability insurance, by removing the burden faced by "deep pocket" defendants routinely targeted in litigation, despite others also causing the same loss and damage which was the subject of a claim. This article explores the impact of the reforms on claims against financial services professionals.

2004: Changes to the law become effective

The key reforms (which remain in force) were implemented in NSW in 2004, making claims for economic loss or damage to property arising from a failure to take reasonable care in contract, tort or otherwise,[1] or in an action for damages for misleading and deceptive conduct under consumer protection laws[2], apportionable claims whereby liability is apportioned to each wrongdoer according to the Court's assessment of the extent of their responsibility.[3]

At the Commonwealth level, amendments were also made to the *Australian Securities and Investments Commission Act* 1974 (Cth) (**ASIC Act**), the *Corporations Act* 2001 (Cth) (**Corporations Act**) and the Trade Practices Act 1974 (Cth) (**TPA**) (which has since been replaced by the *Competition and Consumer Act* 2010 (Cth) (**Australian Consumer Law**)) to introduce proportionate liability in relation to claims for misleading and deceptive conduct.

Where the reforms apply, the plaintiff is now obliged to join all alleged concurrent wrongdoers to an action, rather than leaving it to the defendants to bring in others by way of cross-claims for indemnity and/or contribution.

What is an apportionable claim?

The relevant statutory provisions in all Australian jurisdictions are in similar terms in identifying what is a single apportionable claim. The loss or damage caused by the various wrongdoers must be the same, even if "the claim for that loss or damage is based on more than one cause of action (whether or not of the same or a different kind)".[4]

Those words were subject to intense judicial scrutiny in May 2014 and early June 2014, when two conflicting judgments were delivered by two differently constituted benches of the Full Federal Court considering whether certain claims were apportionable, in *Wealthsure Pty Limited v Selig* [2014] FCAFC 64 (***Wealthsure***) and *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65 (***ABN AMRO***).

In *Wealthsure*, a majority held that in proceedings which involve both an apportionable claim under the Corporations Act (being a claim for damages for a contravention of the misleading and deceptive conduct provision of that Act in relation to a financial product or a financial service) and a claim that is not apportionable, and the same loss and damage has resulted from both causes of action, the claim maintains its character as an apportionable claim in its entirety.

1 Section 34(1)(a) of the Civil Liability Act 2002 (NSW), which applies only to liability arising after 26 July 2004. Importantly, the proportionate liability provisions do not apply to personal injury claims.

2 Section 34(1)(b) of the Civil Liability Act 2002 (NSW).
3 Section 35 of the Civil Liability Act 2002 (NSW).
4 Section 1041L(2) Corporations Act.

White J dissented, holding that the relevant statutory provision which stipulates that "*there is a single apportionable claim in proceedings in respect of the same loss or damage even if the claim for the loss or damage is based on more than one cause of action (whether or not of the same or a different kind)*" refers only to causes of action themselves which are apportionable claims and does not extend to statutory provisions which were deliberately omitted by the legislature as falling within the regime.

That dissenting position gained unanimous support in the second decision delivered by the Full Federal Court in *ABN AMRO* a week later.

The decisions in *Wealthsure* and *ABN AMRO* were made against the backdrop of the High Court of Australia's leading decision on proportionate liability delivered a year ago in *Hunt & Hunt Lawyers v Mitchell Morgan Nominees Pty Ltd and Others* (2013) 247 CLR 613 (***Hunt & Hunt***). In that case (which has wider application than just misleading and deceptive conduct) the court considered whether, in order for liability for "damage" to be apportioned to a concurrent wrongdoer, that damage must be "caused" by each concurrent wrongdoer and what analysis the court should undertake in making that assessment. In a split 3-2 decision, the majority of the High Court concluded that a wrongdoer's acts may be independent of those of another wrongdoer and yet be said to cause the same damage for the purposes of apportionment.

Key messages

It may be some time before there is clarity on the contradicting decisions of *Wealthsure* and *ABN AMRO* in respect of misleading and deceptive conduct claims involving financial services and financial products. Despite widespread anticipation that the decisions would be appealed and even possibly heard together by the High Court, there was no appeal from either decision. The absence of any High Court authority resolving the conflict means that alleged wrongdoers (and by implication, insurers of those alleged wrongdoers) will continue to face uncertainty in terms of how far the proportionate liability regime extends in financial services cases.

It is clear that ten years into the regime, the law of proportionate liability in Australia is still very much in the development phase. It has been largely successful in simplifying the often unfair burden created by allocation of loss under the joint and several liability system. However, part of the mischief the regime was also designed to remedy was the complexity of litigation resulting from the net being cast so widely with too many unnecessary parties being joined to litigation. It is harder to draw the line on joinder given the conflicting authority that has resulted from *Wealthsure* and *ABN AMRO* and the confusion which follows. As a result it appears that Australia may well be in for a few more years of confusion before clarity (likely in the form of further High Court authority) on proportionate liability can prevail.

Drawing a line – response to SIBOR manipulation illustrates difference in regulatory approach in Singapore

Ian Roberts, Partner, Singapore

Fallout from the LIBOR manipulation scandal continues, with Lloyds Bank the latest to receive substantial fines from UK and US regulators. In Singapore, although there were similar investigations and issues in relation to SIBOR manipulation (Singapore Interbank Offered Rate), the regulator took a different attitude and approach to the penalties that should be given to those involved. In this article we discuss the SIBOR investigation and its outcome, and how this illustrates a difference in approach between regulators.

Investigation and outcome

SIBOR is, similar to LIBOR, a daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the Singapore wholesale money market, and reflects how much it would cost banks to borrow from each other. SIBOR was set up by the association of banks in Singapore on the basis of estimates provided by members and is more commonly used than LIBOR or Euribor in the Asian region and, in Singapore, is used for the setting of mortgage interest rates.

The Monetary Authority of Singapore (MAS) carried out a year-long review of SIBOR as well as Swap Offered Rates (SOR) and Foreign Exchange spot benchmarks (FX benchmarks) over the period 2007 – 2011. In June 2013, MAS reported that 133 traders were found to have engaged in attempts to inappropriately influence the benchmarks (although there was no conclusive finding by MAS that the benchmarks had been successfully manipulated). MAS found that twenty banks had deficiencies in governance, risk management, internal controls and surveillance systems. As a result, MAS:

- censured the banks, requiring them to adopt measures to address their deficiencies and to report on a quarterly basis on their progress as well as conduct independent reviews
- required the banks to deposit additional statutory reserves at a rate of zero interest for one year, although the duration for which the reserves were to be held was to be variable depending on the progress made with addressing deficiencies

The sums required were significant, with RBS, ING and UBS being required to deposit over 1 billion dollars.

MAS reported that all of the traders involved had either left their banks, or would be subject to disciplinary action, and that the industry would put in place measures to facilitate reference checks so that an institution looking to hire someone would be made aware if they had been implicated in attempts to manipulate benchmarks. It concluded however, that there appeared to have been no criminal offence committed under Singapore law.

Legislation is to be adopted that will make the manipulation of financial benchmarks in Singapore subject to criminal and civil sanctions under the Securities and Futures Act (SFA) and administrators and submitters of financial benchmarks will be subject to regulation and licensing requirements. A consultation took place on the draft legislation in July/August 2014.

Discussion

The response by MAS is a typically Singaporean response to a scandal of this kind; decisive, pragmatic, and acting with an eye on the bigger picture. In this instance, their focus seems to have been on ensuring the rapid reform of the system, and not on handing out headline grabbing punishments. The approach has been well received, with the penalties for the banks (tied up capital with some interest loss) seen as severe but such as will allow these institutions to move on quickly as their money will be returned. It has been made clear that the individuals involved will no longer be welcome in Singapore's financial services industry. The differing focus of the regulators and the investigation in Singapore has likely influenced the absence of claims against the banks, which is in contrast to the UK and US. Whilst the LIBOR scandal continues to rumble on in London and New York, it appears that a line may have been drawn under the matter as far as Singapore is concerned.

Hong Kong Listed Companies – HK Stock Exchange Consultation on Risk Management and Internal Controls

Simon McConnell, Partner, Hong Kong
Mun Yeow, Partner, Hong Kong

The Stock Exchange of Hong Kong Limited ("**HKEx**") is currently undertaking a period of consultation on Listing Rule changes associated with Risk Management and Internal Controls. HKEx has published a consultation paper (the "**Consultation Paper**") on proposed revisions to the internal controls section of the Corporate Governance Code and Corporate Governance Report ("**Code**").[1]

Consistent with corporate governance developments and trends in various jurisdictions, the core objective of the Consultation Paper is to further highlight the importance of risk management. Other proposals to improve the Code include clearly specifying the respective roles and responsibilities of the board, management and the internal audit function; as well as to provide direction as to specific disclosures that issuers should make in the Corporate Governance Report.

Drawing experience from Singapore, Australia, the UK, the US and Mainland China, the core objectives of the Consultation Paper are to:

- Confirm that internal controls are an important part of risk management
- Increase accountability of the board and management by clearly defining their roles and responsibilities regarding risk management and internal controls
- Accentuate transparency of the issuer's risk management and internal controls by upgrading the recommendation for issuers to disclose their policies, process and details of their annual review of the effectiveness of their risk management and internal control systems
- Strengthen the oversight of issuer's risk management and internal control systems by upgrading the recommendation for issuers to have an internal audit function

The proposals are set out below:

Provision	Current position	Proposed amendment
C.2	Currently titled "Internal Controls" The principle states that the board should ensure that the issuer maintains sound and effective internal controls to protect shareholders' investment and the issuer's assets.	To emphasise the inter-related nature of risk management and internal controls, the current title is intended to change to "Risk management and internal controls". This Principle is regarded as placing insufficient emphasis on risk management; in addition, the connection between the issuer's objectives and risks associated with those objectives are not clearly stated. It is proposed that this Principle should be altered in the following ways: – it should state that the board is responsible for evaluating the risk it is willing to take in achieving the issuer's objectives and ensuring the establishment and maintenance of effective risk management and internal control systems; – it should state that the management is responsible for designing, implementing and monitoring the risk management and internal control systems, and that management should provide assurance to the board on the effectiveness of these systems;

[1] The Code is set out in Appendix 14 of the Main Board Rules and Appendix 15 of the Growth Enterprise Market Rules.

Provision	Current position	Proposed amendment
		– The phrase "to safeguard shareholders' investment and the issuer's assets" should be removed to widen its scope to cover risk management and internal control systems broadly; and – A new Recommended Best Practice ("**RBP**")[2] should be introduced to state that the board may disclose in the Corporate Governance Report that it has received assurance from management regarding the effectiveness of the issuer's risk management and internal control systems.
RBP C.2.3	This RBP currently sets out the matters that the board's annual review should consider.	In order to emphasize the importance of this provision, the Consultation Paper proposes to upgrade the existing RBP C.2.3 to a Code Provision ("**CP**").[3]
RBP C.2.4	This RBP sets out the particular disclosures that issuers should make in their Corporate Governance Reports in relation to how they have complied with disclosure requirements during the reporting period.	To encourage more substantive, meaningful disclosure, it is proposed that the existing RBP C.2.4 be upgraded to a CP. The Consultation Paper also proposes to alter the drafting to include risk management where appropriate, simplify the requirements and remove ambiguous language, and clarify that the risk management and internal control systems are designed to manage rather than eliminate risks.
Amendment of Section S	Section S of the Code sets out additional Recommended Disclosure in respect of internal controls that issuers are encouraged to make in their Corporate Governance Report.	The Consultation Paper proposes to upgrade most of the existing Recommended Disclosures in Section S to Mandatory Disclosures. Under the proposed new regime, issuers will be obliged to disclose: – Whether they have an internal audit function – How often the risk management and internal control systems are reviewed; and an explanation if no review has been conducted – A statement that a review of the effectiveness of the risk management and internal control systems has been conducted and whether the issuer considers them effective and adequate; and – Significant views or proposals put forward by the audit committee.

[2] A RBP is for guidance only and not a mandatory Listing Rule requirement
[3] Compared with a RBP which is for guidance only, a CP is on a "comply or explain" basis.

Provision	Current position	Proposed amendment
Amendment of CP C.2.1	CP C.2.1 requires the directors of an issuer to, at least annually, conduct a review of the effectiveness of the issuer's and its subsidiaries' internal control systems and report to the shareholders.	To emphasise that the board has an ongoing, rather than "one-off", responsibility to oversee the issuer's risk management and internal control systems, the Consultation Paper proposes to require the board to oversee the issuer's risk management and internal control systems on an ongoing basis. The Consultation Paper also proposes the board's annual review should ensure the adequacy of resources, staff qualification and experience, training programs and budget of the issuer's internal audit function.
Amendment of RBP C.2.6	Under the existing Code, issuers are not required to have an internal audit function. It is voluntary.	To address this issue, it is proposed that the RBP C.2.6 should be upgraded to CP, so that it would state that issuers should have an internal audit function, and those without an internal audit function should disclose the reasons for the absence of such a function in their Corporate Governance Report. HKEx has commented that it is a common practice for issuers to engage external service providers to perform the internal audit function, which can give rise to concerns as to the independence of the internal audit function. HKEx is of the current view that compliance with the proposed CP may be achieved either by way of an in-house internal audit function or an outsourced one. There is also a proposal to include new Notes to this provision to clarify that the role of the internal audit function is to perform the analysis and independent appraisal of the adequacy and effectiveness of an issuer's risk management and internal control systems, and a group with multiple listed issuers may share group resources of the holding company to carry out the internal audit function for members of the group.

Moving forward

HKEx is now evaluating market views on these changes, and it is expected to publish consultation conclusions within the next few months. Given that, HKEx listed companies are recommended to review their disclosures and internal control systems to ensure that they are capable of complying with the new requirements when they are introduced.

New financial policies in Shanghai Free Trade Zone

Ik Wei Chong, Partner, Shanghai
Victor Yang, Senior Associate, Shanghai

We report on a number of developments intended to open up China's financial markets.

I. Background of Shanghai Free Trade Zone

The China (Shanghai) Pilot Free Trade Zone ("FTZ") was launched on 29 September 2013. It is a testing ground for reforms in China and also acts as a "sample model" for other provinces/cities.

FTZ is the first free-trade zone in mainland China, integrating four existing bonded zones in the district of Pudong: Waigaoqiao Free Trade Zone, Waigaoqiao Free Trade Logistics Park, Yangshan Free Trade Port Area and Pudong Airport Comprehensive Free Trade Zone. Nine months after the launch of the zone, 10,445 enterprises were registered in the zone; 12% of these being foreign companies. This result is encouraging when compared to a sum of only around 8000 registered enterprises in 20 years for the FTZ's predecessor, the Shanghai Composite Bonded area.

Now a range of financial laws/regulations have been implemented, including liberalization of deposit interest rates and free trade accounts.

II. Liberalization of deposit interest rates

In February, People's Bank of China ("PBoC") announced that the deposit interest rate ceilings on smaller foreign currency deposits below USD 3 million were to be removed as of 1 March 2014.

This move will primarily benefit smaller accounts of foreign currencies in FTZ because, as of 2000, China had already liberalized lending rates and deposit rates on accounts holding more than USD 3 million. This latest move was seen as "a significant step towards implementing a complete, market-based system for setting interest rates".

The rule applies to bank accounts opened by companies and organizations registered in the free trade zone and individuals working there for longer than a year, the Shanghai headquarters of the People's Bank of China said in a statement. On 27 June 2014, the rule was extended across Shanghai. PBoC's Shanghai Head Office stated on 24 July 2014 that one month after the reform, the PVT of the foreign currency market had been steady and no cross-border arbitrage had been found. It is widely believed that the liberalization reform will eventually be extended across the whole country if it is successful.

III. Free trade account policy

The Shanghai Head Office of PBoC said five banks have met the requirements to open free trade accounts. The new accounting system covers all the traditional banking services like deposits, loans, remittance, L/C and letter of guarantee services, but under different mechanisms than those used in the non-FTZ onshore market: "It's as much as creating a new market."

Companies now have easier access to foreign loans. Loan interest rate in FTZ is generally lower than that of the outside-FTZ onshore market. What might excite companies more is that business loans borrowed inside FTZ can be used to pay off business loans borrowed from outside of the FTZ as long as they are borrowed through accounts under the same name.

In addition, non-resident enterprises that previously did not have access to certain services can now enjoy these services through a free trade account. Previously, only a few banks in China could conduct offshore business through their licenses, but this will change following a recent statement of PBoC confirming that at least all local banks in Shanghai will be able to run free trade account business and provide related services to eligible enterprises.

The account is also open to eligible non-resident individuals. However, as the details of cross-border investment activities are yet to be introduced, non-resident individuals can only be involved in general business under current accounts which is equivalent to operations outside the FTZ.

Mis-selling claims in the DIFC: Extending the boundaries of liability for investment advice and unregulated activities

Mark Beswetherick, Partner, Dubai
Shabnam Karim, Associate, Dubai

In a recent (August 2014) decision, the DIFC Court has ruled against financial institutions in a USD 200 million investment mis-selling claim, finding that the defendants, Bank Sarasin-Alpen ("Sarasin") and Bank Sarasin (Swiss Incorporated) ("Sarasin Swiss"), were liable for breaches arising out of Sarasin Swiss' unauthorised conduct of financial services in the DIFC, and in relation to Sarasin's failures in client classification and suitability of the advice.

Background

The defendants operated under a common model for international financial institutions operating in the DIFC. Sarasin had a DFSA Category 4 licence, and its primary role was to introduce and refer clients to Sarasin Swiss, which was not DFSA authorised to conduct financial activity. Those clients were "on-boarded" at booking centres in Switzerland, and it was envisaged that any financial activity or advice would therefore take place outside the DIFC.

In the course of 2007 and 2008, the Claimants (wealthy Kuwaiti nationals) were introduced by Sarasin to Sarasin Swiss, from whom they purchased structured financial products valued at $200m (the "Notes"). The Claimants maintained at trial that they had been looking for capital protection combined with a regular income and were assured that they would not lose any money by investing in the Notes.

In November 2008, Sarasin Swiss made a margin call, and when the Claimants did not meet that call, terminated facilities and closed the Notes. This left outstanding balances on loans taken out to fund the purchases and resulted in portfolio losses.

Findings against Sarasin

The Court accepted that the Claimants were not given sufficient warnings as to the level of risk involved in the investments or an adequate explanation of the nature and effect of the documents signed. It also found that there were regulatory breaches by Sarasin in complying with client classification requirements, and a lack of proper consideration to the individuals' level of financial sophistication and knowledge/understanding of the types of investments involved, such that they did not meet the Conduct of Business Rules definition of "Client" but were instead "Retail Customers".

Sarasin also failed to carry out an adequate suitability assessment, such that products were sold which were unsuitable to the Claimants' investment objectives.

Findings against Sarasin Swiss

Somewhat controversially, the regulatory claim against Sarasin Swiss (which is not DFSA regulated) was upheld, on the basis that it was carrying on regulated activity, in breach of the general prohibition at article 41 (1) of the DIFC Law no 1 of 2004.

The Court highlighted that there was insufficient delineation between Sarasin and Sarasin Swiss, with some documents on file giving a misleading impression that it was the (DFSA regulated) Sarasin which was the provider of bank accounts and investment services when in fact it was the (non-DFSA regulated) Sarasin Swiss which provided these facilities.

Conclusion

Both Sarasin and Sarasin Swiss were ordered to pay compensation to the Claimants in respect of the losses sustained. Damages are as yet unquantified, but are understood to be very large given the amount invested.

The case, of course, turns on its unique facts. Nonetheless, the judgment, which is being appealed, certainly evidences a willingness by the DIFC Courts to look beyond the appearances of formal legal structures and focus on the practical realities when it comes to the assessment of liability for the provision of regulated financial services.

The sting in long tail disease – a warning for directors

Max Ebrahim, Partner, Cape Town
Daniel Le Roux, Partner, Johannesburg

On 4 April this year, not very far from the site where gold was first discovered in South Africa, Judge EJ Francis, in an unreported judgment, dismissed a technical challenge by Anglogold Ashanti Limited ("**Anglogold**") against a claim by a former mine-worker in silicosis related litigation.

The judgment, in very general terms, underlines the court's willingness to take an overbroad approach to the manner in which these types of cases are pleaded, but is particularly significant to the D&O market because, although only Anglogold is cited as defendant, there may well have been scope for the claimant to also name Anglogold's directors, in their personal capacities, as co-defendants.

Background

In this action, the claimant alleges that over the course of a ten year period where he was employed at the Vaal Reefs Mine (the "**mine**"), Anglogold flouted its obligations under safety legislation governing the operation of mines in South Africa, and in particular failed to:

1. regularly perform medical examinations and x-rays on the claimant;
2. design and implement systems relating to the control of dust; and
3. establish dust control policies for the mine and to monitor dust levels within the mine.

The claimant alleges that, as a consequence of these breaches, he contracted silicosis and that Anglogold is liable for the resulting damage suffered. Anglogold's failed technical challenge, which centred on the claimant's failure to outline the precise detail about how the breaches are alleged to have taken place over the ten year period, means that the claim is now free to proceed. In turn, as this was merely a test case, it is now a distinct possibility that tens of thousands of other claimants, who until now have been lurking in the shadows, will step out into the light, claims against Anglogold and other mining companies in hand. There is little doubt that, in doing so, they will be bolstered by the contemplation of class actions as envisaged by the South African Companies Act 71 of 2008. Whilst the jurisprudence in this area is relatively rudimentary at present, there is, in principle, no statutory bar preventing these claimants from launching proceedings as a group of affected parties (*Mankayi v AngloGold Ashanti Ltd* (2011)).

Should they do so, it is possible that not only the mining companies, but also their directors, will be in the firing line.

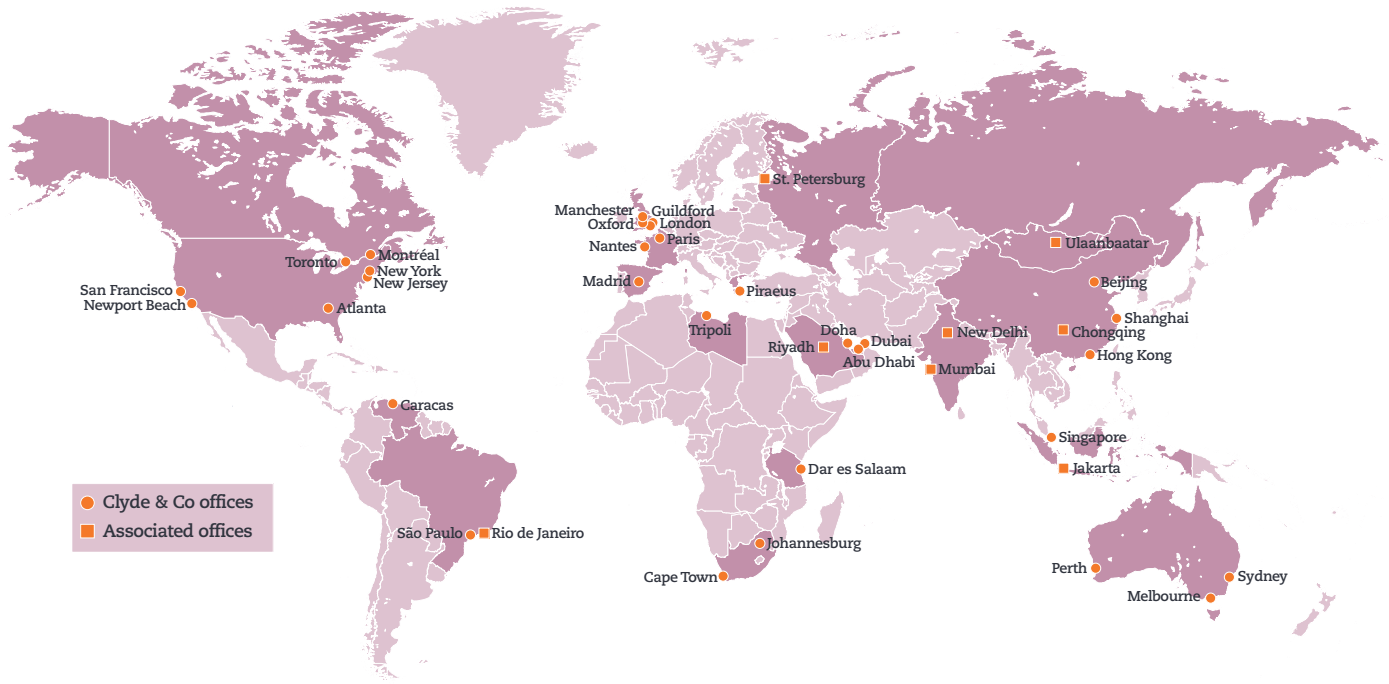
D&O claims

The Mine Health and Safety Act 29 of 1996 (the "**1996 Act**") requires the Chief Executive Officer of a mining company to ensure the discharge of a company's duties under safety legislation – penalties, fines and imprisonment can follow for those directors, officers or managers guilty of a failure to maintain a safe working environment. Moreover, the 1996 Act also created the office of the Chief Inspector of Mines, who is authorised to conduct official inquiries into, broadly, any "*cause for concern on health or safety grounds*". The Chief Inspector may require preventative or remedial action, and can apply punitive enforcement measures (up to removal of a mining licence) in appropriate circumstances. Relying on this statutory framework, there are, therefore, grounds upon which personal claims against relevant directors and officers could be founded.

Directors, of course, are free to procure D&O cover in respect of claims brought against them in their personal capacity. Indeed, given the significant growth of the plaintiff's bar in South Africa in the last ten years, and the additional complexities brought about by international lawyers attempting to shift disease litigation to jurisdictions which tend to award larger sums for general damages, it would not be unreasonable to suggest that such cover, combined with proper risk mitigation strategies, is now critical for directors & officers in this area.

Whilst such policies typically exclude cover for silicosis and related occupational disease litigation, they may respond to claims of the kind set out above (failure to discharge statutory obligations) and may also provide indemnity against the cost of litigation (assuming the policy has been extended to include legal defence costs). D&O insurers should therefore be aware of the potential for claimants afflicted with silicosis-type diseases to directly pursue directors and officers for breaches of, amongst others, the 1996 Act, and consider whether their policies would cover such claims, notwithstanding the applicable exclusions.

Our global reach



Further information
If you would like further information on any issue raised in this newsletter please contact:

UK and Europe
James Cooper
james.cooper@clydeco.com

Laura Cooke
laura.cooke@clydeco.com

James Roberts
james.roberts@clydeco.com

David Meheut
david.meheut@clydeco.fr

Ignacio Figuerol
ignacio.figuerol@clydeco.com

Pablo Guillen
pablo.guillen@clydeco.com

Hong Kong
Simon McConnell
simon.mcconnell@clydeco.com

Mun Yeow
mun.yeow@clydeco.com

Singapore
Ian Roberts
ian.roberts@clydeco.com

Canada
Roderic McLauchlan
roderic.mclauchlan@clydeco.com

Mary Margaret Fox
marymargaret.fox@clydeco.ca

John Nicholl
john.nicholl@clydeco.ca

Catherine Tyndale
catherine.tyndale@clydeco.ca

US
Ned Kirk
edward.kirk@clydeco.us

Bill Lutz
william.lutz@clydeco.us

Kim West
kim.west@clydeco.us

Middle East
Mark Beswetherick
mark.beswetherick@clydeco.com

Australia
John Edmond
john.edmond @clydeco.com

Jenni Priestley
jenni.priestley@clydeco.com

Oscar Shub
oscar.shub@clydeco.com

Jenny Thornton
jenny.thornton@clydeco.com

South America
Liliana Veru-Torres
liliana.veru-torres@clydeco.com

Peter Hirst
peter.hirst@clydeco.com

Lee Bacon
lee.bacon@clydeco.com

South Africa
Max Ebrahim
max.ebrahim@clydeco.com

Daniel Le Roux
daniel.leroux@clydeco.com

Arthur James
arthur.james@clydeco.com

Rashad Ismail
rashad.ismail@clydeco.com

Clyde & Co LLP

www.clydeco.com

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