

London Update: UK Financial Services Regulatory Developments (May 2009)

May 2009

This edition covers UK and EU developments between March 31 and April 30.

UK Developments

FSA Campaign Against Insider Dealing Continues

On March 31, the UK Financial Services Authority (FSA) announced that it had arrested a "senior corporate finance adviser" and another individual in connection with an ongoing investigation into suspected organised insider dealing. Search warrants were also executed by the FSA at a number of addresses in Greater London as part of the investigation. The FSA announced that its arrest operation involved 25 FSA staff, assisted by 11 police officers.

In a separate development, both defendants found guilty in the FSA's first criminal insider dealing prosecution (as reported in the April edition of *London Update*) were sentenced to jail terms of eight months.

Read more.

FSA Wins Market Abuse Case Against Market Maker

On April 2, the FSA announced that it had won its market abuse case at the Financial Services and Markets Tribunal (the Tribunal) against Winterflood Securities Limited (Winterflood), the largest market maker of AIM Securities, and two Winterflood traders, Stephen Sotiriou and Jason Robins.

In June 2008, the Regulatory Decisions Committee of the FSA (RDC) found that Winterflood, Mr. Robins and Mr. Sotiriou carried out an illegal share ramping scheme relating to shares in Fundamental-E Investments Plc (FEI), an AIM listed company. In particular, the market maker had misused rollovers and delayed rollovers thereby creating a distortion in the market for FEI shares and in so doing misled the market for about six months in 2004. The RDC fined Winterflood £4 million

(approximately $5.9 million) and imposed fines of £200,000 (approximately $295,000) on Mr. Sotiriou and £50,000 (approximately $73,500) on Mr. Robins.

The RDC concluded that the FEI share trades executed by Winterflood in the relevant period had a series of unusual features which should have alerted the market maker to the clear and substantial risks of market manipulation. Rather than taking steps to ensure that the trades were genuine, Winterflood continued the trading since it was highly profitable. Winterflood made about £900,000 (approximately $1.3 million) from trading in FEI shares in the relevant period. FEI was its most profitable stock at the time.

Winterflood referred the matter to the Tribunal on a point of law. The Tribunal rejected Winterflood's contentions and upheld the RDC's decision which has therefore now been made public.

Read more.

European Parliament and European Council Approve New Regulation on Credit Rating Agencies

On April 23, the European Commission announced that the European Parliament and the Council of the European Union have approved a new regulation on credit rating agencies (CRAs). The regulation will be directly applicable in EU member states. It will not require implementation by national legislation.

The regulation introduces a common regulatory regime across the EU for CRAs. It includes the following requirements:

- The Committee of European Securities Regulators will operate a registration process. Applications will be decided upon by the relevant securities regulators grouped into a college. (Colleges of regulators will also be involved in the day-to-day supervision of CRAs.)
- CRAs are not permitted to provide advisory services.
- CRAs are required to disclose the models, methodologies and key assumptions on which they base their ratings and to publish an annual transparency report.
- CRAs must create a department akin to internal audit to review the quality of their ratings.
- CRAs must differentiate the ratings of more complex products by adding a specific symbol.
- CRAs are to have at least two independent directors, at least one of whom must have expertise in securitization. Their remuneration must not be linked to the business performance of the rating agency. They must be appointed for a single term of office of no more than five years and the agency may only dismiss them for misconduct.

The requirements imposed on CRAs are largely based on the standards set out in a voluntary code of conduct for CRAs published by the International Organisation of Securities Commissions in 2004 and revised in May 2008.

The regulation will be directly applicable across the EU 20 days after it is published in the Official Journal of the European Union. There will be a six-month transition period before its provisions become fully effective.

Read more.

European Commission Announces Proposed Alternative Investment Fund Managers Directive

On April 29, the European Commission announced a proposed Alternative Investment Fund Managers Directive (Proposed Directive). The Proposed Directive requires approval by the European Parliament and the European Council. It will not come into force until two years after that approval, at the earliest in late 2011.

The Proposed Directive will apply to alternative investment fund managers (AIFMs) managing a portfolio of more than €100 million (approximately $130 million). A higher threshold of €500 million (approximately $665 million) applies to AIFMs that do not use leverage and have a lock-in period of five years or more. AIFMs are defined to include not just managers of hedge funds, private equity funds and other alternative investment funds, but all managers of funds which are not UCITS funds meeting the requirements of the UCITS Directive 85/611/EEC. (UCITS funds are open-ended funds investing in transferable securities and certain other financial instruments which can be marketed to the general public in EU Member States). This will include, for example, managers of real estate funds, commodity funds and infrastructure funds.

The Proposed Directive:

- will require AIFMs to be authorised by the financial services regulator in their home state;
- will subject AIFMs to meet ongoing minimum financial resources requirements and other regulatory requirements including information disclosure to regulators with respect to its principle exposures, performance data and risk concentrations;
- will apply regulatory standards to key service providers to alternative investment funds, including requiring regulated depositaries and regulated valuation agents (valuators);
- will require AIFMs to meet defined standards with respect to management of risk, liquidity and conflicts of interest; and

- will permit AIFMs to market alternative investment funds to professional investors throughout the EU under a private placement regime. This will apply to funds established in non-EU jurisdictions only after a transitional period of three years from the date the Proposed Directive comes into effect and will be conditional on the jurisdiction of the fund's domicile being recognised by the EU as having equivalent regulatory and supervisory standards and information-sharing and co-operation arrangements on tax and other matters.

The Commission stated that it anticipates “intense political discussion and negotiation” in view of the subject matter. It is clear that when the Directive is finally enacted it is likely to differ in significant respects from the Proposed Directive. On one side, the UK government and industry bodies such as the Hedge Fund Standards Board and the Alternative Investment Management Association have condemned the proposed Directive as too heavy handed. On the other side, the Socialist Group of the European Parliament has expressed its dismay that the proposal does not go far enough. The Socialist Group has spoken of a “proposal filled with loopholes which make the real regulatory effects highly ineffective” and is complaining that the Commission is proposing to regulate “only fund managers” and not the funds themselves.

Read more.

Commission Announces Two Recommendations on Remuneration

On April 29, the European Commission announced two Recommendations on remuneration: a Recommendation on remuneration in the financial services sector (FS Remuneration Recommendation) and a Recommendation on the regime for the remuneration of directors of listed companies (Directors' Pay Recommendation).

The FS Recommendation invites Member States to ensure that financial institutions have remuneration policies for risk-taking staff that are consistent with and promote sound and effective risk management.

The FS Recommendation covers four areas:

- Structure of pay: Remuneration policies for risk-taking staff should be consistent with and promote sound and effective risk management. Financial institutions should strike an appropriate balance between basic pay and bonuses. The payment of the major part of any bonus should be deferred in order to take into account risks linked to the underlying performance through the business cycle. Performance measurement criteria should emphasise longer-term performance adjusted for risk, cost of capital and liquidity. There should be provisions for clawback of bonuses based on misstated data.

- Governance: The remuneration policy should be transparent internally, should be clear and properly documented and should contain measures to avoid conflicts of interest.
- Disclosure: There should be clear and easily understandable disclosure of the core elements of the remuneration policy; its design and operation should be disclosed to stakeholders.
- Supervision: Supervisors of financial institutions should ensure that sound remuneration policies are applied and are consistent with effective risk management.

The FS Recommendation will be followed up in June by proposals to revise the Capital Requirements Directive to ensure that regulatory capital adequately covers the risks inherent in remuneration policies as well as banks' trading books and securitisation positions.

The Directors' Pay Recommendation applies to directors of listed companies. It supplements previous Recommendations 2004/913/EC and 2005/162/EC. The new Directors' Pay Recommendation introduces limits on severance pay and bans severance pay in case of failure.

Further specific recommendations include the extension of existing disclosure requirements to improve shareholder oversight of remuneration policies; prohibiting non-executive directors from receiving share options as part of their remuneration to avoid conflict of interests; and strengthening the role of remuneration committees.

For more information on the FS Remuneration Recommendation, click here.
For more information on the Directors' Pay Recommendation, click here.

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