



London Update

UK Financial Services Regulatory Developments

April 2008

This edition of London Update covers UK and EU developments from March 1 – 31, 2008.

UK Developments

FSA Announces Final Rules on Telephone Taping

On March 3, the Financial Services Authority (FSA) published new rules requiring firms to record telephone conversations and other electronic communications. The FSA's stated purpose for introducing these requirements is the deterrence and detection of market abuse.

The rules, which will not come into effect until March 2009, will require FSA authorised firms to record all telephone conversations and electronic communications relating to client orders and the conclusion of transactions in the equity, bond and derivatives markets. There are certain exemptions for discretionary investment managers and for electronic communications with other firms that are subject to the FSA's taping rules. The required retention period for recorded phone calls and electronic communications is six months.

When the FSA first consulted on taping rules in 2007 the proposed required retention period was three years, and it was proposed to require mobile phone conversations to be recorded. Mobile phone conversations have been exempted from the taping rules, subject to review 18 months after the rules come into force.

www.fsa.gov.uk/pubs/policy/ps08_01.pdf

FSA Consultation on Listed Company Sponsor Regime

On March 6, the FSA published consultation paper CPO8/5 *Sponsor Regime – A Targeted Review* with proposed amendments to the sponsor regime for UK listed companies.

All UK companies with what are called "primary" listed equity securities and new applicants seeking a primary listing are required to appoint a sponsor. Sponsors generally include investment banks and corporate finance firms with specialist knowledge of the UK Listing Rules and the London equity market.

The consultation sets out several key proposals which include clarifying the application of the principles for sponsors set out in Chapter 8 of the UK Listing Rules, introducing procedures for identifying and managing conflicts within sponsors, and revising the FSA's guidance on appropriate systems and controls for sponsors. The consultation closes June 6.

www.fsa.gov.uk/pubs/cp/cpo8_05.pdf

FSA Publishes Final Covered Bonds Rules

On March 6, the FSA published policy statement PSo8/2 *Regulated Cover Bonds* with feedback on its proposals for a UK recognised covered bonds regime together with final rule changes for the FSA Handbook, including registration and ongoing requirements.

The policy statement follows a joint consultation with the Treasury launched in July 2007, which proposed the implementation of a UK recognised covered bonds legislative framework (see the August 2007 edition of *London Update*).

The legislative framework under which UK issuers can issue covered bonds that are permitted investments under Article 22(4) of the EU Undertakings for Collective Investment in Transferable Securities (UCITS) Directive also came into effect on March 6 (see the December 2007 edition of *London Update*).

www.fsa.gov.uk/pubs/policy/ps08_02.pdf

FSA Publishes Views on Rogue Trader Risk

On March 11, the FSA published *Market Watch 25*, which highlights measures UK authorised firms should consider to protect themselves against “rogue trader” risk. *Market Watch 25* focuses on prevention, early discovery and remedial action with respect to inappropriate practices that may quickly lead to significant losses. Specific points covered by *Market Watch 25* include: (i) promoting oversight and governance in front office culture (such as encouraging all traders to take two-week vacations each year), (ii) segregating front office staff from middle and back office functions, (iii) monitoring the use of expense accounts, and (iv) producing quality management information.

www.fsa.gov.uk/pubs/newsletters/mw_newsletter25.pdf

Government Announces 2008 Budget

On March 12, the Chancellor of the Exchequer, Alastair Darling, set out the Government’s 2008 Budget in the House of Commons. The Budget included announcements with respect to the UK Investment Manager Exemption, the introduction of Funds of Alternative Investment Funds and a new tax regime for Property Authorised Investment Funds, changes to the offshore funds rules introducing “reporting funds”, reform of the UK’s non-domicile rules and extending the UK VAT exemption for fund management.

The Investment Manager Exemption (IME). A single list of qualifying transactions for the purposes of the IME will be maintained and updated to allow flexibility to adapt to new products and instruments like carbon credits.

Funds of Alternative Investment Funds (FAIFs). In conjunction with changes proposed by the FSA outlining a new regulatory framework for FAIFs that will allow UK funds to invest in other alternative investment funds, as described in the March 2008 edition of *London Update*, new tax rules have been introduced to allow UK authorised funds to elect for exemption from the UK’s offshore funds regime. Instead, investors in FAIFs that make the election (Tax FAIFs) will be taxed as if the Tax FAIF was an offshore fund, effectively moving the point of taxation from the fund to its investors.

New tax regime for Property Authorised Investment Funds (PAIFs). A new tax regime has been proposed for PAIFs (authorised investment funds which invest mainly in property and shares in UK Real Estate Investment Funds (UK-REITs) and similar foreign companies). The new regime came into effect on April 6 and will enable certain alternative investment funds to elect for tax treatment that will move the point of taxation from the fund to its investors. It will also enable PAIFs to provide an open-ended fund alternative to the existing closed-ended UK-REITs.

Changes to the UK offshore funds rules. The existing “distributor status” regime will be replaced with a “reporting” regime. Unlike distributing funds, “reporting funds” will not be required to distribute 85% of income in order to qualify for the new tax regime. Instead, 100% of income will have to be “reported” to investors, who will then be subject to income tax on that reported income.

Reform of the UK non-domicile rules. As previously proposed by the Treasury, non-domiciliaries wishing to benefit from the remittance basis of taxation will be levied an annual charge of £30,000 if they have been residents of the UK for seven years. It is now anticipated that the £30,000 will be creditable under double tax agreements (including agreements with the US), as it will be charged as “tax” instead of some other “levy” or “charge.”

UK VAT exemption for fund management. Exemption from VAT is currently granted to the management of authorised unit trusts, trust-based schemes and open-ended investment companies. This exemption is to be extended to cover UK listed investment entities (including investment trusts and venture capital trusts), and will take effect for supplies of services made on or after October 1.

www.hm-treasury.gov.uk/budget/budget_08/bud_budo8_index.cfm

FSA Admits Failures in Regulatory Oversight of Northern Rock

On March 26, the FSA published a summary of a review carried out by its internal audit division into its supervision of Northern Rock. The review identified numerous areas for improvement in the execution of its supervision, which will be implemented urgently by FSA management as part of a supervisory enhancement programme.

Hector Sants, FSA Chief Executive, admitted that it was clear that the FSA’s supervision of Northern Rock in the period leading up to the market instability of late summer 2007 was not carried out to an acceptable standard, although he added that it was impossible to judge whether without the FSA’s regulatory shortcomings the Northern Rock affair would have had a different outcome.

After considering the internal audit report and the programme of work set out by FSA management in response to the report's conclusions and recommendations, the FSA's board confirmed its support for the FSA's fundamental philosophy of outcomes-focused, more principles-based regulation. It reiterated that regulated firms, their boards and management (rather than the regulator) carried the primary responsibility for ensuring their institutions' financial soundness.

The review identified four key failings of the FSA in relation to Northern Rock:

- lack of sufficient supervisory engagement with the bank and a failure to follow up on questions relating to the bank's potential vulnerability;
- lack of adequate oversight and review by the FSA's line management of the quality, intensity and rigour of the firm's supervision by the FSA;
- inadequate resources directly supervising Northern Rock; and
- lack of intensity in ensuring that available risk information was properly utilised by the supervisory team.

The review makes numerous recommendations for improving FSA bank supervision in the future. These include increased engagement with high-impact firms and day-to-day supervision, improved use of market information and market intelligence in FSA supervision, improved quality and resourcing of financial and sectoral analysis and supervision, and an increased level of oversight (including annual meetings with external auditors).

The review concluded that it was particularly significant that Northern Rock was the only major UK bank not to have a formal Risk Mitigation Program with its FSA supervisors. Further, a number of key risks highlighted by the FSA's risk assessment process were not passed on to the FSA's Northern Rock supervisory team to be addressed in depth with the bank's management.

The FSA's supervisory enhancement programme, expected to be completed by December, includes the establishment of a new group of supervisory specialists to regularly review the supervision of all high-impact firms, expanding the number of supervisory staff engaged with high-impact firms (with a mandated minimum level of staffing for each firm) and upgrading the current supervisory training and competency framework for FSA staff. The program includes an increased focus on liquidity, particularly in the supervision of high-impact retail firms, and a raised emphasis on assessing the competence of firms' senior management. The full report will be published before the end of April.

www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml

Revised FSA Website Financial Promotions Section Launched

On March 27, the FSA revised and re-launched the section of its website which contains information and guidance on financial promotions.

The standard of financial promotions is one of the FSA's retail market strategy priorities and a key part of the FSA's Treating Customers Fairly initiative. The revised financial promotion section of the FSA's website is designed to meet the FSA's commitment to provide regulated firms with information detailing the regulator's expectations of firms' financial promotions.

The financial promotion section contains:

- thematic review results;
- case studies, providing examples of good and poor practice;
- information on issues which have led to the FSA requesting that firms withdraw or amend promotional material; and
- key material additional to the FSA rules such as speeches, enforcement actions, press releases and other relevant information.

www.fsa.gov.uk/Pages/Doing/Regulated/Promo/index.shtml

EU Developments

CESR Publishes a Consumer's Guide to MiFID

On March 7, the EU Committee of European Securities Regulators (CESR) published a consumer's guide to the EU Markets in Financial Instruments Directive (MiFID). The guide explains the basics of MiFID and the key requirements for firms providing investment services in Europe.

It aims to highlight the key principles that EU firms need to fulfill when dealing with consumers, including: (i) a duty to act honestly, fairly and professionally and in accordance with the consumer's best interests; (ii) the provision of appropriate and comprehensive information which is fair, clear and not misleading to the consumer; and (iii) the provision of services that take account of individual circumstances.

www.cesr.eu/popup2.php?id=4984

Industry Report Recommends New EU Retail Real Estate Funds Framework

On March 13, the European Commission published a report on open ended real estate funds that made recommendations on the possible future regulation of retail real estate funds across the European Union.

The report's recommendations cover legislative and tax reform with a view to harmonising the existing national rules and establishing an EU-wide framework. The report calls for the introduction of EU legislative arrangements to provide cross-border retail distribution of open ended real estate funds that invest in high-quality real estate assets, including land and buildings which are currently excluded from the EU's Undertakings in Collective Investment in Transferable Securities (UCITS) Directive. The report recommends EU legislation designed to overcome EU market access barriers. It presents a set of key features which could be used as the regulatory template for competitive investment products incorporating high levels of investor protection safeguards.

www.ec.europa.eu/internal_market/investment/docs/other_docs/expert_groups/report_en.pdf

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Upcoming Breakfast Seminar:

The Liquidity Crisis Phase II – Legal and Regulatory Implications for Managers in a Time of Turmoil

Tuesday, April 22

London Capital Club, London EC4

For an invitation, please send an email to terri.duggan@kattenlaw.co.uk.

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