London Update

UK Financial Services Regulatory Developments

Katten
Katten Muchin Rosenman Cornish LLP

August 2009

This edition covers UK and EU developments between 1 May and 31 July

UK DEVELOPMENTS

UK Treasury Consults on More Effective Arrangements for Dealing with Investment Bank Failures

On 11 May, HM Treasury published a report entitled "Developing effective resolution arrangements for investment banks" (the Report). The Report is the result of Treasury working with a specialist Advisory Panel of investment banking, insolvency, legal and other experts, as well as the UK Financial Services Authority (FSA) and the Bank of England. It sets out the Government's initial thinking on various reforms which may need to be considered in developing effective resolution arrangements for investment banks. It responds directly to the issues that were highlighted by the failure of Lehman Brothers, including the treatment of client money and assets, and the treatment of clients' open or unreconciled trading positions. It also examines what can be done to make the process of insolvency itself more effective, and limit the damage that may be caused by an investment bank failure.

Chapter 2 of the Report outlines the trading, clearing and settlement issues being considered. Client money and client assets issues are addressed in chapter 3, and insolvency proposals are set out in chapter 4.

A key element of the Report is addressing misconceptions on how the US and UK insolvency regimes respectively have dealt with the Lehman Brothers failure. It states:

> There has been some market commentary to the effect that customer protections and insolvency arrangements in the US have been operating more effectively than the UK arrangements in the context of the failure of Lehman Brothers. The industry experts assembled through the Advisory Panel have been clear that this perception is misconceived.
>
> The Government is committed to working with the Advisory Panel and other industry experts, to explain, and where appropriate dispel, any of the misconceptions around how the US and UK regimes have operated with regard to the Lehman Brothers failure.

The comment period ended on 10 July. The next stage will be more detailed consultation as appropriate, including more detailed Treasury consultation in the autumn of 2009 outlining possible market, regulatory and legislative solutions.

Read more.

FSA Bans Trader for Overnight Concealment of Trading Position

The FSA has banned David Redmond, a former proprietary trader in freight and oil with Morgan Stanley's London commodities division, from performing any function in relation to any regulated activity on the grounds that he is not a fit and proper person.

The FSA stated that it made no criticisms of Morgan Stanley or any other individuals at the firm. The firm promptly identified and investigated the issue and took swift action against Mr. Redmond, suspending him the day the acts in question came to light and subsequently dismissing him.

On 6 February 2008, Mr. Redmond built up a substantial short position in WTI Futures on the ICE Futures (Europe) web-based trading platform. In breach of Morgan Stanley's policies and procedures, he then concealed the position overnight, exposing the firm to the risk of incurring a significant loss. On 7 February 2008, rather than informing the firm of his actions, Mr. Redmond traded out of the position. He admitted concealing the position only when directly challenged by the firm.

Margaret Cole, the FSA's Director of Enforcement, in a published comment emphasised that this concealment of positions showed a lack of honesty and integrity that fell short of the standards the FSA expects of approved persons.

The FSA indicated that, based on a number of mitigating factors, it would be likely to agree to an application from Mr. Redmond to lift the ban after two years, provided there is no further evidence of misconduct.

Read more.

FSA Bans and Fines Trader for Unauthorised "Pre-Hedging"

The FSA announced on 26 May that it had banned and fined trader Nilesh Shroff for deliberately disadvantaging his customers on seven occasions between June and October 2007 by partially "pre-hedging" program trades without the clients' consent. Mr. Shroff has been prohibited from performing any regulated function on the grounds that he is not fit and proper and has been fined £140,000.

"Pre-hedging" refers to trading by a broker for his firm's benefit in advance of carrying out a trade for his customer, using information provided by that customer. When customers instructed Mr. Shroff to buy particular stocks, he bought those stocks for the firm first, causing the price to increase before he executed the customers' trades. When the customer order was to sell, he first sold on behalf of the firm, decreasing the price. Mr. Shroff knew such unauthorised pre-hedging was expressly prohibited by the FSA and Morgan Stanley's policies and not in his clients' interests.

The misconduct occurred while Mr. Shroff was a senior trader at Morgan Stanley. Following its own investigation, Morgan Stanley dismissed him for gross misconduct on 28 December 2007. The FSA determined that he was solely responsible in this case and neither Morgan Stanley nor companies related to it, nor any other individuals employed by it, were subject to criticism.

Mr. Shroff agreed to settle at an early stage of the investigation and therefore qualified for a 30% reduction in penalty from £200,000. In a published comment, Margaret Cole, the FSA's director of enforcement, said, "Nilesh Shroff has been banned from trading because he repeatedly abused his position of responsibility as a senior trader and the trust placed in him by clients and by his employer. He was aware of FSA guidance and Morgan Stanley's rules in relation to pre-hedging but nonetheless he broke them".

Read more.

UK Short Selling Disclosure Regime Extended

On 1 June, the FSA issued Consultation Paper 09/15 in which it proposed to extend the current UK disclosure regime for net short positions in the stocks of UK financial sector companies which expired on 30 June.

The FSA did not propose to place a time limit on the extension of the disclosure regime and said its expectation was "that it would either be superseded in due course by broader permanent disclosure measures—preferably agreed on the widest possible international basis—and/or be revoked".

On 26 June, the FSA announced that it has extended, without an expiration date, the current disclosure regime. While no expiration date has been set, the FSA has emphasised that it does not intend to keep the regime permanently.

Short position disclosures remain required for net short positions in relevant issuers which exceed 0.25% of the issued share capital of the issuer. Further filings are required as the position increases by bands of 0.1% (i.e. the net short position reaches 0.35%, 0.45% etc).

Read more.

FSA Proposes Increased Fines

On 6 July, the FSA published its consultation paper CP09/19 *Enforcement Financial Penalties* outlining its proposals for a more consistent and transparent framework for financial penalties. The proposals could mean some fines will triple in size.

The FSA stated that the proposals reflect its determination to change behaviour and address concerns about firms' repeated failure to improve standards. They will also ensure that fines better reflect the scale of the wrongdoing and that any profits made from behaviour subject to penalty will be clawed back. The FSA emphasised the fact that its enforcement philosophy is "credible deterrence". It aims to achieve this by focusing on cases that can make a real difference to consumers and markets, and using enforcement strategically as a tool to change industry behaviour.

The main proposal in CP09/19 is for a change in the FSA's policy on determining the level of financial penalties. The FSA intends to increase the level of penalties it imposes and also to be more transparent and consistent in the way that it sets penalties.

The proposed revised penalties framework will consist of the following steps: (i) removing any profits made from the breach; (ii) setting a figure to reflect the nature, impact and seriousness of the breach; (iii) considering any aggravating and mitigating factors; (iv) achieving the appropriate deterrent effect; and (v) applying any settlement discount.

The consultation will close on 21 October, and any new policy is likely to apply to breaches committed after February 2010.

Read more.

UK Government Issues Proposals for Reforming Financial Markets

On 8 July, the Chancellor of the Exchequer, Alistair Darling, presented to Parliament a White Paper entitled "Reforming Financial Markets". The White Paper sets out the Government's proposals for further reforms necessary to strengthen the financial system and its regulation as well as the Government's analysis of the causes of the current financial crisis and the actions already taken to restore financial stability.

The White Paper sets out a number of core issues to which the Government's strategy for regulatory reform must respond:

- strengthening the UK's regulatory institutional framework, so that it is better equipped to deal with all firms and, in particular, globally interconnected markets and firms;
- dealing with high impact firms that may be seen as being "too big to fail", through improved market discipline and improved supervisory focus on such firms;
- identifying and managing systemic risk as it arises across different financial markets and over time; and
- working closely with international partners to deliver the global action required to respond to the lessons of the financial crisis.

The Government proposes to increase the FSA's powers by adding a statutory objective of financial stability and extending its rule-making powers. The Government also proposes to extend the FSA's powers to deal with individual firms on a case-by-case basis through firm-specific interventions and to enhance its enforcement powers in relation to market misconduct. In addition, the FSA will be empowered to constantly review the scope of regulation, gathering information from unregulated entities to determine whether they pose a threat to stability and should be brought within the FSA's regulatory regime.

The Government intends to strengthen the structure of the regulatory system by increasing the powers of both the FSA and the Bank of England and creating a Council for Financial Stability.

In order to ensure a competitive and fair market for consumers, the Government proposes a range of consumer protection measures. These include measures to raise financial capability; improve access to simple, transparent products; develop better and faster ways of dealing with widespread complaints; improve depositor protection arrangements; and strengthen competition and choice.

In a separate announcement, the FSA welcomed the Government's intention to legislate to give the FSA a statutory objective with respect to financial stability as well as new powers to act in pursuit of this objective.

Read more.

Walker Review Proposes Fundamental Changes to Strengthen Bank Governance

On 16 July, HM Treasury published a consultation document setting out Sir David Walker's recommendations from his review of corporate governance of the UK banking industry (the Walker Review).

The Walker Review was commissioned in February 2009 by the Chancellor of the Exchequer, the Secretary of State for Business, Innovation & Skills, and the Financial Services Secretary to the Treasury who recommended substantial changes to the way the boards of banks and other big financial institutions function in particular through boosting the role of non-executives in the risk and remuneration process.

The Walker Review recommends strengthening bank boards, making rigorous challenge in the boardroom a key ingredient in decisions on risk and measures to encourage institutional shareholders to play a more active role.

The terms of reference of the Walker Review were to examine corporate governance in the UK banking industry and make recommendations, in areas including the following:

- the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively;
- the balance of skills, experience and independence required on the boards of UK banking institutions;
- the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees;
- the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and
- whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.

Specific proposals include:

- Board level risk committees chaired by a non-executive
- Risk committees to have power to scrutinise and if necessary block big transactions
- More power for remuneration committees to scrutinise firm-wide pay
- Remuneration committee to oversee pay of high-paid executives not on the board
- Significant deferred element in bonus schemes for all high-paid executives
- Increased public disclosure about pay of high-paid executives
- Chairman of remuneration committee to face re-election if report gets less than 75% approval
- Non-executives to spend up to 50% more time on the job
- Non-executives to face tougher scrutiny under FSA authorisation process
- Chairman of board to face annual re-election
- Financial Reporting Council to sponsor institutional shareholder code
- FSA to monitor conformity and disclosure by fund managers
- Institutional shareholders to agree MOU on collective action

Sir David Walker said: "These proposals are designed to improve the professionalism and diligence of bank boards, increasing the importance of challenge in the board environment. If this means that boards operate in a somewhat less collegial way than in the past, that will be a small price to pay for better governance".

The FSA welcomed the publication of the Walker Review, saying that many of the recommendations complement the work the FSA is currently doing in respect of risk management, remuneration policies and strengthening the approval process of significant influence functions.

The consultation period will end on 1 October and a final version of the report and its recommendations is expected to be published in November 2009.

Read more.

FSA Announces Changes to Approved Person Registration Requirements

On 27 July, the FSA confirmed an extension of the approved persons registration regime to include any person performing a "significant influence" function at an FSA authorised firm. The FSA also stated that it would place greater emphasis on the role of senior management, including non-executive directors.

In particular, the FSA has:

- extended the scope and application of CF1 (director function) and CF2 (Non-Executive Director) to include those persons employed by an unregulated parent undertaking or holding company, whose decisions or actions are regularly taken into account by the governing body of a regulated firm;
- extended the definition of the significant management controlled function (CF29) to include all proprietary traders who are not senior managers but who are likely to exert significant influence on a firm; and
- amended the way that the approved persons regime applies to UK branches of overseas firms incorporated outside the European Economic Area.

The changes take effect from 6 August, with a transitional period of six months. The FSA regulated firms should immediately commence an assessment of which additional individuals require registration with the FSA in order to ensure that the registration process is completed within the transitional period.

The FSA has indicated that it will announce further proposals in relation to non-executive directors after it has had the opportunity to consider the conclusions of the Walker and Financial Reporting Council reviews. The Walker Review is the subject of the item above. The Financial Reporting Council review of the impact of the Combined Code on Corporate Governance, with which UK listed companies are required under the Listing Rules to "comply or explain", is due to be published later in 2009.

Read more.

EU DEVELOPMENTS

Proposed Alternative Investment Fund Managers Directive Published

In the May 2009 edition of *London Update* we reported that on 29 April, the European Commission had announced a proposed Alternative Investment Fund Managers Directive (Proposed Directive) and that the Proposed Directive had not yet been published by the Commission.

The Proposed Directive has now been published and is available here.
See also the Katten *Client Advisory* on this subject.

Commission Publishes Two Recommendations on Remuneration

In the May 2009 edition of *London Update* we reported that on 29 April, the European Commission had 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) and that the Commission had only published press releases and frequently asked questions (FAQs) in relation to the two Recommendations.

Both Recommendations have now been published.

The FS Remuneration Recommendation is available here.
The Directors' Pay Recommendation is available here.

European Council Adopts UCITS IV Directive

On 22 June, the European Council formally adopted the UCITS IV Directive on Undertakings for Collective Investments in Transferable Securities (UCITS) (amending 85/611/ECC) (Directive).

Member States have until 1 July 2011 to implement the Directive into national legislation.

New provisions include:

i. UCITS Funds can in future be managed by a management company authorised and supervised in a Member State other than the home Member State of the Fund;
ii. a new unified regime for both cross-border and domestic mergers of UCITS Funds;
iii. for the first time UCITS to be able to be established as master-feeder funds;
iv. a "Key Investor Information" document will replace the current simplified prospectus; and
v. a simplified notification procedure/cross-border marketing process will be brought in.

Read more.

Consultation on CESR's Proposal for a Pan-European Short Selling Disclosure Regime

On 8 July, the Committee of European Securities Regulators (CESR) published a consultation paper outlining its proposals for a pan-European harmonised and permanent short selling disclosure regime.

CESR proposes a two-tier disclosure system for the disclosure of significant net short positions held in shares admitted to trading on regulated markets or multi-lateral trading facilities (MTFs) in the European Economic Area. When a short position reaches a specified initial threshold (CESR's proposal is 0.10%), the short seller will be required to make a private disclosure to the regulator of the most liquid market for the share in which the position is held. Further disclosures will be required at increments of 0.10%. If the position reaches a second-tier threshold (CESR's proposal is 0.50%), the short seller will then also be required to make a public disclosure. Further disclosures will be required if the short position crosses subsequent incremental 0.10% thresholds. Disclosure will also be required when the positions which had previously been disclosed fall below any of the disclosure thresholds down to the initial disclosure threshold. Disclosure reports will be required to be made on the trading day after the day on which the relevant threshold is passed.

The proposed disclosure regime will apply to instruments with the economic effect of holding a short position and will include positions held in exchange-traded and over-the-counter derivatives. Long positions will be netted against short positions to calculate whether disclosure thresholds were met.

In the consultation, CESR explicitly acknowledged the fact that short selling plays an important role in financial markets, contributing to efficient price discovery, increasing market liquidity, facilitating hedging and other risk management and possibly helping to mitigate market bubbles. CESR also acknowledged that short selling could be used in an abusive fashion to distort the prices of financial instruments, thereby contributing to disorderly markets.

The consultation will close on 30 September, and a final proposal will be made to the European Commission for its consideration by the end of 2009.

Read more.

For more information, contact:

	Direct Dial	Email
Martin Cornish	+44 (0) 20 7776 7622	martin.cornish@kattenlaw.co.uk
Edward Black	+44 (0) 20 7776 7624	edward.black@kattenlaw.co.uk

Katten

Katten Muchin Rosenman Cornish LLP

www.kattenlaw.co.uk

1-3 Frederick's Place • Old Jewry • London EC2R 8AE
+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax

8/19/09