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London Update

UK Financial Services Regulatory Developments

December 2007

This edition of London Update covers UK and EU developments from October 26 to November 30, 2007.

UK Developments

FSA Issues Policy Statement on Conduct of Business and Postponement of Telephone Recording

On October 26, the UK Financial Services Authority (FSA) published a further Policy Statement (PS07/18) on its conduct of business regime. The statement includes measures applicable to incoming firms from late-implementing EEA states and feedback on two previous consultations: *CP 07/9 - Conduct of Business Regime: Non-MiFID Deferred Matters*, issued in May 2007, and *CP 07/16 - Consequential Handbook Amendments,* issued in July 2007. The FSA stated that this Policy Statement "substantially completes" its consultation program arising from the implementation of the EU Markets in Financial Instruments Directive (MiFID) and its conduct of business reform.

PS07/18 also addressed the FSA's proposals for mandatory telephone recording, which had attracted widespread concern. The FSA stated that, in light of concerns expressed particularly about the cost-benefit analysis of its proposals, it would defer a final policy decision and rule-making until 2008, in order for further consideration to be given to the issues raised by respondents to the earlier consultation.

www.fsa.gov.uk/pubs/policy/ps07_18.pdf

FSA Focuses on Hedge Fund Managers and Market Abuse

On October 29, the FSA published issue 24 of its Market Watch Newsletter. The lead article focused on market abuse systems and controls of hedge fund managers (HFMs).

As part of the FSA's ongoing market abuse prevention work, a number of hedge fund managers were visited in order for the FSA to review their market abuse controls. The FSA's conclusion was stark: "We are disappointed by some of what we saw. We will be following up with the firms visited and are also launching a program of visits to a wider cross section of HFMs over the coming months to formally assess their market abuse systems and controls."

In the newsletter, the FSA set out their views on the sorts of measures that HFMs should be taking, along with examples of good practice they found during the first set of visits.

www.fsa.gov.uk/pubs/newsletters/mw_newsletter24.pdf

FSA Arrests Two in Boiler Room Criminal Investigation

On November 2, the FSA announced the arrest of two men on October 31 in connection with an ongoing FSA investigation into overseas boiler room activities.

This is the FSA's first criminal investigation into such activities, and follows several complaints the FSA had received arising from cold calling and high-pressure selling.

The FSA obtained search and arrest warrants using its criminal powers under the Financial Services and Markets Act 2000, and also obtained freezing orders against assets of up to £5.45 million ($11 million).

www.fsa.gov.uk/pages/Library/Communication/PR/2007/112.shtml

UK Government to Introduce New Covered Bonds Regime in March 2008

The UK Government announced on November 8 that it will introduce a new covered bonds regime to take effect from March 6, 2008. Originally the Government had intended to implement the regime in January 2008, as described in the July 27, 2007 edition of *Corporate and Financial Weekly Digest*. There is currently no UK legislative framework under which UK issuers can issue covered bonds which are permitted investments under Article 22(4) of the EU Undertakings for Collective Investment in Transferable Securities (UCITS) Directive for funds established under that Directive.

The UK Treasury and the FSA have been considering proposals for a covered bonds regime that complies with the UCITS Directive requirements and it is anticipated that a UCITS-compliant regime will enable UK issuers to access a larger investor base. The proposals were first announced in July 2007 and the consultation closed last month. A summary of all responses together with proposed regulations is expected to be published in January 2008.

www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_120_07.cfm

FSA Proposes Disclosure for UK Contracts for Difference

On November 12, the FSA published a consultation paper proposing greater disclosure of significant "economic interests" in shares held through derivatives such as Contracts for Difference (CFDs). The FSA's position has gradually evolved since the publication of consultation paper CP06/4, as described in the April 9, 2006 edition of *Corporate and Financial Weekly Digest*, in which the FSA announced that it was not minded to expand the shareholding disclosure regime to apply to derivatives. It has now concluded that potential market failures could occur where CFDs are used on an undisclosed basis to influence corporate governance and build up stakes in companies. The FSA has stated that such failures, although not widespread, need to be addressed to ensure that market confidence and efficiency are maintained.

CFDs currently fall outside the scope of the FSA's disclosure and transparency rules, although disclosure of dealings in CFDs during an offer period is required under Takeover Panel rules.

The consultation proposes two alternative approaches: (i) strengthening the current regime by requiring disclosure in defined circumstances of CFDs that reference three percent or more of the total voting rights attached to a company's shares, or (ii) introducing a general disclosure regime that would require CFD holders to reveal all economic interests of five percent or more in a company's shares.

The consultation period ends on February 12, 2008.

www.fsa.gov.uk/pages/Library/Policy/CP/2007/07_20.shtml

Study Identifies Keys to AIM's Success

On November 13, the London School of Economics published a research report, *From Local to Global – The rise of AIM as a stock market for growing companies*, commissioned by the London Stock Exchange. The report reviews the growth and development of the Alternative Investment Market (AIM) since its inception in 1995 and highlights that the amount of capital raised on AIM has increased from £2 billion ($4.1 billion) in 2003 to £15.7 billion ($32.15 billion) in 2006.

According to the report, since 1995 some 2,300 British and 400 foreign companies have come to AIM, raising a total of £49 billion ($100 billion). Over 40 percent of the funds raised on AIM has been in the form of further issues.

The report attributes AIM's success to several key factors including: (i) distinctive regulation, (ii) broad market profile, (iii) strong after-market performance and low failure rates, and (iv) strong liquidity for larger securities.

www.londonstockexchange.com/en-gb/about/Newsroom/pressreleases/2007/AIM+Study+Identifies+Keys+To+Success.htm

FSA Issues Update on Funds of Alternative Investment Funds

On November 14, the FSA issued an update on its proposals to allow UK retail consumers to invest in funds of hedge funds and other alternative investments sold by UK authorized firms.

The FSA had planned to issue a policy statement and final rules at the end of this year that would have allowed the development of a Funds of Alternative Investment Funds (FAIFs) vehicle for the retail market, as described in the March 30, 2007 edition of *Corporate and Financial Weekly Digest*.

There remain a number of tax issues that are currently being considered in conjunction with proposed changes to the UK's offshore funds regime, as described in the October 19, 2007 edition of *Corporate and Financial Weekly Digest*, and the FSA now considers it appropriate to delay publication of its FAIF proposals until early 2008.

www.fsa.gov.uk/pages/Library/Communication/PR/2007/116.shtml

FSA Fines Bank for Systems and Controls Failings

On November 16, the FSA fined Toronto Dominion Bank (London Branch) £490,000 (approximately $1 million) and banned one of its former employees from carrying out regulated activities. The Bank's employee had been mis-pricing trading positions and entering fictitious trades between early 2005 and his resignation in March 2007. The Bank was held to have had systems and controls failings while the employee was found not to be a fit and proper person.

In March 2007, the employee disclosed to the Bank that he had been mis-pricing trading positions for almost two years in order to hide losses on his trading book, and that he had entered fictitious trades just prior to his resignation. The mis-pricings and fictitious trades resulted in losses to the bank of £4.25 million ($8.77 million).

The FSA identified three main system and control failings at the Bank: (i) an absence of an independent price verification system, (ii) a lack of effective trading supervision, and (iii) a failure to implement effective trade break escalation procedures. By agreeing to settle at an early stage of the FSA's investigation, the Bank qualified for a 30 percent reduction of the penalty under the FSA's executive settlement procedures.

www.fsa.gov.uk/pages/Library/Communication/PR/2007/117.shtml

FSA Reviews Portfolio Valuation Services

On November 19, the FSA published the first issue of its Capital Markets Bulletin, in which it focuses on the provision of valuation services by UK banks. The FSA observed that the provision by banks of formal valuation statements to their clients is a key part of an independent determination of the market value of clients' investment portfolios. Where banks provide this service, they must ensure compliance with:

- FSA Principle 2 (to conduct business with due skill, care and diligence), Principle 6 (to treat customers fairly), and Principle 7 (requiring clear, fair and not misleading communications) across all aspects of the valuation services, and
- Rule 4.2.1(1) of the FSA's Conduct of Business Sourcebook (COBS) for communications to be clear, fair and not misleading.

The bulletin sets out numerous examples of industry practices in valuation services identified during the FSA's review.

www.fsa.gov.uk/pubs/newsletters/cm_bulletin1.pdf

IOSCO Publishes Reports on Hedge Fund Valuations and Soft Commissions

On November 19, the International Organization of Securities Commissions (IOSCO) published its final report on the principles for the valuation of complex financial instruments in hedge fund portfolios.

The hedge fund valuation report sets out several principles designed to ensure that valuations are not distorted to the disadvantage of investors, including:

- Establishing comprehensive, documented policies and procedures for the valuation of financial instruments.
- Identifying the methodologies used for valuing each type of financial instrument.
- Valuing financial instruments consistently and reviewing policies and procedures periodically.
- Ensuring that a high level of independence is maintained in the application of policies and procedures and that an appropriate level of independent review is undertaken of each valuation and, in particular, of any valuation that is influenced by the hedge fund manager.

www.iosco.org/news/pdf/IOSCONEWS110.pdf

BVCA Publishes Private Equity Guidelines and Recommendations

On November 20, the Working Group established by the British Venture Capital Association (BVCA) and chaired by Sir David Walker published its final guidelines and recommendations on transparency and disclosure for the private equity industry. As described in the August edition of *London Update,* in July 2007, Sir David Walker was appointed by the BVCA and a group of private equity firms to carry out an independent review of the adequacy of disclosure and transparency and to devise guidelines for the private equity industry,

The Working Group's final report emphasizes the need for greater openness and transparency in the private equity industry and sets out voluntary guidelines to be applicable to FSA authorized firms that manage or advise funds which own or control at least one UK company. The final report proposes that FSA authorized firms should either comply with the "voluntary" guidelines or explain areas of non-compliance. The report also includes recommendations on data gathering, processing and reporting on an industry-wide basis. In particular, private equity firms should publish certain recommended information either in a printed annual review or through a regularly updated website.

www.walkerworkinggroup.com/sites/10051/files/wwg_report_final.pdf

CEBS Gives in to Market Pressure on Large Exposures Regime

On November 6, the EU Committee of European Banking Supervisors (CEBS) published the first part of its technical advice reviewing its treatment of large exposures, produced in response to the European Commission's request for advice on the EU's large exposures regime.

CEBS recognized shortcomings of the existing regime and proposed an amended limits-based "back-stop" regime. The advice also included an analysis of non-EU countries' approaches to large exposures.

www.c-ebs.org/press/06112007LEPart1.htm

UK Opposes Single European Regulator Proposal

On November 7, the FSA and the UK Treasury published a joint paper rejecting calls for a single European financial services rulebook or regulator.

There has recently been a debate about whether the existing pan-EU regulatory committees are sufficient for enforcing supervisory convergence within the EU. The existing committees are comprised of CEBS, the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The FSA and Treasury believe that convergence of national regulatory frameworks and supervisory practices is desirable, but differences in national markets require domestic supervisors to adopt different approaches and apply different tools.

The joint paper recommends that the committees operate in a principles-based way to achieve equivalent regulatory outcomes. The FSA and Treasury support moves towards more group-based approaches to supervision, where tasks are delegated amongst supervisors and where one supervisor has overall responsibility for the group as a whole.

The joint paper also commented that, occasionally, insufficient time had been allowed for implementing EU legislation and that substantial directives and legislative changes in the future should ensure that there is sufficient time between their adoption and their implementation date.

www.fsa.gov.uk/pubs/international/eu_framework.pdf

CESR Reports on EU Market Abuse Powers

On November 22, CESR published a report setting out the differing sanctions available in EU Member States under the EU Market Abuse Directive (MAD). The report is part of an ongoing process to achieve uniformity across the EU.

MAD requires Member States to have "effective, proportionate and dissuasive" measures and sanctions in place to be imposed against persons failing to comply with the provisions of the directive. MAD allows Member States to determine the size of fines and the types of administrative measures that their regulatory authorities may take and also leaves the application of criminal sanctions in market abuse cases at the discretion of Member States.

CESR's report highlighted variations in the ability to administer fines, force imprisonment, withdraw licenses, disgorge profits, and require settlements.

www.cesr-eu.org/index.php?page=home_details&id=252

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