London Update

UK Financial Services Regulatory Developments

Katten
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This edition covers UK developments between 1 December 2009 and 31 January 2010

UK DEVELOPMENTS

UK Government Publishes Supplementary Market Abuse Regulations

On 1 December 2009, the UK Government published additional regulations relating to some of the Market Abuse provisions of the Financial Services and Markets Act 2000 (FSMA). The effect of the regulations is to extend the effect of two provisions of FSMA which relate to "misuse of information" (Section 118(4)) and "behaviour likely to give rise to false or misleading impressions or to distort the market" (Section 118(8)), so that they remain in force until 31 December 2011.

The UK currently has a wider definition of market abuse than many other European countries, reflecting the FSMA market abuse regime that existed before the implementation of European market abuse legislation. FSMA contained "sunset" clauses under which sections 118(4) and 118(8) were due to expire on 31 December 2009. It was anticipated that a review by the UK Treasury would be completed before the expiration date based in part on the outcome of the Europe-wide review of the Market Abuse regime. Since the European review has been delayed, the UK Government has extended the sunset date until 31 December 2011.

To read the explanatory memorandum in full, click here.

Corporate Governance Code Changes Proposed

On 1 December 2009, the UK Financial Reporting Council (FRC) published a report on the findings of its review of the impact and effectiveness of the Combined Code of Corporate Governance. The Code sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. As a result of the review the FRC is proposing a number of changes which include:

- new Code principles on: the roles of the chairman and non-executive directors, the need for the board to have an appropriate mix of skills, experience and independence, the commitment levels expected of directors, and the board's responsibility for defining the company's risk appetite and tolerance;
- new "comply or explain" provisions including: board evaluation reviews to be externally facilitated at least every three years, the chairman to hold regular development reviews with all directors, and companies to report on their business model and overall financial strategy;
- changes to the section of the Code dealing with remuneration to emphasise the need for performance-related pay to be aligned with the long-term interest of the company and to the company's risk policies and systems and to enable variable components to be reclaimed in certain circumstances;
- the introduction of a Stewardship Code for institutional investors; and
- the Code to be renamed "The UK Corporate Governance Code" to make clearer its status as the UK's recognised corporate governance standard.

Consultation on the draft revised Code ends on 5 March 2010, and it is intended that the revised Code will apply to accounting periods beginning on or after 29 June 2010.

To read the report, click here.

JMLSG Publishes Revised Money Laundering Guidance

On 3 December 2009, the UK Joint Money Laundering Steering Group (JMLSG) published its revised Money Laundering Guidance for the Financial Sector. The proposed amendments have been made following a review by the JMLSG of its guidance which looked at:

- areas of omission;
- provisions of the guidance that are difficult to implement or effect; and
- provisions of the guidance that no longer reflect current practice.

This revised guidance has been submitted to the UK Treasury for approval.

To read the guidance in full, click here.

FSA Publishes Feedback Statement on Remuneration

On 8 December 2009, the UK Financial Services Authority (FSA) published a feedback statement on the main issues arising from its March consultation on reforming remuneration practices in financial services (as reported in the April 2009 edition of *London Update*). The FSA's Remuneration Code came into force for large banks, building societies and broker dealers on 1 January 2010. It applies to any remuneration awards made by these firms for 2009.

Part of the March consultation paper invited discussion on whether the Remuneration Code should be extended to other FSA authorised firms. At this stage the FSA has decided not to introduce any new rules and will not extend the rules to other sectors. The FSA does not think it is beneficial to make changes now as adjustments will need to be made in 2010 because of the many pending European directives that contain remuneration provisions.

To read the feedback statement in full, click here.

UK Government Announces One-Off Bank Payroll Tax

In its 9 December Pre-Budget Report, the UK Government announced a new one-off bank payroll tax (BPT) payable by banks and certain other financial services firms. The BPT will be chargeable at 50% on bonuses exceeding £25,000 per employee between 9 December 2009 and 5 April 2010, although certain payments (including some existing contractual entitlements) are excluded. The BPT will also apply to the UK branches of foreign banks and financial services firms. The draft rules include carefully drafted anti-avoidance provisions, but independent asset managers and investment advisers and asset management and investment adviser subsidiaries of banks appear to be excluded from the BPT.

The UK IRS issued a further press release, clarifying that, for a non-deposit taker, the definitions of a bank will apply only to a person which is a full scope BIPRU 730k investment firm or who would be a full scope BIPRU 730k investment firm if its head office was in the UK. A BIPRU 730k investment firm is an investment firm whose FSA scope of permission authorises it to deal in investments as principal without the imposition of certain specific limitations and which accordingly is subject to the highest level base capital requirement of € 730,000.

To read the UK Government summary, click here.
To read the technical note, with draft legislation, click here.

FSA Publishes Policy Statement on Stress and Scenario Testing

On 11 December 2009, the FSA published a policy statement entitled "Stress and Scenario Testing". It outlines the FSA's policy on stress testing and includes a new "reverse stress testing" requirement.

The strengthened integrated stress testing regime is made up of three main elements:

- Firms' own stress testing—The FSA expects firms to develop, implement and action a robust and effective stress testing program (including reverse stress testing) that assesses their ability to meet capital and liquidity requirements in stressed conditions.

- FSA stress testing of specific firms—As part of its more intrusive supervisory procedures, the FSA runs its own stress tests on a periodic basis for a number of firms, to assess their ability to meet minimum capital levels throughout a stress period. It does this regularly for specific high-impact firms, and for other firms when it is considered necessary.
- Simultaneous system-wide stress testing—This is carried out by firms using a common scenario for the purposes of specific system-wide analysis for financial stability purposes.

The FSA has set out its view of good practices in stress and scenario testing in an annex to the statement. Firms subject to the new reverse stress testing requirement will have 12 months to implement the new requirements. In the first quarter of 2010, the FSA plans to issue an implementation timetable for firms to submit to the FSA to explain how they plan to incorporate reverse stress testing into their current risk management.

Click here to read the policy statement in full.

UK Government Sets Out Plans to Manage Investment Bank Failures

On 16 December 2009, the UK Government published a report entitled "Establishing resolution arrangements for investment banks", in which it set out proposals to strengthen the UK's ability to deal with any future failure of an investment bank. The report builds on ideas outlined by the UK Government in a May 2009 discussion paper (as reported in the August 2009 edition of *London Update*).

The UK Financial Services Secretary, Paul Myners, said: "The collapse of Lehman Brothers last October had a major impact on financial centers across the world. It is important that the government acts to ensure that any future failure of an investment bank does not cause the same degree of damage to markets or investors."

The core of the proposals is a set of measures designed to enable the managed wind-down of an investment bank. This includes the development of a new administration (insolvency) regime for a failed investment bank. Specific initiatives set out in the report expressed to be designed to achieve better outcomes for key groups affected by the failure of an investment bank include measures to speed up the return of client money and assets, address counterparty exposures to the firm and ensure creditors are sufficiently protected.

The report recognises the need for proposals such as these to be taken forward in an international context.

The UK Government aims to continue a period of consultation before publishing a final report in the second quarter of 2010 setting out firm proposals and a timetable for action.

Click here to read the report in full.

FSA and UK Treasury Publish Joint Paper on Reforming OTC Derivative Markets

On 16 December 2009, the FSA and the UK Treasury published a joint paper entitled "Reforming OTC Derivative Markets" in which they set out the steps required to address the deficiencies with the over-the-counter (OTC) derivative markets highlighted by the financial crisis.

In summary, the paper sets out the following measures to be implemented and/or developed to address perceived systematic shortcomings in OTC derivative markets:

- Greater standardisation of OTC derivatives contracts—This would enhance efficiency of operational processes and facilitate the use of central counterparty (CCP) clearing.
- More robust counterparty risk management—This would mean using CCP clearing for clearing eligible products and using proper arrangements and appropriate risk capital requirements for trades which are not centrally cleared.
- Consistent and high global standards for CCPs—Increased use of CCPs will heighten their systemic importance, so it is crucial that they are regulated to high standards which are consistently applied in major jurisdictions.
- International agreement as to which products are "clearing eligible"—Both regulators and CCPs will need to be involved in assessing which products are eligible for clearing.

- Capital charges to reflect appropriately the risks posed to the financial system—Non-centrally cleared trades should have proportionately higher charges.
- Registration of all relevant OTC derivative trades in a trade repository—This will facilitate regulators having access to the information they need to fulfill their regulatory responsibilities.
- Greater transparency of OTC trades to the market—This will aid price formation and market efficiency.
- On-exchange trading—With all of the above steps implemented, there will not be a need for mandating the trading of standardised derivatives on organised trading platforms.

Click here to read the paper in full.

Research Analyst and Investment Manager Found Guilty of Market Abuse

On 11 January 2009, the FSA announced that a former research analyst and a friend of his who worked for another regulated firm have been found to have committed market abuse by using inside information to carry out a series of profitable spread bets.

During the summer of 2004, Mr. Chhabra was a research analyst at Evolution Securities Limited, a stockbroker. His friend, Mr. Patel, who worked as an investment manager at General Motors Asset Management, was an experienced spread better who regularly placed bets on FTSE indices. Following a thorough investigation into the activities of the two friends, both of whom were FSA Approved Persons, the FSA found that on three separate occasions Mr. Chhabra had become aware of important confidential information relating to listed companies. Mr. Chhabra had then contacted Mr. Patel, often within minutes of receiving the information, and shortly afterwards Mr. Patel had placed bets on the stocks of the listed companies concerned. The total benefit to Mr. Patel was found to be £85,541.

The FSA found that they had committed market abuse and proposed to ban and fine them both. The pair referred the FSA's findings to the Financial Services and Markets Tribunal (FSMT). The FSMT confirmed the FSA's findings of market abuse. A separate hearing will take place to establish the penalties to be imposed on each of Mr. Chhabra and Mr. Patel.

To read the decision in full, click here.

FSA Fines Standard Life £2.45M for Systems and Controls Failures

On 20 January 2010, the FSA announced that it had fined Standard Life Assurance Limited (SLAL) £2.45 million for systems and control failures which had led to SLAL circulating misleading marketing material about one of its funds.

The FSA ruled that SLAL had breached two of the FSA's Principles for Businesses—Principle 3 (management and control) and Principle 7 (communications with clients). The FSA concluded that:

- marketing material regarding the fund was not "clear, fair and not misleading"—it referred to the fund being wholly invested in cash despite the majority of the fund's investments being in floating rate notes; and
- there were no adequate systems and controls in place at SLAL to ensure that marketing material that was issued accurately reflected relevant investment strategies, and as a result, in this case customers were given misleading information.

The fine was discounted from £3.5 million, since SLAL had cooperated fully with the FSA and had agreed to settle at an early stage in the investigation. Margaret Cole, the FSA Director of Enforcement and Financial Crime, said, "The FSA takes the issue of misleading financial promotions very seriously and the fine announced today demonstrates our commitment to the principle of credible deterrence. It is critical that consumers are given an accurate understanding of the nature of investment products and the risks involved."

To read the decision in full, click here.

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