London Update

UK Financial Services Regulatory Developments

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This edition covers developments between 1 May and 30 June 2010.

UK DEVELOPMENTS

FSA Fines Firm and MLRO for Anti-Money Laundering Failings

On 5 May, the Financial Services Authority (FSA) announced that it had fined Alpari (UK) Ltd., an online foreign exchange firm, £140,000 for failing to have adequate anti-money laundering systems and controls. Its former money laundering reporting officer (MLRO), Sudipto Chattopadhyay, was fined £14,000.

Between September 2006 and November 2008, Alpari failed to carry out the risk assessments of the money laundering and financial crime risks required under FSA rules. Alpari's failures included:

- failing to carry out satisfactory customer due diligence procedures at the account opening stage and inadequate monitoring of accounts—these were regarded as particularly serious, as Alpari's customer base included those from higher-risk jurisdictions and its customer relationships did not operate on a face-to-face basis;
- failing to have in place adequate systems for screening customers against UK and global sanctions lists and for determining whether customers were politically exposed persons; and
- failing to expand its compliance and anti-money laundering function in line with an increase in its customer base from 400 to 11,500 live accounts.

As Alpari's MLRO during this period, with responsibility for compliance oversight and money laundering reporting, Mr. Chattopadhyay was accountable for these breaches and was therefore also fined. He also gave an undertaking to the FSA that he will not, for three years, apply to be permitted to hold a compliance oversight or MLRO role.

Both Alpari and Mr. Chattopadhyay received a 30% discount applied to their fine for cooperating fully with the FSA investigation and agreeing to settle at an early stage. The FSA also took into account the fact that Alpari and Mr. Chattopadhyay had put in place a remedial action plan to address the failings.

Margaret Cole, the FSA's Director of Enforcement, said: "The FSA expects firms to assess the financial crime risks to which they are exposed properly. The FSA also expects expanding businesses to commit sufficient resource to their compliance and anti-money laundering functions. Alpari failed to operate and maintain adequate money laundering systems and controls, leaving it open to the risk of financial crime."

Read more.

FSA Imposes Ban and Highest-Ever Fine on Individual

On 20 May, the FSA announced that it had fined Simon Eagle £2.8 million and prohibited him from working in financial services as a result of the deliberate market abuse scheme he had carried out in 2003-2004. The fine, made up of a penalty of £1.5 million and disgorgement of profits of £1.8 million, is the largest fine ever imposed by the FSA on an individual.

Mr. Eagle acquired SP Bell Ltd (SPB), an agency stockbroker, in May 2003 and became its chief executive. Between July 2003 and May 2004 he carried out a complex and prolonged scheme that ramped up the share price of Fundamental-E Investments (FEI) for his own benefit at the expense of other FEI investors and misusing accounts of SPB clients.

This case is linked to the fines totalling £4.25 million imposed on Winterflood Securities Limited and two of its traders (as reported in the May 2009 edition of *London Update* and confirmed on 22 April 2010 after an appeal to the Court of Appeal) for their role in misuse of rollovers and delayed rollovers that created a false market for FEI shares and misleading the market.

FSA Director of Enforcement and Financial Crime Margaret Cole said: "This scheme was rotten throughout and at the core was Simon Eagle. He showed a breathtaking disregard for his clients, for his duty as an approved person and chief executive and for the effect of his scheme on markets. He has played procedural games in an attempt to avoid being held accountable for his actions and this tough action shows that we are determined to keep dishonest cheats, like Simon Eagle, out of financial services."

To read more about Simon Eagle, click here.

To read more about Winterflood, click here.

FSA Bans Former Broker Employee for Fraud

On 25 May, the FSA announced that it had prohibited John White, a former employee of Seymour Pierce Limited, from working in financial services for committing fraud.

As reported in the November 2009 edition of *London Update*, the FSA fined Seymour Pierce £154,000 for failing to establish effective controls to prevent an employee committing fraud; Mr. White was that employee.

FSA Director of Enforcement and Financial Crime Margaret Cole said: "We expect people who work in the financial services industry to behave with honesty and integrity, yet White's conduct was anything but. As this case demonstrates, we are committed to deterring behaviour of this kind by punishing anyone found to have committed such misconduct."

Read more.

Offshore Funds Practice Manual Issued

Her Majesty's Revenue and Customs (HMRC) has issued its new Offshore Funds Practice Manual. This sets out official guidance as to which funds will be treated as "offshore funds" for UK tax purposes and details of HMRC's approach as to how offshore funds will be treated. The redemption or sale of an interest in an offshore fund by a UK investor is treated as income, rather than as a capital disposal. This means that, for example, UK personal investors would be charged income tax (at rates of up to 50%) rather than capital gains tax (at a flat rate of 18%) on a redemption or sale of their interest in the fund.

The most significant changes are that:

1) A fund will be able to avoid being treated as an offshore fund for tax purposes if it becomes a "reporting fund." A "reporting fund" will be obliged to report all of its income to HMRC, and any UK investors will be taxed on their share of that income, regardless of whether or not they have actually received this income. Previously, a fund needed to actually distribute at least 85% of its income to investors in order to avoid offshore fund treatment.
2) There are significant changes to the definition of an offshore fund. A fund need no longer be a "collective investment scheme" within the Financial Services and Markets Act. Instead, subject to certain exceptions, it will be treated as an offshore fund if it has certain characteristics. These are that (i) the fund is not a UK tax resident; (ii) the fund enables investors to take part in any benefit arising from the acquisition, holding, management or disposal of assets; (iii) the investors do not have day-to-day control of the management of the assets; and (iv) a reasonable investor would expect to be able to realise his investment based entirely or almost entirely by reference to the net asset value of the assets under management or to any index.

The new Offshore Funds Practice Manual sets out in some detail how HMRC intends to apply these new rules.

Read more.

FSA Fines and Bans Commodity Broker

On 2 June, the FSA announced the imposition of a prohibition order on Andrew Charles Kerr together with a fine of £100,000 for market abuse. At the time of his offense, Mr. Kerr was a broker with Sucden Limited. The FSA said that the company had cooperated fully with the FSA and there was no criticism of its supervision of Mr. Kerr nor of its internal procedures.

In August 2007, Client X, one of Mr. Kerr's clients, held a 2000 contract put options position on an exchange-traded coffee futures contract. Implementing a strategy planned with Client X, Mr. Kerr executed a series of trades designed to artificially increase the price of the coffee future during the trading period when the options reference price was determined. The intent was that the resulting price change would lead to the reference price moving above the strike price so that Client X would avoid incurring a loss on its put options position. By so doing Mr. Kerr committed market abuse by creating a false or misleading impression as to the price of the coffee futures contract and the options reference price.

The FSA determined that while the strategy was instigated by Client X, Mr. Kerr actively encouraged and participated in the market manipulation. It was a serious case of market abuse. In addition, Mr. Kerr provided false and misleading information during the FSA's investigation. This further demonstrated to the FSA that he lacked the integrity required of a fit and proper person and that he posed a risk to the FSA's statutory objective of maintaining confidence in the financial system. Accordingly, a prohibition order and substantial fine was the appropriate penalty.

Alexander Justham, the FSA's Director of Markets, said: "Market manipulation is a serious offence. Kerr breached the standards expected of approved persons and has paid the price. Participants in the futures and options markets should be in no doubt about how seriously the FSA views manipulation which disrupts proper pricing mechanisms and risks a false market in the underlying commodity."

Read more.

FSA Insider Dealing Prosecution Fails

On 2 June, the FSA announced that, after a jury trial at Southwark Crown Court, not guilty verdicts had been entered against a finance director and two lawyers (present or past partners in City of London firms). The charges arose from profits alleged to have been made by the lawyers as a result of their trading in the shares of the finance director's technology company based on inside information provided by him when the company was taken over in 2006.

This case follows several successful recent criminal prosecutions by the FSA in insider trading cases. Margaret Cole, FSA Director of Enforcement and Financial Crime, stated that the FSA will continue with insider dealing prosecutions. She said that the FSA remains "100 per cent committed to the strategy of achieving credible deterrence. Bringing criminal prosecutions sends a message, loud and clear, that insider dealing is a serious crime and we are not afraid to pursue cases through the criminal courts."

Read more.

FSA 2009-10 Annual Report Published

On 10 June, the FSA issued its annual report covering the year ended 31 March 2010. The FSA emphasised its priorities and targets including:

- a radically changed approach to prudential supervision, particularly of high impact firms, including stress testing, accounting reviews, challenges to business models, detailed liquidity assessments and reviews of remuneration policy;
- a fundamental change in its enforcement approach, aiming for "credible deterrence" and pursuing market abuse and management responsibility far more aggressively;
- the launch of a new approach to "conduct" risk, improving customer protection in retail markets by earlier intervention to reduce the scale and frequency of problems potentially leading to customer detriment; and
- the need for increased involvement in international and European regulatory initiatives.

Among many specific issues addressed in the 127-page report was market confidence. While highlighting action taken and planned against insider dealing and market abuse, the market confidence section of the report highlighted the result of FSA's latest Market Cleanliness Study, which showed a further increase (from 29.3% to 30.6%) in the number of takeovers preceded by abnormal pre-announcement price movements.

Read more.

FSA Continues to Focus on Client Money

In June, the FSA wrote to the chief executive officers of all firms handling client money asking for a response:

- confirming that their controls over the handling of client money and assets have been reviewed by management;
- stating whether or not the firm is in compliance with its obligations respecting client money and assets; and
- identifying the person at the firm with overall responsibility for compliance with FSA's client money and assets rules.

The letter follows an FSA communication earlier this year that pointed out significant weaknesses and failings discovered during visits to firms carried out in late 2009. It also comes at the same time as several highly publicised disciplinary actions and fines imposed by the FSA on regulated firms for client money failings.

In addition, the FSA focused on this area in its Annual Report (see "FSA Annual Report Published," above), in which it stated its concern that firms "were not always achieving an adequate level of client money protection, thereby potentially threatening market confidence in the UK financial services industry." The FSA added that it had taken and would continue to take "various actions to address risk in this area. We have increased dedicated visits to firms, and have expanded, and continue to expand, the level of resource within the FSA dedicated to client money and assets supervision."

Read more.

Government Announces Transfer of FSA Powers to Bank of England and New Regulators

In a speech delivered on 16 June, the Chancellor of the Exchequer announced that the Government intended to transfer the regulatory functions of the FSA to the Bank of England and certain proposed new regulatory bodies. The FSA will cease to exist in its current form. In its place, the government intends to establish the following new entities between now and the end of 2012:

- Prudential Regulation Authority (PRA)—The PRA, which will be a subsidiary of the Bank of England, will be responsible for the prudential regulation of financial firms, including banks, investment banks, building societies and insurance companies. Hector Sants, the current FSA Chief Executive, will become the PRA chief executive and also a deputy governor of the Bank of England.
- Consumer Protection and Markets Authority (CPMA)—The CPMA will regulate firms providing financial services to consumers. It will also be responsible for retail and wholesale financial services conduct of business.
- Financial Policy Committee (FPC)—The FPC will be a committee of the Bank of England. It will have responsibility for macro issues potentially affecting economic and financial stability. An interim FPC will be established during the course of 2010. The Governor of the Bank of England will chair the FPC, and its members will include the PRA chief executive and the CPMA chair.
- Economic Crime Agency (ECA)—The ECA will be created to prosecute economic and financial crimes. This is currently in the hands of a number of agencies, including the FSA, the Serious Fraud Office, the Office of Fair Trading and the Serious Organised Crime Agency.

A consultation document providing details of the Government's proposals will be issued in July.

Read more.

Regulators Focus on Role of Auditors

The FSA and the Financial Reporting Council (FRC) issued a discussion paper on 24 June which considers ways of enhancing auditors' contribution to regulation.

The paper FSA DP 10/3 is entitled "Enhancing the auditor's contribution to prudential regulation" and covers the following areas:

- questions aspects of the quality of audit work relevant to prudential regulation—in particular, whether the auditor has always been sufficiently sceptical and has paid sufficient attention to indicators of management bias when examining key areas of financial accounting and disclosure that depend critically on management judgement;
- outlines the FSA's concerns about auditors' work on client assets and how auditors fulfil their legal obligation to report to the FSA;
- explores a variety of ways in which changes are being made and further changes could be made by the FSA, FRC and auditors to increase the effectiveness with which auditors undertake their work; and
- examines the regulatory environment in which auditors operate more widely and suggests measures to enhance how auditors contribute to prudential supervision.

Paul Sharma, the FSA's Director of Prudential Policy, said, "Our experience has indicated that, at times, auditors have focused too much on gathering and accepting evidence to support firms' assertions rather than exercising sufficient professional scepticism in their approach—this falls far short of what the FSA—and society at large—expects from auditors."

Read more.

FSA Fines and Bans Oil Broker for Market Abuse

On 28 June, the FSA announced that it had fined Steven Perkins, a former oil broker, £72,000 for market abuse and had banned him from working in the UK financial services industry for a minimum of five years on the grounds that he was not a fit and proper person.

Mr. Perkins was an oil futures broker with PVM Oil Futures Ltd. His job involved trading Brent Crude Futures contracts on an execution-only basis in the ICE Futures Europe Exchange for PVM's clients. PVM did no proprietary trading.

In the early hours of the morning of Tuesday, 30 June 2009, Mr. Perkins traded in the ICE August 2009 Brent contract without any client authorisation, and in doing so accumulated a long outright position in Brent in excess of 7,000 lots (representing over 7 million barrels of oil).

As a direct result of Mr. Perkins' trading, the price of Brent increased significantly. His trading manipulated the market in Brent by giving a false and misleading impression as to the supply, demand and price of Brent and caused the price of Brent to increase to an abnormal and artificial level.

The FSA findings state that Mr. Perkins initially lied repeatedly to PVM in order to try and cover up his unauthorised trading. They also stated that Mr. Perkins' relevant trading seems to have been a consequence of extremely heavy drinking resulting from alcoholism, which he now acknowledges. He drank excessively over the weekend prior to and throughout Monday, 29 June.

Alexander Justham, the FSA's Director of Markets, said, "The FSA views market manipulation extremely seriously. Perkins' trading caused disruption to the market and has been met with both a fine and prohibition. This reinforces the fact that a severe sanction will apply in cases of market manipulation, even where no profit is made."

The FSA stated that Mr. Perkins' behaviour merited a penalty of £150,000. Because such a fine would cause him serious financial hardship, this was reduced to £90,000. Since Mr. Perkins agreed to settle the case, he qualified for a 20% discount on the fine under the FSA's executive settlement procedures, bringing the fine down to £72,000. The ban imposed on Mr. Perkins was limited to a minimum term of five years since Mr. Perkins had joined an alcoholics' rehabilitation program. Accordingly, the FSA considered that Mr. Perkins may be a fit and proper person for regulatory purposes at some future date.

Read more.

Government Announces 2009-10 Budget Tax Changes

The newly-elected Government announced its first Budget on 22 June. Key provisions include:

1) Capital Gains Tax is increased to a top rate of 28%, from a flat rate of 18%, with effect from midnight on 22 June.
2) The introduction of a UK levy on banks (including the UK branches and subsidiaries of foreign banks). The levy will take effect on 1 January 2011 and will initially be charged at a rate of 0.04% on the total liabilities of the bank or branch (subject to certain exclusions). The rate will be increased to 0.07% on 1 January 2012. In order to encourage longer-term borrowings (perceived as less risky), liabilities with longer than a year to maturity will be taxed at half the standard rate.

   There will be the following exceptions to the levy: (i) Tier 1 capital (i.e. equity); (ii) insured retail deposits; (iii) repos secured on sovereign debt; and (iv) policyholder liabilities of retail insurance businesses within banking groups. Banks or branches with relevant liabilities below £20 billion will also be exempt from the levy.
3) In relation to asset management, the UK Government intends to: (i) implement the UCITS IV rules; (ii) establish tax transparent contractual funds along the lines of those currently offered by Ireland and Luxembourg; and (iii) consult on rules designed to reform the taxation of UK authorised investment trust companies and UK authorised funds investing in offshore funds (the budget gave no details of these reforms).

Read more.

EU DEVELOPMENTS

AIFM Directive Progress

As a result of votes on 17 and 18 May, respectively, of the European Parliament's Economic and Monetary Affairs Committee (ECON) and European finance ministers at the meeting of the Economic and Financial Affairs Council (ECOFIN), there are now Parliament and Council draft texts of the Alternative Investment Fund Managers (AIFM) Directive. These competing texts will serve as the basis for negotiations at a series of "trilogue" meetings, which will take place starting shortly between representatives of the Parliament, Council and European Commission. Once a compromise text is agreed and approved by ECOFIN, it will be sent for approval by a plenary session of the Parliament. The target date for the plenary vote was 6 July. The provisions of the Directive when formally approved will then be implemented by individual EU member states and will come into force in July 2012 or later.

Among the areas on which there is substantial divergence between the ECON and ECOFIN texts are the terms under which funds and managers established outside the EU can market to EU investors. Accordingly, until the trilogue process is completed and the final text of the Directive has been published, it will not be possible to know the shape of the regulatory regime that will begin to apply from 2012.

Read more.

CESR Publishes European Short Selling Technical Details

On 26 May, the Committee of European Securities Regulators (CESR) published its report CESR/10-453 *Technical Details of the Pan-European Short Selling Disclosure Regime*.

CESR/10-453 follows on from CESR's *A Model for a Pan-European Short Selling Disclosure Regime* (CESR/10-088) (see the May 2010 edition of *London Update*).

The technical details set out in CESR/10-453 relate to the key areas identified in CESR/10-088 as needing in-depth explanation and elaboration. Accordingly, further detail is provided on the following issues:

1) Determination of economic exposure for the purposes of calculating a net short position
2) Calculating changes of net short positions

3) Netting and aggregation within an organisational structure
4) The mechanics of disclosure
5) Exemptions from disclosure obligations

Read more.

EU Consults on Derivatives and Market Infrastructures

On 14 June, the European Commission published a consultation on Derivatives and Market Infrastructures. This follows on from its October communication on future policy actions to ensure efficient, safe and sound derivatives markets (as reported in the November 2009 edition of *London Update*).

The consultation addresses a number of topics, including: clearing and risk mitigation of over-the-counter derivatives contracts; requirements for central counterparties (CCPs); interoperability between CCPs; and reporting obligations and requirements for trade repositories.

The consultation closes on 10 July 2010. The Commission will then prepare a formal legislative proposal, currently scheduled to be published in September.

Read more.

EU Consults on Short Selling

On 14 June, the European Commission published a consultation on short selling, which sets out options being considered by the Commission for a pan-European regime for the regulation of short selling.

The consultation focuses on five key areas: scope; transparency; risks of uncovered short sales; emergency powers for national regulatory authorities; and potential exemptions.

The consultation closes on 10 July 2010. The Commission will then prepare a formal legislative proposal, currently scheduled to be published in September.

Read more.

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