



London Update

UK Financial Services Regulatory Developments

March 2008

UK Developments

FSA Publishes 2008 Financial Risk Outlook

On January 29, the Financial Services Authority (FSA) published its latest Financial Risk Outlook warning firms and investors of the risks inherent in a significantly less benign economic environment. The Financial Risk Outlook is focused on the risks arising from the events of the second half of 2007 that have led to tighter financial conditions.

The Financial Risk Outlook notes that risks have increased considerably in the last year and that the recent tightening in financial conditions may have exposed some firms' business models as being potentially unsuitable in more stressed financial conditions.

The FSA has identified five priority risks for 2008: (i) existing business models may be under strain as a result of adverse market conditions; (ii) increased financial pressures may lead to firms shifting efforts away from conduct of business requirements and from maintaining and strengthening business-as-usual processes; (iii) market participants and consumers may lose confidence in financial institutions and in the regulatory authorities' ability to safeguard the financial system; (iv) a significant minority of consumers could experience financial problems because of high levels of borrowing; and (v) tighter economic conditions could increase the incidence or discovery of some types of financial crime or lead to firms' resources being diverted away from tackling financial crime.

www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2008.pdf

Joint Consultation Launched on Changes to Banking Regulation

On January 30, HM Treasury, the FSA and the Bank of England published a consultation on proposals for strengthening the current framework for banking regulation. The consultation, "Financial stability and depositor protection: strengthening the framework," sets out proposed action, both in the UK and internationally, to achieve five key objectives: (i) strengthening the stability of the financial system; (ii) reducing the likelihood of banks facing difficulties; (iii) reducing the impact where a bank gets into difficulties; (iv) providing effective compensation arrangements in which consumers have confidence; and (v) strengthening the Bank of England and ensuring effective coordinated actions by appropriate authorities.

The deadline for comments is April 23. The Government intends to introduce legislation to give effect to the new regulatory scheme later in 2008.

www.hm-treasury.gov.uk/media/3/5/banking_stability_pu477.pdf

FSA Publishes Financial Crime Newsletter

On January 30, the FSA published its tenth Financial Crime Newsletter dealing with issues such as changes to the UK's regime to fight money laundering and terrorist financing from the implementation of the Money Laundering Regulations 2007, the introduction of new FSA enforcement powers related to the EU Wire Transfer Regulations and a summary of recent FSA enforcement actions.

Of particular note were details of initiatives being led by HM Treasury, which holds the presidency of the Financial Action Task Force (FATF), and changes by the Serious Organised Crime Agency (SOCA) in respect of Suspicious Activity Reports (SARs).

The UK is currently part way through a 12-month term in the presidency of FATF, the global standard-setting body which aims to develop and promote national and international policies to combat money laundering and terrorist financing. The newsletter sets out the UK's strategic objectives for its presidency, which include: (i) enhancing the capability of FATF to undertake more strategic surveillance of emerging trends and threats; (ii) enhancing engagement between FATF and the private sector; (iii)

examining how FATF can reinforce the effective implementation of its recommendations in low-capacity countries; and (iv) enhancing the accountability of FATF to all member jurisdictions.

The newsletter also highlights that SOCA is introducing changes to the way firms submit SARs. Presently, SARs may be made in any format. The changes, which are expected to take effect on April 1, will require reports to be received in a prescribed form.

www.fsa.gov.uk/pubs/newsletters/fc_newsletter10.pdf

New “Gold Standard” for Covered Bonds and Mortgage-Backed Securities to Be Introduced

On February 6, Chancellor Alistair Darling, in a speech to a trade body, addressed a number of issues relating to continued difficulties in the financial markets. He stated that one of the causes of the current credit market crisis has been the market in mortgage-backed securities, where banks repackage mortgage and other debts for resale to investors.

The Chancellor indicated that he would shortly announce a consultation on new regulations for asset-backed securities. He pledged to create a “gold standard” to enable investors to judge the quality of asset-backed securities and covered bonds. It has yet to be decided whether any such regulatory scheme will be supervised by the FSA or by an industry-based self-regulating authority.

www.hm-treasury.gov.uk/newsroom_and_speeches/press/2008/press_12_o8.cfm

FSA Publishes 2008/9 Business Plan

On February 6, the FSA published its Business Plan for 2008/9. The plan sets out the FSA’s programme of work for the year ahead, in particular with respect to addressing the risks highlighted by the Financial Risk Outlook, as described above.

The document outlines specific FSA initiatives regarding heightened supervisory oversight in areas such as firms’ liquidity, adequacy of stress testing and their general operational preparedness for unexpected events.

In addition, the FSA will continue to focus on its Treating Customers Fairly (TCF) programme, the Retail Distribution Review and the Financial Capability Programme. The FSA intends to publish in 2008 a report on firms’ systems and controls for managing the risk of consumers’ personal data being lost or stolen, with feedback on good practice and areas of improvement. The FSA also intends to increase penalties in its enforcement actions to create a more credible deterrent for regulated firms.

The 2008/9 budget shows an overall increase of 7.1%, resulting in a rise in the FSA’s Annual Funding Requirement of 6.9%. Underlying costs have increased by £11.5 million primarily due to increased staff costs.

www.fsa.gov.uk/Pages/Library/corporate/Plan/bp2008.shtml

HM Treasury Consults on Market Abuse Regime

On February 7, HM Treasury launched a consultation on the UK’s market abuse regime. It focuses on areas where the UK regime is super-equivalent (*i.e.*, imposes additional requirements) to those under the EU’s 2003 Market Abuse Directive (MAD). The UK regime was first introduced in 2001 and was amended in 2005 upon the UK implementation of the MAD.

The UK currently has a wider definition of market abuse than that established in the MAD and the purpose of this consultation is to enable the Treasury to assess whether that wider definition remains justified. In 2005, the UK introduced “sunset clauses” on some elements of the UK regime that were super equivalent to the MAD. The provisions that are subject to such sunset clauses will fall away on June 30 unless they are extended. In addition, the EU will review the MAD during 2008.

The consultation closes on May 7.

www.hm-treasury.gov.uk/media/3/2/consult_fsmamarket_abuse070208.pdf

FSA Bans and Fines Broker for Dishonesty and Misleading Customers

On February 11, the FSA imposed a Prohibition Order on Mohammed Suba Miah, a former broker at Square Mile Securities Limited, and fined him £21,000.

The FSA determined that Mr. Miah and the firm had failed to act with integrity (breach of Principle 1) and failed to act with due skill, care and diligence (breach of Principle 2). In particular, there was a failure to provide adequate risk warnings and to make adequate suitability determinations; inaccurate and potentially misleading statements were made to customers; and

unacceptable sales methods and practices were employed resulting in high and undue pressure on customers to purchase securities which were improperly recommended.

An FSA review of Mr. Miah's transactions between December 2005 and May 2006 found that Mr. Miah had dishonestly recorded the purchase of shares by his customers without their knowledge or consent.

Mr. Miah accepted that his conduct was improper and co-operated with the FSA's investigation. Consequently, Mr. Miah's fine was reduced by 30% under the FSA's Executive Settlement scheme. The terms of the Prohibition Order are that Mr. Miah is prohibited from performing any function in relation to any regulated activity carried on by any authorised or exempt firm. That is a ban from working in the financial services industry.

The firm was fined £250,000 for persistently using high pressure sales tactics and misleading information to sell customers shares they did not want or could not afford. This is the second fine on a firm resulting from a continuing FSA thematic project examining sales practices of smaller broking firms with respect to higher risk equity securities. This is part of the FSA's Treating Customers Fairly (TCF) initiative.

www.fsa.gov.uk/pubs/final/Suba_Miah.pdf

HM Treasury Publishes Regulations for Recognised Covered Bonds Regime

On February 14, HM Treasury published a summary of the responses it has received to its consultation on proposals for a UK covered bonds regime. The Treasury has also published draft legislation implementing the proposed regime.

The regulations introduce a new UK regime for covered bonds complying with the EU Undertakings in Collective Investment in Transferable Securities (UCITS) Directive (85/611EC). Respondents to the consultation supported the proposals, but pointed out that new legislation should focus on quality rather than flexibility. The Treasury has made a number of amendments in light of the responses it has received.

The new regime came into force on March 6.

www.hm-treasury.gov.uk/consultations_and_legislation/ukrec_covbonds/consult_ukrec_covbonds.cfm

FSA Launches Further Consultation on Funds of Alternative Investment Funds (FAIFs)

On February 22, the FSA published a further consultation (CPo8/4) on establishing investment vehicles designed to allow UK retail consumers to invest in funds of hedge funds and other alternative investment funds.

The consultation paper proposes the introduction of retail-oriented Funds of Alternative Investment Funds (FAIFs) as part of the UK's regulated funds regime. The paper initiates a further round of consultation (following on from CPo7/6 issued in the Spring of 2007) on a number of issues raised by fund managers and interested parties during consultation, such as whether the existing repayment standards for Non-UCITS Retail Schemes (NURS) need to be altered to take account of the time required for funds of funds to obtain valuations of assets held in underlying funds, and allowing a FAIF (and NURS more generally) to act as "feeder funds" into one master fund. It is also proposed to address a current anomaly under which a NURS can invest in an offshore fund but not where that fund is a feeder fund investing solely in its master fund.

It is proposed to introduce FAIFs into the existing UK NURS regime by: (i) relaxing the existing NURS rules that restrict investment in unregulated collective investment schemes from 20% and allowing up to 100%; (ii) removing the prescription of the 15% rule that prohibits circularity of investment within NURS and to extend this to the UK Qualified Investor Scheme (QIS) regime; and (iii) applying due diligence criteria to investment managers where they invest more than 20% into any unregulated collective investment scheme.

The consultation closes on May 22.

www.fsa.gov.uk/pubs/cp/cpo8_04.pdf

FSA Publishes Guidance on Passporting Under Prospectus Directive

On February 26, the FSA published a factsheet giving details of the passporting process it has adopted under the EU Prospectus Directive. The factsheet, which supersedes an earlier October 2006 edition, sets out procedures to be followed by issuers and their advisers when submitting passporting requests for a prospectus.

To obtain a passport from the FSA to circulate a prospectus in other EU Member States the issuer must submit a written request for an FSA certificate of approval, using a template request letter which can be found on the FSA's website. Almost all EU Member States will require translations of equity and retail debt prospectus Summaries. The only exceptions are Luxembourg, Austria and the Netherlands, which will accept a Summary in English.

Passporting a prospectus approved by another EU Member State into the UK requires the issuer to contact the home state regulator which approved its prospectus and for that regulator to submit to the FSA an electronic version of the approved prospectus and a translation of the Summary into English when required by the FSA.

www.fsa.gov.uk/pubs/ukla/factsheet4.pdf

EU Developments

European Commission Publishes Research on UCITS Investment Policies

On February 12, the European Commission published new research on EU investment funds, including analysis of their use of investment powers, investment outcomes and related risk features in both funds established under the UCITS Directive and non-UCITS funds.

The study surveyed the investment outcomes (performance and related risks) of UCITS and non-UCITS funds over the past five years since the introduction of the “UCITS III” Directive in 2004, which allowed UCITS fund managers to invest in a much wider range of eligible assets. UCITS III introduced an expanded range of assets including derivatives for a wider range of permitted purposes. It also allowed fund managers to pursue new types of investment strategies such as index-based investing and fund of fund strategies within UCITS funds.

The study concluded that a large number of UCITS funds have started to invest in derivatives, although the intensive use of derivatives is confined to a small subset of UCITS funds. Generally, UCITS funds tend to use derivatives more than non-UCITS fund managers, who either do not use leverage or have recourse to other methods to leverage fund performance such as borrowing or short selling.

The study examined the risks associated with the use of enlarged investment powers and concluded that fund managers develop strong risk management procedures before launching more complex products. As such, the study found that UCITS funds making intensive use of derivatives do not exhibit a higher level of market risk in comparison with other surveyed funds.

ec.europa.eu/internal_market/investment/docs/other_docs/pwc-report_en.pdf

CESR Publishes Consultation on Credit Rating Agencies and Structured Finance

On February 13, the EU Committee of European Securities Regulators (CESR) published a consultation on the role of credit rating agencies in structured finance as part of its continuing review of the role of credit rating agencies and the rating process for structured finance instruments.

CESR's consultation follows the European Commission's request to CESR for a review of several aspects of the rating process regarding structured finance instruments. CESR is now seeking market participants' views on the main issues included in the European Commission's request.

The deadline for responses is March 31.

www.cesr-eu.org/index.php?page=home_details&id=267

CESR Publishes Advice on UCITS Key Investor Disclosures

On February 15, CESR published its advice to the European Commission on the content and form of key investor disclosures for European Undertakings in Collective Investments Transferable Securities funds. The new Key Information Document (KID) is to replace the current simplified prospectus for retail investors and the Commission will now carry out market testing on the possible form and content of the KID.

CESR's advice follows its work at the request of the Commission, which included a consultation launched in October 2007, as described in the November 2007 edition of *London Update*.

The Commission is expected to publish final proposals in Spring 2009.

www.cesr-eu.org/index.php?page=home_details&id=268

EU Proposes Sovereign Wealth Fund Code of Conduct

On February 27, the European Commission proposed a common EU approach to increasing the transparency, predictability and accountability of sovereign wealth funds. The common approach is intended to strengthen the European Union's voice in international discussions on establishing a code of conduct which would include standards in areas of transparency and governance, with the overall aim of maintaining an open investment environment.

The proposals are based on five principles: (i) commitment to an open investment environment both in the EU and elsewhere; (ii) support of multilateral work in international organisations such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD); (iii) use of existing instruments at EU and individual Member State levels; (iv) respect of EU obligations and international commitments; and (v) proportionality and transparency.

ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf

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Upcoming Breakfast Seminar:

Comparing London and Switzerland as a Domicile for Fund Managers

Tuesday, March 11

London Capital Club, London EC4

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

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