



London Update

UK Financial Services Regulatory Developments

November 2006

Bank of England Acknowledges Hedge Funds' Positive Contribution to Financial Stability

In a major speech entitled *Hedge Funds and Financial Stability* delivered to an industry conference on October 17, Bank of England Deputy Governor, Sir John Gieve, discussed the impact of hedge funds on the financial system and considered potential risks to financial stability.

He suggested that the recent explosive growth of hedge funds was a response to technological advances and the innovation and specialization they allowed. He observed that: "In the long term that shift should be good for stability." Adding further detail, he continued: "The active trading of hedge funds makes markets more liquid and facilitates genuine hedging activity by others – including systemically important banks. Increasingly, hedge funds – led by those managed from London – have become an important part of the risk transfer process."

Sir John considered that there were risks in the short term. "Periods of rapid growth and innovation in financial markets have often led to difficulties and overshooting and we should not assume that this one will be different." He noted that "after a short pause in May and June, we have seen the return of aggressive risk taking in many financial markets this autumn."

He concluded by stating that the regulators were working with the industry to assess and mitigate the risks. He observed that the rapid growth of hedge funds was part of a wider transformation of financial markets which in the long term there were good reasons to consider welcome "not just in widening the range of options for investors but in promoting the stability of the financial system."

<http://www.bankofengland.co.uk/publications/speeches/2006/speech285.pdf>

FSA Consults on Proposed Changes to Listing and Prospectus Rules

On October 6, the FSA published a consultation paper (CPo6/17) on proposed changes to the Listing and Prospectus Rules. The purpose of the proposals is to address issues that have emerged since the entry into force, on 1 July 2005, of the new UK rules which implemented the EU Prospectus Directive. The FSA has stated that its aim is to deal with a number of areas where their rules may be hindering market efficiency. CPo6/17 proposes changes to the procedural aspects of prospectuses, the application for listing procedure, the cancellation of listing and the application process for depositary receipts and securitised derivatives. The FSA considers that the net effect of these proposals would be deregulatory, in line with the FSA's aim of simplifying its rules and its long term objective of transforming its approach from "rules-based" to "principles-based." Whilst the proposals in CPo6/17 are relatively minor, they represent examples of the FSA's approach of working closely with market participants and co-operating with them in developing market-based solutions where possible.

http://www.fsa.gov.uk/Pages/Library/Policy/CP/2006/o6_17.shtml

FSA Issues Update on MiFID Implementation

On October 17, the FSA published an update on its plan for implementation of the EU Markets in Financial Instruments Directive ("MiFID"). The FSA set out a revised programme of consultation; papers and rulemaking, together with other planned publications in the run-up to transposition of MiFID (due by January 31, 2007) and implementation (due date is November 1, 2007). The MiFID-led changes to the regulatory system in the UK and the rest of Europe are enormously far-reaching and will have a significant impact on aspects of the business of every regulated investment firm.

The following papers have been issued so far and feedback on consultation responses is awaited: DPo6/3: *Implementing MiFID's Best Execution Requirements* (May 2006); CPo6/9: *Organizational Systems and Controls - Common Platform for Firms* (May 2006); CPo6/14: *Implementing MiFID for Firms and Markets* (July 2006). Two further consultation papers : CPo6/19: *Reforming Conduct of Business Regulation* and CPo6/20: *Financial Promotion and Other Communications* were published on October 31 and are discussed below.

http://www.fsa.gov.uk/pubs/international/mifidplan_update.pdf

HMRC Consults on Investment Manager Exemption

On October 20, HM Revenue & Customs (HMRC) released for consultation a draft of its revised Statement of Practice concerning the application of the Investment Manager Exemption (IME). The significance of the IME is that unless it applies to the London-based managers of hedge funds and other offshore funds, the funds can be liable to UK tax on their profits (subject only to relief available under any applicable double tax treaty.) The IME is particularly important for more actively managed vehicles, such as hedge funds.

The HMRC consultation draft addresses a number of issues with respect to the IME's qualifying conditions, including:

- Basis on which a manager and a fund are considered to be independent
- Customary payment rate for managers
- What transactions are "trading" as opposed to "investment"

Responses to the Consultation are due by January 12th, 2007, and HMRC aims to issue final revised Statement of Practice by March 31st, 2007.

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_026217

FSA Publishes Proposals for More Principle-Based Regulation

On October 31 the FSA published proposals for a radical simplification of its conduct of business rules - the rules that firms must follow in carrying on investment business with customers.

The details are set out in two consultative papers: CPo6/19: *Reforming Conduct of Business Regulation* and CPo6/20: *Financial Promotion and Other Communications*. CPo6/19 also includes proposed amendments to other (non-conduct of business) parts of the FSA rules which are necessary for implementation of the EU Markets in Financial Instrument Directive ("MiFID"). These papers represent the final parts of FSA consultation for implementation of MiFID. Earlier CPs published this year were CPs o6/9 *Organisational systems and controls – Common platform for firms*; o6/14 *Implementing MiFID for Firms and Markets* and o6/15 *Reforming the Approved Persons Regime*.

The reform of the conduct of business rules is a key part of the FSA move towards more principle-based regulation and away from detailed prescriptive rules. The FSA is aiming to remove around half the content of the old rulebook with the end result being a very substantially shorter rule book. The deadline for comments on CPo6/19 and CPo6/20 is November 28, 2006 for MiFID related material and February 23, 2007 for other proposals.

http://www.fsa.gov.uk/pubs/cp/cpo6_19.pdf
http://www.fsa.gov.uk/pubs/cp/cpo6_20.pdf

FSA Proposes to Encourage the Use of Industry Guidance

On November 1 the FSA issued a discussion paper in which it sets out proposals to encourage greater use of Industry Guidance as part of its moves towards "more principle-based regulations".

Industry Guidance includes codes of practice and similar statements generated by trade associations and professional bodies to help their members understand and follow good practice in meeting regulatory requirements.

Discussion Paper DPo6/5: *FSA Confirmation of Industry Guidance* sets out the FSA's thinking on the role of Industry Guidance and proposes a standardized process for FSA's recognition of Industry Guidance. It also makes clear the standards that will be applied in recognising such guidance. The FSA has indicated that it will not take enforcement action against a firm which complies with recognised Industry Guidance covering the issue concerned.

The deadline for comments on DPO6/5 is January 31, 2007.

http://www.fsa.gov.uk/pubs/discussion/dpo6_05.pdf

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Upcoming Breakfast Seminar:

Date: Tuesday 12 December 2006

Venue: London Capital Club, London EC4

Title: UK Taxation of Hedge Funds and Latest HMRC Consultation on Investment Manager Exemption.

For an invitation please contact terri.duggan@kattenlaw.co.uk

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