

London Update

UK Financial Services Regulatory Developments

Katten

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This edition covers UK and EU developments between 28 August and 30 September

UK DEVELOPMENTS

FSA Issues *Market Watch* 33

The UK Financial Services Authority (FSA) published issue 33 of its *Market Watch* newsletter on 28 August. It includes articles warning about order book manipulation and emphasising the importance of Suspicious Transaction Reports (STRs) in preventing and detecting insider dealing.

The FSA highlighted conduct termed “layering” and “spoofing” in particular as manipulation of the order book for firms who offer direct market access (DMA) to their clients. These terms refer to the use of multiple orders placed in a particular manner and which may give a false or misleading impression about the supply and demand for securities.

The FSA considers that such behaviour can constitute market abuse and stated that it expects DMA providers to have appropriate systems and controls in place to identify and prevent it just as exchanges and multilateral trading facilities are required to do.

The FSA stated that in general it considers that the market abuse STR regime is working well, pointing out that suspicious transactions sometimes come to its attention where the firms involved have not submitted an STR, although the FSA would have expected to receive one. As a result, the FSA is “increasingly initiating telephone contact with firms as a matter of course in these cases”. The regulator wants to understand why firms do not submit STRs in cases where they should. It also explained that these phone calls will help it to identify where a firm’s practices may have fallen below the standards expected under the rules and that in appropriate cases this will lead to disciplinary action. The next item highlights the consequences of a failure to file an STR.

[Read more.](#)

FSA Fines Manager for Suspicious Transaction Reporting Failure

The FSA announced on 2 September that it had fined Mark Lockwood, a former trading desk manager at a retail stockbroker, £20,000 for failing to observe proper standards of market conduct. He failed to identify and report insider trading by clients in shares of Amerisur Resources plc, an oil and gas exploration company.

The transaction in question was a sale of shares on 23 May 2007, ahead of an announcement by the company of a placing of shares the next day (Lockwood’s clients were fined a total of £19,050 in December 2008 after a separate FSA enforcement action). The FSA concluded that Lockwood knew of the impending transaction and ignored clear warning signals from the clients as to the basis of the trade. Lockwood’s conduct resulted in the failure to prevent the trade and meant that his firm did not submit an STR to the FSA. The trade came to the FSA’s attention only because of an STR submitted by another broker.

Margaret Cole, the FSA’s Director of Enforcement, said the fine emphasised the importance of the STR regime. The submission by broking firms of STRs is a key element in detecting market abuse. The failure to file an STR can mean that transactions based on inside information remain undetected and unpunished. Brokers and their employees should be in no doubt as to their responsibilities in this area, and the FSA will not hesitate to take action where they fail to meet them. See also the final paragraph of the previous item on *Market Watch* 33.

[Read more.](#)

FSA Enforcement Director Speaks on Prosecutorial Approach

On 14 September, the FSA published the text of a speech by Margaret Cole, FSA Director of Enforcement, about the FSA's strategy and approach to fighting fraud.

Ms. Cole explained that historically the FSA had used its prosecution powers sparingly. That has changed; it is now committed to a tough stance on markets offenses. It is determined to be a "feared and respected prosecutor" of insider dealing and unauthorised business fraud.

The FSA will increasingly use its criminal powers against insider dealing and in relation to fraud by investment businesses which do not have FSA authorisation, rather than proceeding for civil penalties.

[Read more.](#)

FSA Chairman Continues to Push for Regulatory Reform

On 22 September, Lord Turner, the Chairman of the FSA, gave a speech in which he emphasised that the momentum for regulatory reform needs to be maintained and restated his belief that if a more robust global capital and liquidity regime for banks is not implemented now, a similar crisis to that of 2008-9 may occur in the future.

Lord Turner described the current financial crisis as having been "cooked up in trading rooms where not just a few but many people earned annual bonuses equal to a lifetime's earnings of some of those now suffering the consequences". He went on to describe it as "the worst crisis for 70 years" and said that a worse outcome was "only averted by quite exceptional policy measures".

Lord Turner said that he maintained his belief that the City of London should continue to be a major provider of wholesale financial services to the rest of the world. However, he also reiterated that some financial innovation is not valuable, some trading activity is not useful, and a larger financial system is not necessarily a better one. The financial industry has an ability to "generate unnecessary demand" for its services, as "more trading and more financial innovation can under some circumstances create harmful volatility against which customers have to hedge, creating more demand for trading liquidity and innovative products".

Lord Turner stated that the banking industry needed to restore trust in the vital role that it performs. Banks should be refocusing on their core social and economic functions of providing savings, credit and payment products to customers, instead of focusing on over-complex products that are "of no real use to humanity". This may mean that banks will be lower return, but also lower risk, investments: "Bank investments might become more boring, but after the last year, there's a lot to be said for boring".

The FSA's response to the crisis has concentrated on ensuring that banks have more capital and liquidity both through domestic requirements and international agreements. But recently, public concern has been more focused on the debate surrounding bonus levels. When commenting on this, Lord Turner said that the FSA has led the world in introducing rules that focus on reducing risk.

He concluded by advising that the Financial Stability Board's forthcoming report to the G20 will state that it is essential that banks prioritise using profits to rebuild their capital base, support lending and reduce risks rather than to pay high bonuses. Lord Turner believes that regulators have a legitimate interest in banks' aggregate bonus payments where these have implications for their financial resources position.

Click [here](#) to read the full speech.

FSA and UK Treasury Issue Joint Response to EU Commission's Consultation on OTC Derivatives

On 24 September, the FSA and the UK Treasury (collectively, the UK Authorities) released a response to the European Commission's 3 July consultation on ways to reduce the risks of derivative markets (see the August edition of [London Update](#)).

The UK Authorities welcomed the proposals by the Commission for enhancing the resilience of the over-the-counter (OTC) derivatives markets. They agreed with the Commission's view that these markets have exhibited weaknesses, specifically in terms of counterparty risk management and market transparency, and that appropriate steps should be taken to strengthen these aspects in order to safeguard financial stability.

The UK Authorities outlined key steps which in their view will strengthen the OTC derivatives markets. They state that by ensuring that market participants have access to an appropriately robust, resilient and transparent market, authorities can help to improve confidence and financial stability both in the OTC derivative markets and the broader financial sector. The UK Authorities:

- i. support the Commission's drive for further standardisation of contract and economic terms. By using operational capital charges which are proportionate to the operational risks, the cost impact on non-standardised contracts will further encourage the use of standardised contracts.
- ii. strongly support the greater use of central counterparty (CCP) clearing arrangements in OTC derivatives markets for products which are "clearing-eligible". CCPs could offer a number of value-added services, such as the provision of additional market information which would encourage market participants to make greater use of CCP clearing.
- iii. take the view that bilateral collateralisation arrangements where market participants are unable to directly access CCP clearing, or are using non "clearing-eligible" contracts, remain important. These arrangements must be subject to robust risk management, which should include: regular (preferably daily) valuation and margin call processes; strong legal and operational frameworks; and appropriate capital requirements.
- iv. share the Commission's view that some market participants do not have adequate access to trade information. They support moves to address this, however they also noted that careful consideration will need to be given to how such a regime is implemented and how to ensure data accuracy.

The full response can be found [here](#).

FSA Publishes Amendments to the Listing Rules

On 25 September, the FSA (in its capacity as the UK Listing Authority) published the Listing Rules Sourcebook (Amendment No 3) Instrument 2009 making changes to the UK Listing Rules. This is the conclusion of a review of the UK listing regime started by the FSA in January 2008 (as reported in the [February 2008](#) and [January 2009](#) editions of *London Update*).

The effects of the amendments are as follows:

- The most notable change involves providing two categories under which companies can obtain a UK listing: Premium and Standard. A company with a Premium Listing will have to comply with requirements exceeding those set out under the relevant EU directives. Companies with Standard Listings will be required to comply with the minimum EU standards.
- Overseas companies which have a Premium Listing will be required to comply with the UK Combined Code on Corporate Governance or explain any failure to comply.
- Overseas companies which have a Standard Listing will be required to comply with the EU Company Reporting Directive.
- The Standard Listing segment will become available to UK companies for the first time as well as overseas companies.

In addition, the process for companies with an equity listing wishing to move from one segment to another has been simplified by the FSA clarifying that a cancellation of listing is not required.

The changes will take effect on 6 April 2010—except for the change which permits UK companies to have a Standard Listing, which took effect on 6 October 2009.

[Read more.](#)

UK to Implement G20 Pay Reforms

On 30 September, the UK Treasury announced that the UK government intends to implement the remuneration reforms agreed upon at the Group of Twenty's Pittsburgh summit held on 24 and 25 September. This was confirmed in a speech delivered by Prime Minister Gordon Brown in which he promised to implement legislation before the general election, which must be held no later than May 2010.

Key elements of the remuneration reforms include:

- i. requiring a significant portion of variable pay to be deferred, tied to performance and subject to appropriate clawback;
- ii. prohibiting multi-year guaranteed bonuses;
- iii. requiring significant financial institutions to have an independent board remuneration committee to exercise competent judgment on compensation policies and the incentives for managing risk, capital and liquidity, and to carry out an annual compensation compliance review to be submitted to the FSA;
- iv. adding new disclosure requirements including (a) disclosure of aggregate information on the pay of senior executives and all employees whose actions have a material impact on the risk exposure of the bank; and (b) an annual report on compensation to shareholders, providing information to help shareholders hold boards accountable, such as the remuneration committee mandate, performance criteria and information on the linkage between pay and performance;
- v. limiting variable pay as a percentage of total net revenues so that banks have the ability to maintain a sound capital base over the long term, while managing the risks that arise if an organisation cannot pay competitively to retain the right people;
- vi. determining remuneration of risk management independently of other business areas; and
- vii. mandating that failure to implement sound policies in line with the Financial Stability Board implementation standards will result in appropriate corrective measures by the FSA to offset the extra risk, including requiring additional capital to be held.

Click [here](#) to read the UK Treasury press release.

FSA Publishes Feedback to Turner Review

On 30 September, the FSA published a response to the feedback it has received on the Turner Review and the related discussion paper DP09/2, both published on 18 March (as reported in the April edition of [London Update](#)). The Turner Review, led by Lord Turner, the FSA Chairman, considered the underlying causes of the financial crisis and recommended a regulatory response stressing the importance of future regulation and supervision based on a different approach.

The response sets out the FSA's analysis of the feedback received and reports on the progress made since March in implementing changes and in achieving international agreement. Generally, the feedback received agreed with the analysis set out in the Turner Review and the broad approach it proposed. The majority of respondents offered clear support for the analysis of causes, the main recommendations and the FSA's supervisory approach as detailed in the Turner Review and the discussion paper.

The feedback raised the following key issues:

- Respondents agreed upon the need for an international approach when looking at policy options.
 - Respondents raised concerns that any measures implemented by the UK alone could damage London's competitiveness in the global market.
 - Large firms were opposed to increasing requirements for systemically important firms.
 - Respondents stated an impact assessment of the "whole package" of reform is needed.
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The issue of most concern for respondents was the need for international consistency in formulating and implementing the regulatory policy response to the global financial crisis.

In the foreword to the response, Lord Turner stated that “wider debate has continued on the overall approach to financial regulation and the FSA’s own thinking has continued to evolve”. The FSA considers that some issues which were covered only to a limited extent in the Turner Review now require a more detailed analysis. As a result, the FSA intends to publish a further discussion paper in October which will focus on key areas, including:

- Systemically important firms—The Group of Twenty Finance Ministers and Central Bank Governors has called for higher prudential standards for systemically important firms, and thus the FSA intends to address in particular the issues related to how to identify and deal with such firms, what policy tools are available and how they might be applied.
- Cumulative impact of capital and liquidity reforms—There is a need for a comprehensive analysis of the combined impact of the various elements of regulatory reform which have been proposed or are under consideration. These elements include more robust capital and liquidity requirements, changes to trading book capital and countercyclical capital. The changes will have a significant impact on leverage and maturity transformation in the banking systems, and thus the FSA will have to consider methodologies for making trade-offs between the costs of intermediation and financial stability.

The full text of the FSA’s response can be found [here](#).

UK Companies Act 2006 Implementation—Practical Implications

The Companies Act 2006 (2006 Act) has come into effect in tranches spanning approximately three years (as reported in past issues of *London Update* from [December 2006](#), [January 2007](#) and [September/October 2007](#)). The final implementation date was 1 October 2009.

Below are certain of the key changes the 2006 Act has already implemented:

- a codification of directors’ duties (1 October 2007);
- new provisions for shareholder approval of directors’ substantial property transactions, loans, long-term service contracts and payments for loss of office (1 October 2007);
- changes to formalities for shareholders’ meetings and resolutions (1 October 2007);
- the repeal of the prohibition on financial assistance for private companies (1 October 2008);
- new rules dealing with directors’ conflicts of interests (1 October 2008); and
- a simplified share capital reduction procedure for private companies (1 October 2008).

The following changes were implemented on 1 October 2009:

- simplified and “model” constitutional documentation is provided for new companies;
- the concept of authorised share capital is abolished and directors of private companies with only one class of share will be free to allot shares unless prohibited from doing so by their articles;
- directors may file a “service” rather than home address; and
- a simplified procedure has been adopted to change company names.

All UK companies should be taking the opportunity to consider whether or not they comply with the 2006 Act regime and how they can take advantage of certain simplified and modernised procedures. For example, in relation to the recent changes existing UK private limited companies might:

- consider whether to pass resolutions to remove restrictions that are no longer required (e.g., to allow directors to allot shares without prior authority);
 - review the company’s articles and consider whether to:
 - adopt new articles to reflect the new model articles available; or
 - introduce amendments to existing articles (e.g., to remove or update provisions that are altered or relaxed by the 2006 Act); or
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- entrench any provisions of the company's articles; and
- update internal processes to ensure that registers of directors and secretaries are correctly and confidentially maintained.

For more information see separate [Client Advisory](#) of 8 October.

[Read more.](#)

EU DEVELOPMENTS

UK Financial Services Minister Criticises Draft AIFM Directive

On 11 September, HM Treasury released the text of a hard-hitting speech by Lord Myners, Financial Services Secretary to HM Treasury, on the draft EU Alternative Investment Fund Managers Directive (Draft Directive).

Lord Myners, in criticising the Draft Directive, said, “[I]mposing ill-considered rules in haste is counterproductive, whether at European or national level”. Lord Myners emphasised that the UK “is not in the business of blocking more stringent regulation and effective supervision”. He continued: “We must not be beguiled by protectionism hiding as though it were protection. Hedge funds and private equity have not been central to the financial crisis”. He commented on the success of UK hedge fund regulation and noted the failure of the European Commission to consult on the Draft Directive. Lord Myners also said that the UK would work hard to achieve a directive “that allows efficient, well run and well regulated fund managers to compete for business without restriction across the EU and to make the EU a base from which to compete in global markets. But current proposals need remedying before this can be delivered”.

In response to points made by critics who said that the Draft Directive did not go far enough to address certain issues, Lord Myners commented that the Draft Directive was not the right place to address short selling or tax avoidance.

[Read more.](#)

Consultation on EU Communication on Financial Supervision

On 15 September, the European Commission published a summary of the responses it has received to the public consultation on its Communication on Financial Supervision dated 27 May (the Communication), together with those responses which were authorised for publication.

The Communication sets out proposals for a new European financial supervisory framework based on the recommendations in the de Larosière report. Respondents generally welcomed the proposals set out in the Communication and broadly supported its conclusions.

[Read more.](#)

European Commission Adopts Legislative Proposals Designed to Strengthen EU Financial Supervision

On 23 September, the European Commission announced that it had adopted a package of draft legislation designed to significantly strengthen the supervision of the financial sector in Europe. The proposals are based on the de Larosière report on the future of European supervision and regulation. The June 2009 EU Summit endorsed the new supervisory framework and called for the rapid adoption of the necessary legislative texts.

The proposals aim to:

- Address risks to financial stability throughout the EU
- Create consistent supervision and enforcement throughout the EU

- Ensure early identification of risks in the financial system
- Achieve effective cooperation in emergencies, and dispute resolution among supervisors

Under the proposals, the following new bodies will be created:

- European Systemic Risk Board (ESRB)—a “macro-prudential” supervisor which will monitor and assess risks to the stability of the financial system as a whole. The ESRB will be tasked with providing early warning of systemic risks that may be building up and, where necessary, recommendations for action to deal with these risks.
- European System of Financial Supervisors (ESFS)—a “micro-prudential” supervisor for the supervision of individual financial institutions. It will consist of a network of national financial supervisors working in tandem with three new European Supervisory Authorities (a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA)). ESFS will absorb and replace the existing Committees for the banking securities and insurance and occupational pensions sectors: the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR). In addition ESFS will be tasked with the following:
 - Developing proposals for technical standards, respecting better regulation principles
 - Resolving cases of disagreement between national supervisors
 - Ensuring consistent application of relevant EU rules
 - A coordination role in emergency situations

The ESMA will also exercise direct supervisory powers over Credit Rating Agencies.

Click [here](#) for more information on financial services supervision and committee architecture.

Click [here](#) for more information on the new legislative proposals.

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