London Update

UK Financial Services Regulatory Developments

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This edition covers developments between 28 July and 31 August 2010.

Supreme Court Confirms Court of Appeal Ruling on FSA Enforcement Capabilities

On 28 July, the UK Supreme Court upheld the English Court of Appeal's judgment that the power of the FSA to prosecute criminal offenses was not limited to the offenses specified in sections 401 and 402 of the Financial Services and Markets Act 2000 (see the November 2009 edition of *London Update*). In particular, the Supreme Court confirmed that the FSA has the power to prosecute money laundering and other offenses within the ambit of the FSA's statutory objectives.

Read more.

Court of Appeal Decides LBIE Client Money Application

On 2 August, the English Court of Appeal handed down its judgment on the client money directions application made in the Administration of Lehman Brothers International (Europe) (LBIE). The Court of Appeal overturned Mr. Justice Briggs' High Court decision in part, holding unanimously that:

1) Clients whose money (as opposed to securities and other assets) should have been segregated by LBIE as client money prior to administration but was not are entitled to share in the client money pool.
2) Money held by LBIE (at the time of administration) outside its segregated client money accounts which is "identifiable client money" is to be pooled with the client money held in its segregated accounts.
3) The client money pool will be distributed *pro rata* to all of LBIE clients entitled to claim against the pool, with the share of each client calculated based on the amount of client money which should have been segregated, as a proportion of the total amount which LBIE should have segregated.

LBIE's Joint Administrators stated that they were considering the Court of Appeal's judgment carefully to assess its implications for LBIE's client money claimants and creditors, including, in particular, on the likely timing and level of any distribution of client money.

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FSA Fines Royal Bank of Scotland Group £5.6m for UK Sanctions Controls Failings

On 13 August, the UK Financial Services Authority (FSA) announced that it had fined RBS Plc, NatWest, Ulster Bank and Coutts and Co (RBSG) £5.6 million for failing to have in place adequate systems and controls to prevent breaches of UK financial sanctions. This is the biggest fine imposed by the FSA to date in pursuit of its financial crime objective. It is also the first fine imposed by the FSA under the Money Laundering Regulations 2007.

The Regulations require that firms maintain appropriate policies and procedures in order to prevent funds or financial services being made available to those on the HM Treasury Sanctions List. The FSA found that between 15 December 2007 and 31 December 2008, RBSG failed to adequately screen both their customers and the payments they made and received against the List.

The FSA considered that RBSG's failings in relation to their screening procedures were particularly serious because of the risk posed to the integrity of the UK financial services sector. Specifically, it could have facilitated transactions involving sanctions targets, including terrorist financing.

Margaret Cole, FSA Director of Enforcement and Financial Crime, said: "The scale of the fine shows how seriously the FSA takes this issue and should act as a warning to other firms to ensure that they have adequate screening procedures."

As RBSG agreed to settle at an early stage of the FSA investigation, it qualified for a 30% reduction in penalty which would otherwise have been £8 million.

Read more.

FSA Cracks Down on Sales of Private Funds

The FSA has recently publicised widespread failings in the marketing of "unregulated collective investment schemes"—a category of fund products which includes almost all private funds including all hedge funds other than those established within the Undertakings for Collective Investment in Transferable Securities (UCITS) framework. This does not mean that such funds cannot be sold in or from the UK, but it emphasises the need for great attention to the details of the relevant regulations before, and while, doing so.

The FSA announced that it had just completed a project examining the promotion and sale of unregulated collective investment schemes to retail customers by financial advisors. The FSA stated that it had uncovered widespread failings by financial advisor firms in understanding the regulatory requirements for the promotion of these funds, a lack of understanding of the market within which these schemes operated and of the risks of investment in these funds. This has resulted in firms marketing and selling these funds to customers who were not eligible to purchase them. The FSA is bringing enforcement proceedings against a number of regulated firms.

Read more.

FSA Hedge Fund Surveys Conclusions Published

The FSA recently published a report entitled "Assessing possible sources of systemic risk from hedge funds." It sets out the FSA's key findings and conclusions from two surveys it conducted in April 2010—the Hedge Funds as Counterparties Survey (HFACS) and the Hedge Fund Survey (HFS). The FSA intends to continue conducting these surveys every six months to help monitor trends in hedge funds. (The results of the October 2009 surveys, published in February 2010, were reported in the March 2010 edition of *London Update*.)

The HFACS has been conducted every six months since 2005. It asks some of the largest FSA-authorised banks with exposures to hedge funds about their credit counterparty risks. The HFS was introduced in October 2009 to complement the HFACS. It surveys the 50 largest FSA-authorised investment managers, on this occasion with a combined total of $345 billion in hedge fund assets under management. The survey asks questions about the assets the firms managed and the larger funds for which they undertake management activities.

The report's conclusions, which were in line with the FSA's expectations of an increase in risk appetite and improved market conditions since the previous survey in October 2009, were:

- hedge funds are using more leverage;
- hedge funds are borrowing more through repurchase agreements and less through prime brokerage;
- with the exception of corporate bonds, positions held by the surveyed hedge funds did not comprise a particularly large proportion of any total asset class;
- measures such as performance, open positions, concentration of positions, overall exposure of funds by long market value vs. short market value and prime brokerage cash balances to net equity ratio suggest hedge funds have a higher risk appetite at April 2010 compared to six months earlier; and
- hedge funds appear to have further diversified their credit exposures to bank counterparties.

The FSA reported that there was no material change in the systemic risk to financial stability as against the survey six months previously. That survey had concluded: "The HFACS data suggests that on 31 October 2009, major hedge funds did not pose a potentially destabilising credit counterparty risk across the surveyed banks. HFS data shows a relatively low level of ‘leverage’ under our various measures and suggests a contained level of risk from hedge funds at that time.”

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FSA Fines Zurich Insurance for Loss of Customer Details

On 24 August, the FSA announced that it had fined the UK branch of Irish company Zurich Insurance Plc (Zurich UK) £2.275 million after 46,000 customers’ confidential information was lost. This is the highest fine imposed to date on a single firm for failings in data protection.

In August 2008, Zurich UK outsourced certain data processing to its South African affiliate Zurich SA. The data losses occurred when Zurich SA transferred data stored on an unencrypted back-up tape to a data storage centre as part of a routine transfer. A lack of inter-company communication meant that a year passed before Zurich UK was informed of the incident. The data loss left the customers vulnerable to theft and financial loss.

The FSA found that Zurich UK had not taken reasonable care to ensure that its systems and controls were sufficient to cope with the risks involved in the outsourcing arrangement nor to prevent the customer data being used for financial crime. (It appears that the lost data was not misused and no customers were compromised.)

As Zurich UK settled early, the original fine of £3.25 million was reduced by 30% to £2.275 million.

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FSA Signals Fundamental Changes to Trading Activity Regulation

On 25 August, the FSA published a discussion paper (*The Prudential Regime for Trading Activities - a Fundamental Review* DP10/4) proposing fundamental changes to the regulation of the trading activities of banks and investment firms. The FSA considers that its proposed regulations will address key elements of risks currently posed to the financial system.

The proposals cover three key areas:

1) **Valuation**—more comprehensive regulation of valuation of trading positions and investigations into valuation uncertainty
2) **Coverage, coherence and the capital framework**—a restructuring of the capital framework, improving coherence and reducing structural arbitrage in the banking and finance sector
3) **Risk management and modelling**—measures targeting firms’ risk management and modelling standards, aligning both with regulatory objectives

The closing date for responses is 26 November. The FSA anticipates that it will issue a feedback statement and final rules in the first half of 2011.

Read more.

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