

Financial Services and Markets

A postcard from the UK – wish you had been here?

Here is a round-up of some of the more significant things that you might have missed during the dog days of July and August (or which were just too big to read on your BlackBerry®). The summary below highlights the key issues - more detail and links to relevant documents are on the following pages.

SUMMARY

Action required

- All firms should be considering whether there are any individuals who will be caught by the extended approved persons regime who are not currently approved. The regime came into force on 6 August and firms must submit any applications by 6 February 2010 for persons within the limited transitional regime. There are some significant issues for UK subsidiaries of non-UK firms and branches of non-UK firms. Firms must also now be prepared to ask and respond to reference requests for anyone who has fulfilled a controlled function (not just the customer function).
- The Payment Services Directive comes into force on 1 November - affected firms (other than banks) should have applied to FSA for authorisation or registration. All affected firms (including banks) must have compliant client documents by 1 November. In addition, banks, building societies and credit unions which accept deposits from retail customers have to prepare for the fact that BCOBS also comes into force on 1 November.
- Large banks, building societies and broker dealers will be subject to the new FSA Code on remuneration from 1 January 2010. Remuneration committees must send their remuneration policy statements to the FSA by the end of October 2009. Other FSA authorised firms will have to wait until the end of October to find out whether and to what extent they will be subjected to the Code. Banks and investment firms should keep an eye on the proposed CRD amendments which will create binding obligations as regards remuneration policies.
- "White labelling" - distributors of products and services actually provided by a different entity - the FSA will be reviewing their financial promotions in the last quarter and has warned of enforcement action. Firms need to take action to check their promotions now in the light of the recent Financial Promotions Industry Update.
- All firms should consider if the new case work examples of "real cases" on financial promotions are applicable to their promotions and make appropriate changes. Firms which have "outdoor financial promotions" should check them against the specific FSA review comments on such promotions.
- Estate agents and certain consumer credit lenders need to submit registration forms to the OFT by the end of November in relation to OFT supervision of the Money Laundering Regulations.
- Firms who are responsible for the security of their customer data should ensure that they have better systems and controls than the three HSBC companies recently fined for having inadequate controls, particularly in light of the significant increases in financial penalties being proposed by the FSA.

Consultations

- White Paper on Reforming Financial Markets-HM Treasury's response to the Turner review.
 - Sir David Walker's review of corporate governance in UK banks.
 - FSA consultation on increasing financial penalties in enforcement cases-firms to suffer enforcement penalties based on their income.
 - CESR proposal for a permanent European short-selling disclosure regime.
 - European Commission on strengthening the regime for UCITS depositaries. This has potential read-across implications for firms that will be caught by the proposed Alternative Investment Fund Manager's Directive. Also note the CESR draft advice on UCITS management company issues.
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- HMT and FSA on introducing a protected cell regime for OEICs.
- European Commission on amendments to the Capital Requirements Directive-relevant to banks, those with securitisation positions, and its provisions on remuneration are relevant to all banks and investment firms.(Also note enhancements to the Basel II Framework).
- Similarly, it will amend the existing power of the FSA under section 45 FSMA to vary a firm's permission on the Authority's own initiative so that it can be exercised in furtherance of any of its regulatory objectives (as expanded);
- The FSA's power to intervene against incoming EEA firms under section 194 FSMA will also be enhanced with a similar reference to the regulatory objectives.
- BIS consultation on implementing the Consumer Credit Directive.
- JMLSG on revisions to anti-money laundering guidance.

THE DETAIL

Approved persons regime – significant influence function review

At the end of July 2009, the FSA published its feedback and final rules making changes to the approved persons regime, which changes are described below. All firms should be considering whether there are any individuals who will be caught by the extended regime but who are not currently approved. The new rules came into force on 6 August 2009. However, there is a transitional period of six months meaning that firms will have to ensure that they have submitted all additional applications for approval by 6 February 2010 at the latest. The FSA is encouraging firms to speak to their supervisors – or the FSA's permissions department – before applications are submitted in order to "ensure a consistent application of the regime". Determining whether someone is exercising a significant influence will not always be straightforward, so, if not already started, it is essential to begin one's assessment now and allow sufficient time to take advice or guidance if necessary.

The FSA "unintentionally omitted" to include the transitional relief in relation to the changes applicable to UK branches of non-EEA firms (see below): the omission will be addressed by a rule change on 6 October 2009 and, until then, firms can rely on a modification by consent to avoid breaching the new requirements:

<http://www.fsa.gov.uk/pages/Doing/Regulated/Notify/Waiver/Consent/sup1017r.shtml>).

Expansion of the scope of CF1 and CF2 – persons employed by unregulated parent/holding company

Broadly, controlled functions CF1 (director) and CF2 (non-executive director) have been extended to cover any persons employed by a parent undertaking or holding company (which is not a regulated EEA firm) and who exercise a significant influence over an authorised firm – i.e. whose decisions or actions are regularly taken into account by the authorised firm's governing body.

The FSA gives some non-exhaustive examples (in SUP 10.6.5G and SUP 10.6.9G) of persons who would be caught by the wider regulatory net, and so, amongst other things, firms should be considering any employees who exert a significant influence by, e.g., sitting on audit and remuneration committees (or otherwise being involved in setting the objectives for and the remuneration of executive directors), exercising significant influence through decision-taking or otherwise influencing the operations of the firm or setting business strategy. It should be noted that it is not the status of the individual within the parent or holding company which matters – he or she could be a director, non-executive director, partner, member, senior manager or employee – it is the influence he or she exerts on the regulated firm.

Extension of CF29 – proprietary traders

Controlled function CF29 (significant management) has been extended to include **all proprietary traders** who are not senior managers but who exercise a significant influence. Since a proprietary trader uses the firm's money and can commit the firm to positions, the FSA deems that all such traders at least have the *potential* to be able to exercise significant influence on the firm. The FSA therefore expects all firms with proprietary traders to assess which ones require approval (i.e. those who actually exercise a significant influence on the firm).

Of course, some proprietary traders in some firms may already be approved under the existing regime: for instance, they may already require approval under CF29 (significant management function) if they are senior managers and either are the head of a trading desk or have trading limits that could expose their firm to significant risk if anything went wrong, or under CF30 (customer function) where they deal with customers who are not market counterparties. If such proprietary traders are already approved under CF29 (significant management function) they will not need to be approved again on the introduction of the extended regime. If they are already approved but only under CF30, then it will be necessary to apply for approval under CF29 as well.

Approved persons regime to apply in full to UK branches of non-EEA firms

The approved persons regime previously applied to UK branches of non-EEA firms on a limited basis. Under the extended regime, all controlled functions will need to be considered. Therefore, in addition to those functions which had previously been applicable, persons who have responsibility for the regulated activities of a UK branch and exercise a significant influence over the branch or whose decisions or actions are regularly taken into account by the governing body of the branch will have to be registered as CF1 (director) or CF2 (non-executive director) as appropriate. In addition, the systems and controls function (CF28) is now registrable.

Reference request requirement to be extended to all controlled functions

Currently, if a firm is considering appointing a person to perform a *customer* function and requests the former employer of that person to provide a reference or other information, the latter firm must provide all relevant information and not just a brief reference as soon as reasonably practicable. Under the rule as extended, this provision will apply in respect of persons moving firms to perform *any* controlled function.

The policy statement is at:

http://www.fsa.gov.uk/pages/Library/Policy/Policy/2009/09_14.shtml

Payment services regulations—do you need to be authorised or registered by 1 November 2009?

Any non-bank firm that will be required by the Payment Services Regulations 2009 (PSRs) to be authorised or registered as a payment institution should have spent time over the summer preparing for the rapidly approaching deadline of 1 November 2009, the date on which the new regime comes into force. The FSA started accepting early applications for authorisation or registration on 1 May 2009. Subject to limited transitional provisions, payment institutions must be registered with or authorised by the FSA by 1 November 2009, otherwise they commit an offence by that date. In addition to making applications to the FSA, in-scope firms (including banks) should have been reviewing and amending their client documentation to ensure that it complies with the information requirements of the PSRs by that date.

See the FSA's webpage devoted to the implementation of the Payment Services Directive:

<http://www.fsa.gov.uk/Pages/About/What/International/psd/>

In addition, you should have received our series of briefings on the introduction of payment services regulation. If not, and you would like to receive copies, please contact Mark Evans at mark.evans@traverssmith.com

Financial promotion

There has been a recent spate of activity from the FSA in relation to financial promotion, starting with its review of outdoor financial promotions in the latter half of June (http://www.fsa.gov.uk/pages/Doing/Regulated/Promo/thematic/out_fin_prom.shtml). The review covered financial promotions made by way of billboards, posters (including digital video displays) and advertisements appearing on ticket barriers, train carriages, taxis and buses. One interesting finding was that some firms, when marketing high-risk products, assumed that their audience would be relatively sophisticated, despite the fact that the nature of outdoor advertising means that the promotion cannot be specifically targeted.

In early July the **FSA published a set of ten case work examples** describing "real life" cases that the FSA has acted upon, although information which might identify the offenders has been changed. While the FSA says that the case work examples are not intended to "set any precedent or act as a guide" to how the regulator may resolve cases in the future, they nevertheless highlight recurrent themes about what firms get wrong (e.g. lack or insufficiency of risk warnings) and, therefore, how one can avoid regulatory action. The examples cover a variety of different types of firm, including a high-street retailer, an insurance intermediary, a mortgage broker and fund managers of different sizes.

The case work examples are at:

<http://www.fsa.gov.uk/Pages/Doing/Regulated/Promo/actions/case/index.shtml>

Later in July there was a *real* "real life" enforcement case, so the identity of the offender was not hidden: **City Gate Money Managers** was fined £42,000 for failing to ensure that the financial promotions approved by it and issued by its appointed representatives set out the key features and risks of the relevant investment. The failings were considered particularly serious by the FSA because City Gate had specifically held itself out as a provider of compliance services and this was a particular revenue stream for it – but, in any event, the case highlights the perils for any firm in agreeing to approve a third party's financial promotion and not apply the same stringency which it applies (or ought to apply) to a financial promotion of its own

The FSA Final Notice is at: http://www.fsa.gov.uk/pubs/final/city_gate_jul09.pdf

Finally, you may or may not be familiar with the term "**white labelling**". In the second issue of its **Financial Promotions Industry Update** the FSA has adopted a term widely known in retail markets other than financial services (such as supermarkets and high-street electrical retailers) to describe arrangements where a product or service is offered under the brand (label) of a retailer or distributor, but that product or service is actually made or provided by a separate producer or provider. The focus of the July Update is on the promotion of white labelled investment and insurance products under COBS. The FSA points to examples of promotions of packaged products or stakeholder products using the terms "we" and "our" which can create the impression that the person making the promotion is also the provider of the financial service, which is misleading. Similarly, in the context of insurance products, promotions from high-street distributors of insurance products should not give the impression that the insurance is provided by them. Clearly, the white labelling exercise can be seen as part of the FSA's wider TCF initiative. The FSA will be undertaking a white label review in the last quarter of this year and has said that it will take action in relation to non-compliant promotions. The warning has been given.

The Financial Promotions Industry Update is at:

http://www.fsa.gov.uk/pages/Doing/Regulated/Promo/pdf/white_labeling.pdf

The FSA and the OFT have published a joint paper on **online sponsored links** which contains some simplified mock advertisements as examples of poor advertising and which distinguishes between the regulatory jurisdictions of the OFT, the FSA and the Advertising Services Authority and the fact that, in certain cases, sponsored links may be subject to dual regulation by the OFT and the FSA because there are links to both secured and unsecured credit.

The joint paper is at:

<http://www.fsa.gov.uk/pages/Doing/Regulated/Promo/pdf/links.pdf>

Money, money, money

One of the limbs of the Walker Review described below relates to remuneration. This is not the only initiative to have focused on this topic.

FSA requirements

In March 2009 the FSA had consulted on a Code of Practice on remuneration policies which would apply to an estimated 48 of the largest banks, building societies and broker dealers and discussed whether the Code should be applied more widely to other FSA firms. In August, the final rules were published in PS **09/15: Reforming remuneration practices in financial services**. The FSA Code is being implemented in advance of a settled and aligned policy internationally: things are very much in a state of flux .

The FSA has narrowed the scope of application for the Code so that it will only apply to an estimated 26 firms. The new Code will come into force on 1 January 2010 (with transitional relief in relation to employment contracts entered into before 31 March 2009, which lasts until 31 March 2010 – there is no relief in respect of employment contracts entered into after 31 March 2009). The FSA has already written to CEOs of the in-scope firms telling them that guaranteed bonuses which run for more than a year may be inconsistent with effective risk management (Dear CEO Letter: http://www.fsa.gov.uk/pubs/ceo/ceo_letter0709.pdf) and we understand that the FSA has sent letters to the remuneration committees of in-scope firms setting out the information which the regulator will require in the remuneration policy statement and asking them to return their statements to the FSA by the end of October 2009.

The policy statement is at:

http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf

We still await the FSA's response as to whether it will propose widening the scope of the Code to other FSA-authorized firms. The FSA has said that it will respond on this point in October.

CEBS and CRD amendments

On 20 April 2009, CEBS published the final version of its high-level principles on remuneration, requesting that supervisors and firms implement those principles by the end of the third quarter of this year (<http://www.c-eps.org/getdoc/edae9c8f-01bd-4f6f-88ef-b3a80660b8d7/CEBS-publishes-its-principles-on-remuneration.aspx>).

This was followed by the publication by the EU Commission of two non-binding Recommendations, one of which related to executive pay disclosure requirements for EU listed companies and the other which addressed remuneration policies in the financial sector. Importantly, the Commission also published some **draft amendments to the Capital Requirements Directive**, the formal proposals for which were published on 13 July 2009. These proposals will be subject to the European legislative process and may therefore be subject to further amendment. Amongst other things, the CRD amendments will impose binding obligations on banks and investment firms in relation to remuneration policies.

See the following Commission page for all of these Commission documents:

http://ec.europa.eu/internal_market/company/directors-remun/index_en.htm

The financial crisis - financial reform

In early July the Treasury issued its **White Paper on Reforming Financial Markets**, the government response to the findings and recommendations of the Turner Review. (See our two Legal Briefings on the Turner Review:

http://www.traverssmith.com/assets/pdf/Legal_Briefings/the_turner_review_a_brief_overview.pdf

http://www.traverssmith.com/assets/pdf/Legal_Briefings/the_turner_review_detailed_assessment.pdf

This long paper is short on concrete proposals, but the government expressed its support for the tripartite regulatory system (unlike the Conservatives). It will replace the Standing Committee of the Treasury, the Bank and the FSA with a formal and statutory Council for Financial Stability. The FSA will not have responsibility for financial stability, but will be given a new statutory objective under which it will be required to take into account, *in the context of its existing functions*, the importance of international developments on financial stability within the UK. The FSA will be able to make rules under section 138 Financial Services and Markets Act 2000 in line with *any* of its regulatory objectives as expanded i.e. not just where it is expedient or necessary for the purposes of consumer protection.

For a fuller summary of the White Paper, see our Legal Briefing at:

http://www.traverssmith.com/assets/pdf/Legal_Briefings/fsmgfyertreasurywhitepaperreform.pdf

The White Paper itself is at:

http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf

If the polls are right, we will have a government of a different colour this time next year, so you may also be interested to read the views of the Conservatives in their **alternative white paper "From Crisis to Confidence: Plan for Sound Banking"**, in which, amongst

other things, they state that they will "abolish the FSA and the failed tripartite system and create a strong and powerful Bank of England", together with a new Consumer Protection Agency. The Conservative policy document is at:

http://www.conservatives.com/News/News_stories/2009/07/~~/media/Files/Downloadable%20Files/PlanforSoundBanking.ashx

Corporate governance and remuneration

In the middle of July HM Treasury published, by way of consultation, **Sir David Walker's "A review of corporate governance in UK and other financial industry entities"**. Sir David had been asked by the Prime Minister to review corporate governance in UK banks in the light of the experience of critical loss and failure throughout the banking system.

The following is a very broad outline of the specific recommendations:

- Board size, composition and qualification –the FSA's ongoing supervisory process should give closer attention to the overall balance of the board in relation to risk strategy. Non-executive directors should be appropriately trained in order to have the level of knowledge and understanding in order to enable them to engage in board deliberations, particularly as regards risk strategy;
- Functioning of the board and evaluation of performance –non-executive directors should adopt a more high-profile role, being ready, able and encouraged to challenge and test proposals on strategy put forward by the executive;
- Governance of risk – a board risk committee should be established (separate from the audit committee) with responsibility for oversight and advice to the board on the current risk exposures and future risk strategy facing the firm. A chief risk officer (CRO) should participate in risk management and oversight at the highest level, and should be entirely independent from individual business units of the firm;
- Remuneration –recommendations in relation to the scope of what the remuneration committee should oversee and disclosure requirements. There are some specific recommendations in relation to deferral of incentive payments, with staggering of vesting of benefits and the use of clawback in cases of misstatement and misconduct.
- The role of institutional shareholders: communication and performance – the remit of the Financial Reporting Council should be extended to cover principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the current Combined Code (which might be described as the "Corporate Governance Code"), from what might be appropriately described as "Principles for Stewardship".

The consultation period for the Walker Review expires on 1 October 2009 – Sir David Walker will issue a final version of the report and its recommendations in November 2009.

The Walker Review is at:

http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf

FSA Enforcement – more credible, more deterrent?

The FSA has published a **consultation paper (CP 09/19)** in relation to **financial penalties**. The FSA suggests that the new framework may result in a doubling or trebling of penalties when compared to current levels. It is proposing to introduce **a sliding scale of penalty tariffs linked to financial income**, which will differ between cases against firms, non-market abuse cases against individuals and market abuse cases against individuals.

Therefore, in cases against firms, the penalty tariff will, depending upon the seriousness of the breach, be 0%, 5%, 10%, 15% or 20% of the firm's pre-tax income over the period of the breach from the product or business area to which the breach relates.

The framework will be underpinned by three principles: that a person should not benefit from any breach, a firm or individual should be penalised for wrongdoing (discipline) and the financial penalty should have deterrent value – i.e. that it should deter the offender from committing further breaches and it should also deter other persons from committing similar breaches (deterrence).

In the case of non-market abuse cases against individuals, there would be a similar sliding scale of penalties depending upon the seriousness of the breach, but with a maximum penalty of 40% of the individual's pre-tax benefits from the relevant employment in connection with which the breach occurred, for the period of the breach.

In market abuse cases against individuals, the **minimum** penalty which the FSA would impose in all cases (subject to mitigation) would be £100,000. The penalty would be higher than that if twice the profit made or the loss avoided is higher than £100,000 and, if the breach is referable to the individual's employment, the penalty may be higher still (40% of the pre-tax benefits received from the last 12 months of employment).

The toughening of the FSA's stance is also evident in its proposals in relation to serious financial hardship: the regulator wants to move away from the suggestion that it would not pursue a particular penalty if the result would lead to, or threaten, insolvency. The FSA obviously anticipates controversy here and therefore puts forward two options. Under the first, more draconian, option, the FSA would not reduce a penalty against an individual on the grounds of serious financial hardship – and would therefore be prepared to bankrupt him. Under the second (and not that much less draconian) option, the FSA would consider reducing a financial penalty against an individual on the grounds of serious financial hardship, but usually only if the penalty would have the effect of reducing the individual's net annual income below £14,000 and his capital resources falling below £16,000.

The consultation paper remains open for comments until 21 October 2009 and is at:

http://www.fsa.gov.uk/pubs/cp/cp09_19.pdf

Within the existing enforcement framework the *FSA has imposed hefty fines on three HSBC firms for data security failures*. This has been a particularly "hot topic" for the FSA for the past five years or so and the HSBC firms join a growing band of other well-known firms which have received large fines for data security failings, including Nationwide Building Society, CGNU Life Assurance Limited and BNP Paribas Private Bank SA.

The three HSBC firms, HSBC Life (UK) Limited (fined £1.61 million), HSBC Actuaries and Consultants Limited (fined £875,000) and HSBC Insurance Brokers Limited (fined £700,000) each had inadequate systems and controls to address the risks relating to data security. Confidential customer information had been sent through the post or by couriers on unencrypted electronic media, such as floppy disks, and had been routinely left on open shelves or in unlocked cabinets in the office.

The final notices are at:

http://www.fsa.gov.uk/pubs/final/hsbc_ins0709.pdf

http://www.fsa.gov.uk/pubs/final/hsbc_actuaris0709.pdf

http://www.fsa.gov.uk/pubs/final/hsbc_inuk0907.pdf

Finally, Christopher McQuoid – the former general counsel at TTP Communications who, with his father-in-law, was convicted of insider dealing last year – has had his appeal against his sentence of twelve months' imprisonment dismissed (**R v Christopher McQuoid [2009] EWCA Crim 1301**). His counsel had argued that his sentence should be reduced because the Crown Court case had been undertaken by the FSA at the time at which the regulator had decided to change its policy in relation to whether to proceed in market abuse cases by way of criminal prosecution rather than by civil regulatory proceedings. Mr McQuoid had been the first to be tried under the changed policy and "others, no less culpable than he, were not prosecuted but were dealt with through the regulatory system" (Mr Jonathan Caplan QC). Unfortunately for Mr McQuoid the Court of Appeal gave short shrift to this argument. While the appeal judges accepted that there may have been previous subjects of investigations who may have been very fortunate (i.e. to escape criminal prosecution), "their good fortune cannot enure to the benefit of anyone else". In dismissing the appeal, and finding that the original sentence had been "as merciful as it properly could have been", the court offered some general guidance to sentencers about the considerations which may be relevant to their sentencing decisions in criminal market abuse cases.

Short selling/market conduct

In early July, **CESR** published a consultation on a **proposal for a permanent pan-European short selling disclosure regime**. Consultation closes on 30 September 2009.

In outline, the CESR paper included the following proposals:

- *scope*: the disclosure model would apply to short positions creating an economic exposure to shares admitted to trading on regulated markets or MTFs, in relation to EEA issuers and non-EEA issuers solely or primarily admitted to trading on the regulated market/MTF;
- *two-tier disclosure model*: CESR favours a mixture of private and public disclosures, based on the net short position (howsoever obtained) expressed as a percentage of the company's issued share capital. Therefore, there would be an initial disclosure to the relevant regulator once a net short position had reached a specified first trigger threshold, followed by a second public disclosure to the market as a whole once a second, higher threshold had been passed.
- *disclosure thresholds*: CESR proposes that there should be one set of disclosure thresholds applicable to all EEA jurisdictions (with an exception for rights issues): the initial private disclosure threshold would be at 0.10% and the public disclosure threshold would be set at 0.50%. Further notifications (whether to the regulator or to the market) would be required at changes in holdings at 0.1% intervals (e.g. additional private disclosures would be required at 0.2%, 0.2%, 0.3% and 0.4% and additional public disclosures would be required at 0.6%, 0.7% etc). Disclosures would also be required for downward movements through the disclosure bands.
- *rights issues*: CESR is proposing a lower public disclosure level in relation to rights issues: 0.25% (with private disclosure still required at 0.1% etc). These tighter thresholds could be introduced "on a permanent basis or even a temporary basis, with regulatory discretion as to when they are imposed".
- *net short position*: the net short position would not be limited to that taken in the cash equity markets but would also extend to positions in linked exchange-traded or OTC derivative contracts. The economic exposure would be calculated taking into account all classes of shares admitted to trading. Derivative positions would be calculated on a delta-adjusted basis. CESR is currently proposing that the netting calculation should be done at legal entity level (and not group level).
- *timing*: disclosures would be made at a specified time before the end of the trading day following the day on which the disclosure is triggered;

In its latest Market Watch newsletter the FSA has urged firms to respond to the CESR consultation.

The CESR consultation paper is at:

<http://www.cesr.eu/popup2.php?id=5791>

A couple of days after its consultation paper on a pan-European short selling regime, CESR published its **response to the European Commission's call for evidence on the review of the Market Abuse Directive (MAD)**, which had been published in April. CESR's response is restricted to those matters on which CESR members are in common agreement.

The CESR response is at:

<http://www.cesr.eu/popup2.php?id=5801>

Funds

It has been anything but a quiet summer for the fund industry. In spring the European Commission published the controversial draft **Directive on Alternative Investment Fund Managers** (the "AIFM Directive"). For our briefings on the Directive please see:

http://www.traverssmith.com/assets/pdf/Legal_Briefings/aifm_directive_overview_-_april_2009.pdf

http://www.traverssmith.com/assets/pdf/Legal_Briefings/aifm_flyer_-_longer_version.pdf

The Directive will have a significant impact upon the EU alternative investment fund management industry and for those who provide services to it. Broadly, and subject to some limited exemptions, the provisions of the AIFM Directive will apply in relation to the management of all kinds of collective investment vehicles which are not regulated UCITS funds (including private equity, hedge funds, real property, debt, commodity, infrastructure, VCTs, investment trusts, REITs – and even domestically regulated funds such as UK QIS and NURS. The progress of the AIFM Directive is currently being driven by the Swedish presidency; there is still somewhat ambitious talk of reaching a political agreement by the end of the year. In the UK, discontent has been growing – with concerns raised by the funds trade associations being endorsed by well-known politicians, the financial press and the FSA.

In the meantime, there have been developments in relation to the Directive which provided the European legislators with the (arguably ill-fitting) model for the AIFM Directive: the UCITS Directive. In early July, the European Commission issued its **consultation paper on the depositary function under the regime for Undertakings for Collective Investment in Transferable Securities (UCITS)**. The consultation is part of an initiative designed to strengthen and clarify the UCITS regime, particularly in the light of the Madoff scandal and the Lehman collapse. Under the draft AIFM Directive (see above) the Commission had made proposals as to strict regulation of depositaries in the context of alternative investment funds and the desire is to create a regime in relation to UCITS depositaries which is at least as stringent.

Amongst other things, the consultation:

- suggests that there should be clarification as to a depositary's safe-keeping liabilities so that, for listed financial instruments capable of being registered in the depositary's book, requirements could be introduced to ensure that the UCITS depositary complies with European custody regulation and, for other UCITS eligible assets that cannot be kept in custody in the UCITS depositary's book (such as OTC contracts) operational duties could be clarified in further detail;
- suggests that there should be a harmonisation of the regime of depositary liability in the event of a failure to perform its safe-keeping duties – the consultation notes the fact that, under the draft AIFM Directive, the burden of proof is inverted in favour of the investor (so that the depositary can only discharge its liability if it can prove that it could not have avoided the loss which has occurred);
- suggests that there should be clarification as to the basis upon which a depositary is permitted to delegate its duties to a third party;
- suggests that organisational requirements, akin to those found in MiFID, might be imposed on UCITS depositaries;
- suggests that the valuation of the net asset value of a UCITS and UCITS units/shares should be calculated by an independent valuer.

The consultation closes on 15 September 2009. The consultation paper is at:

http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/consultation_paper_en.pdf

Staying with the UCITS theme, on 13 February 2009, the European Commission requested technical advice on possible implementing measures concerning the future UCITS IV Directive, in relation to (i) measures related to the UCITS management passport, (ii) measures related to key investor information and (iii) measures related to fund mergers, master feeder structures and the notification procedure. CESR is required to deliver its final advice on these matters by 30 October 2009.

In working towards this deadline, on 8 July 2009 CESR published two separate consultation papers dealing with the points in (i) and (ii).

The draft CESR advice in the **consultation paper on its technical advice to the European Commission on the level 2 measures related to the UCITS management company passport** includes proposals that UCITS managers be required to have a remuneration policy, a permanent compliance function, complaints handling procedures; measures in relation to personal transactions and criteria for identifying, and procedures for dealing with, conflicts of interest. It also includes requirements relating to the direct sale of UCITS by management companies and requirements as to best execution, order handling and inducements and the written agreement to be drawn up between the manager and the depositary.

The second paper which CESR published on 8 July 2009 was the **technical advice at level 2 on the format and content of Key Information Document disclosures for UCITS**. This paper addresses the Commission's proposal to replace the discredited Simplified Prospectus regime with Key Investor Information disclosures. CESR proposes in its draft advice that the key investor information as required by UCITS be made in a document known as the Key Information Document (KID).

The consultation period for both of the above papers expires on 10 September 2009. Both consultation papers can be found at:

<http://www.cesr-eu.org/index.php?page=consultation&mac=0&id=>

While there was much going on in Europe in relation to funds over the summer, our domestic regime for open-ended investment companies received some attention too. In July, H.M. Treasury and the FSA published a joint **consultation on introducing a protected cell regime for OEICs**. Protected cell regimes are already operated in jurisdictions such as Jersey, Ireland and Luxembourg and the government considers it desirable to introduce a similar regime in this country, since large fund managers generally operate a small number of OEIC umbrella companies, with a large number of sub-funds underneath each umbrella. Between these sub-funds there is currently no segregation of liabilities and consequently there is a risk of contagion across the sub-funds.

In outline, the key features of the proposed protected cell regime are as follows:

- Where an OEIC is established as an umbrella company, the assets of each sub-fund will be "ring-fenced" from the other sub-funds and from the umbrella company itself. Therefore, the assets of one sub-fund may not be used to meet the liabilities of another sub-fund. Assets received or liabilities incurred by the umbrella company on behalf of its underlying sub-funds, but not attributable to a particular sub-fund, may be allocated between the sub-funds. While the sub-funds will not be separate companies they will be treated as if they are separate legal persons by the courts;
- Part V of the Insolvency Act 1986 will be amended so that a sub-fund may be wound up as if it were an unregistered company;
- Umbrella companies must disclose in their instrument of incorporation that their sub-funds have protected cell status;
- For umbrella companies, the protected cell status of their OEIC sub-funds will be compulsory. For existing OEICs there will be a one year transition period at the end of which they must "convert" to protected cell status – the consultation paper alludes to the fact that umbrella funds may have existing ISDA Agreements in place with counterparties, covering a number of outstanding positions, and it may prove to be problematic getting these renegotiated;
- The FSA rule requirements will be amended, amongst other things, to change disclosure requirements and to allow cross sub-fund investment subject to safeguards regarding maximum holdings and charges.

Consultation closes on 27 September 2009. The consultation paper is at:

<http://www.fsa.gov.uk/pubs/cp/oeics.pdf>

Regulatory capital

In July the Basel Committee on Banking Supervision finalised its proposals for enhancing the Basel II framework (on which the EU Capital Requirements Directive is based) to address significant weaknesses exposed in the recent financial crisis. The enhancing measures are set out in three documents, **Enhancements to the Basel II framework, Revisions to the Basel II market risk framework and Guidelines for computing capital for incremental risk in the trading book**.

In outline, the key measures in the Enhancements document include:

- A strengthened treatment for certain securitisations under Pillar 1 (which sets out minimum capital requirements), with higher risk weights for resecuritisation exposures and a requirement for more rigorous credit analysis of externally-rated securitisation exposures;
- Supplemental Pillar 2 (supervisory review process) guidance to address weaknesses which became apparent in banks' risk management processes during the recent financial crisis. The supplemental guidance also incorporates the FSF Principles for Sound Compensation Practices, issued by the Financial Stability Board (formerly the Financial Stability Forum) in April 2009;
- A strengthening of the Pillar 3 (market discipline) requirements in a number of areas measures in relation to securitisation and resecuritisation measures and sponsorship of off-balance sheet vehicles.

According to the Basel Committee, banks and supervisors are expected to begin implementing the Pillar 2 guidance immediately, while the new Pillar 1 capital requirements and Pillar 3 disclosures should be implemented by no later than 31 December 2010.

The Revisions and Guidelines documents introduce revised trading book rules, with higher capital requirements to capture the credit risk associated with complex trading activities: these revised rules will take effect at the end of 2010.

All three papers are available at:

<http://www.bis.org/press/p090713.htm>

On the same day on which the Basel Committee published its enhancements to the Basel II framework, the European Commission published its proposal for **amendments to the Capital Requirements Directive**. In brief, the proposed amendments include:

- The imposition of an obligation on credit institutions and investment firms to have remuneration policies that are consistent with effective risk management – the relevant provisions will be included in the Capital Requirements Directive, but will be "closely aligned" with those set out in Commission Regulation C(2009) 3159 of 30 April 2009 on remuneration policies in the financial sector (see above under "Corporate governance and remuneration");

- some specific amendments with respect to capital requirements for bank trading books (in line with the approach developed by the Basel Committee (see above));
- the assignment of a higher capital requirement for re-securitisations than other securitisation positions (again, in line with the approach developed by the Basel Committee (see above));
- The disclosure of securitisation risks.

Consumer credit

On 23 July 2009, the Department for Business, Innovation and Skills (BIS) (the department formerly known as "BERR") published its proposals as to how the Consumer Credit Directive (2008/48/EC) will be implemented in the UK through regulations (the consultation closed on 1 September 2009). The UK must implement the Consumer Credit Directive by 11 June 2010.

BIS intends to make the final regulations before the end of this year, to give firms time to prepare for implementation by the June 2010 deadline.

The drafts are available at the following address (which BIS encourages readers to check regularly as updated drafts will be published there):

<http://www.berr.gov.uk/whatwedo/consumers/consumer-finance/ec-directives/CCD-draft-regs/page52321.html>

In July the government published a White Paper, **A Better Deal for Consumers** which, amongst other things, sets out a new approach to consumer credit, including the following action items:

- Implementation of the Consumer Credit Directive (see above), including requirements on the part of lenders to explain their products to consumers, to check the credit-worthiness of consumers before lending and to follow OFT guidance to avoid irresponsible lending practices;
- A review of the regulation of credit cards and store cards, including a ban on the sending of unsolicited credit card cheques;
- A review by the OFT of high cost credit markets (the OFT announced the launch of the review on the same day that the White Paper was published).

The White Paper also proposes a modernisation of consumer law, including:

- A simplification of the law on misrepresentation and duress;
- A reform of consumer law;
- The introduction "in due course" of a new Consumer Rights Bill which will implement the proposed EU Consumer Rights Directive.

The White Paper is at:

<http://www.berr.gov.uk/files/file52072.pdf>

Anti-money laundering

On 6 August 2009, the Joint Money Laundering Steering Group (JMLSG) published for consultation a revised draft of Part I of its **money laundering guidance**. The JMLSG describes the amendments as "mostly minor". Amendments to the text of Part II (which JMLSG is considering splitting into two parts) are still being considered, and proposed revised text will be published for comment in due course.

Consultation closes on 9 October 2009.

The webpage announcing the consultation is at:

<http://www.jmlsg.org.uk/bba/jsp/polopoly.jsp?d=754&a=16435>

A cover note which summarises the proposed amendments is at:

http://www.jmlsg.org.uk/content/1/c6/01/64/34/JMLSG_GUIDANCE_-_cover_note_Jul_09_doc.pdf

A black-lined copy of Part I of the JMLSG Guidance is at:

http://www.jmlsg.org.uk/content/1/c6/01/64/33/Part_I_August_09_pdf.pdf

On 31 July 2009, the OFT somewhat belatedly issued details of its **registration requirements for businesses it supervises under the Money Laundering Regulations 2007** ("the MLRs"). The OFT supervises all **estate agents** and **Consumer Credit Financial**

Institutions (CCFIs), being businesses which carry on consumer credit lending activities but which are neither regulated by the FSA nor are they money services businesses supervised by HMRC. Any firms falling within the OFT's supervisory scope will have to ensure that they register before 31 January 2010. We understand that the OFT is recommending to firms that they should submit their registration forms before the end of November 2009 in order to ensure that there is sufficient time to process the application before the January deadline. It may take up to 45 days from the date on which the OFT receives a completed registration form to process each application. Carrying on business as an estate agent or CCFI after that date without being registered with the OFT is an offence and could result in prosecution.

The OFT's prescribed registration form and accompanying guidance notes are available here:

http://www.of.gov.uk/advice_and_resources/resource_base/legal/money-laundering/guidance.

July also saw the publication by the Financial Action Task Force (FATF) of a document entitled: **Risk-based Approach: Guidance for Money Service Businesses**. This is a useful sector-specific piece of guidance on how to apply a risk-based approach in the context of money service business.

The guidance is at:

<http://www.fatf-gafi.org/dataoecd/45/1/43249256.pdf>

If you would like further information or advice on these matters, please contact Margaret Chamberlain, Jane Tuckley, Mark Evans, Tim Lewis or Nigel Barratt in the Financial Services and Markets Department or your usual contact at Travers Smith.

Travers Smith LLP

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Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

www.traverssmith.com



Margaret Chamberlain
margaret.chamberlain@traverssmith.com
+44 (0)20 7295 3233



Jane Tuckley
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238



Mark Evans
mark.evans@traverssmith.com
+44 (0)20 7295 3351



Tim Lewis
tim.lewis@traverssmith.com
+44 (0)20 7295 3321