TRAVERS SMITH

Financial Services and Markets

End of Summer 2010 - a postcard from the UK

It's that time of the year again. Summer is over, the schools are back, the leaves are turning colour and you are now back at your desk (if you managed to leave it at all). Here is a round-up of some of the more significant things that you might have missed during July and August (or which you might welcome a reminder about). As you will see, it was anything but a quiet summer and there is no sign of any let up. The next few months are going to be busy…..

SUMMARY

Items requiring specific action

- If you have not done so already, you should determine whether your firm is potentially within the scope of the FSA's proposed new Remuneration Code. If it is, you may need to change your remuneration arrangements. You should note that the consultation remains open and several trade associations are involved in preparing responses – you may want to contribute to that process.
- If you have not done so already, you must immediately register to use the FSA's new Online Notifications and Applications (ONA) system. The Firms Online system is being decommissioned and will not accept any applications or notifications after **4 October 2010**. You should also check that you have paper copies of all previous applications or notifications you made through the Firms Online system. You will not be able to recover any historical information after Firms Online is finally switched off at the beginning of next year.
- If your firm uses an external consultant, re-examine your arrangements in the light of the FSA's action against Simply Trading and its directors and the HMRC statement regarding Nominated Officers under the Money Laundering Regulations.
- Revisit your firm's AML/CFT arrangements to check that they take account of jurisdictions considered to be deficient by FATF and that the automated process for checking customers and transactions against the HMT sanctions list is robust and sufficiently calibrated to ensure "fuzzy matches".
- Revisit your firm's transaction reporting arrangements in the light of the Société Générale case.
- Revisit your firm's data protection systems and controls - learn from the mistakes Zurich Insurance made.

Live consultations

- FSA: CP10/14: Delivering the RDR: Professionalism, including its applicability to pure protection advice, with feedback to CP09/18 and CP09/31 – closes on 24 September 2010
- HMT: Bank Levy: a consultation – closes on 5 October 2010
- CEBS: Consultation on guidelines to Article 122a of the CRD – closes on 10 October 2010
- FSA: CP10/19: Revising the Remuneration Code – closes on 8 October 2010
- HMT: A new approach to financial regulation – closes on 18 October 2010
- HMT: A consultation on implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements – closes 29 October 2010.

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THE DETAIL

The UK regulatory landscape - "All change…!"

HM Treasury consultation on a new approach to financial regulation

In July 2010, as expected, HM Treasury published a consultation paper – **A new approach to financial regulation: judgement, focus and stability** – setting out its high level proposals regarding the Coalition Government's new regulatory landscape.

The document confirmed what we already knew from the comments of the Chancellor and press reports – i.e. the abolition of the FSA (at least in its current form), the dismantling of the Tripartite system and the transfer of prudential oversight to the Bank of England.

In outline, the consultation paper set out the following proposals:

- The Bank of England should assume responsibility for macro-prudential or systemic oversight of the financial system and micro-prudential oversight of large banks and firms. The Government will give effect to this in two ways:
    - a Financial Policy Committee (FPC) will be created within the Bank with authority to identify risks in the system and to take action in order to protect the economy. As the legislation needed to create the new regulatory structure will take some time to become law, an interim FPC will be created this autumn to carry out preparatory work and to undertake, as far as is practical, the macro-prudential role that will eventually be carried out by the permanent FPC;
    - a new Prudential Regulation Authority (PRA) will be created. This will operate under the auspices of the Bank of England but will be a separate legal entity. It will have responsibility for day-to-day firm-specific regulation. The proposal is that it will directly regulate banks and other deposit-takers (such as building societies and credit unions), broker dealers and investment banks and insurers (including friendly societies). We will have to wait for draft secondary legislation to see precisely how far its regulatory jurisdiction will extend – the suggestion in the consultation paper is that its jurisdiction will be defined by reference to the regulated activities which a particular firm carries on and that these will include taking deposits, effecting and carrying out contracts of insurance and dealing in investments in principal. (On the face of it this last limb looks too wide and would capture a wide range of firms including many who do not fall within the "target group" of broker dealers and investment banks);
- The Bank of England will be responsible for regulation and supervision of settlement systems and central counterparty clearing houses;
- A new Consumer Protection Markets Authority (CPMA) will be formed (possibly out of the remains of the FSA). The CPMA will be responsible for:
    - conduct of business regulation of all regulated firms – including all firms authorised and subject to prudential supervision by the PRA – in their "dealings with ordinary retail customers";
    - regulating dealings in "wholesale financial markets";
    - regulating market conduct and being the lead authority in representing the UK in the European Securities and Markets Authority (ESMA);
    - authorising all those firms that will not be prudentially supervised by the PRA and for prudentially supervising them;
    - making conduct of business rules and prudential rules (for those not supervised by PRA);
    - supervising and enforcing conduct of business rules;
- The markets division within the CPMA will assume responsibility for market conduct;
- The role of the FSA (as the UK Listing Authority) might be transferred to the Financial Reporting Council or "remain" within the CPMA markets division.

The Government is also considering whether to transfer the responsibility which the FSA currently has for prosecuting certain criminal offences (such as insider dealing) to a new Economic Crime Agency. This will be subject to a separate consultation, expected shortly. The Government will also consider further how the regulated activities relating to Lloyd's of London (currently regulated by the FSA) should be split between the PRA and the CPMA.

The Treasury and BIS will issue a joint consultation shortly (this autumn) to consider whether the existing consumer credit regime might be simplified and whether the CPMA should assume full responsibility for supervising consumer credit.

While the consultation sets out the "bare bones" of the new regulatory structure, it raises many more questions than it answers. We are expecting to see more detailed proposals – including the draft legislation – for further consultation "early in 2011". At the same time, the FSA will be introducing a "shadow" internal structure, which will allocate FSA staff and responsibilities in anticipation of the creation of the CPMA and the PRA.

In terms of overall timing, the Government is ambitious: it is looking to secure Royal Assent to the legislation within two years. In the consultation, HM Treasury confirms that, in the first quarter of 2011, the FSA will introduce a "shadow" internal structure, which will allocate FSA staff and responsibilities in anticipation of the creation of the CPMA and the PRA.

Consultation closes on 18 October 2010. A copy of the consultation paper is available at:
http://www.hm-treasury.gov.uk/consult_fullindex.htm

Implementation of the Financial Services Act 2010

The implementation of the Financial Services Act 2010 has been overshadowed by the Coalition Government's proposals for a restructuring of the financial services supervisory landscape (see above). However, the Act is on the statute book and the FSA has responsibilities for implementing certain aspects.

CP10/18: Implementing aspects of the Financial Services Act 2010 was published on 23 July 2010. It included feedback on CP10/11 (the FSA's April 2010 consultation paper on implementing aspects of the Act) and final rules. CP10/18 was only a consultation paper insofar as it extended the consultation on proposed amendments to the FEES rules to allow the Financial Services Compensation Scheme (FSCS) to recover management expenses in relation to acting for other compensation schemes. This extended consultation ended on 23 August 2010. If as a result of that consultation the FSA decides to make rules it will do so this month (September).

The following Handbook changes were consequently made on 6 August 2010:

- the FSA's policy regarding its new financial stability information-gathering power is set out in chapter 1 of a new sourcebook, the Financial Stability and Market Confidence sourcebook (FINMAR);
- the FSA's short selling rules were moved from the Code of Market Conduct (MAR 2) into chapter 2 of FINMAR. Given that it is expected that the European Commission will publish its formal proposal for a pan-European short selling regime this month (following its working paper in June) it is evident that the FSA's rules in their current form are only temporary;
- the FSA's policy on using the new statutory enforcement powers which it assumed on 8 June 2010 is set out in amendments to the Decision Procedure and Penalties Manual (DEPP) and the Enforcement Guide (EG). These powers are:
    - the power to impose suspensions or restrictions on authorised persons under section 206A FSMA and on approved persons under section 66 FSMA;
    - the power to impose penalties on persons that perform controlled functions without approval under section 63A FSMA;
    - the power to impose financial penalties on persons who breach the short selling prohibition rules or the short selling disclosure requirement under section 131G FSMA;
- changes were made to the FEES manual to reflect changes made by the Financial Services Act 2010 in relation to the FSCS's contribution to the costs associated with resolutions under the Banking Act 2009.

Remuneration

On 29 July 2010 the FSA published **CP10/19: Revising the Remuneration Code**, setting out its proposals for revising the content and scope of its Remuneration Code in order to implement the amendments to the Capital Requirements Directive concerning remuneration (as part of a set of amendments commonly referred to as "CRD3"). Whereas the existing Code was applied to only 27 of the largest banks, building societies and investment banks, by the FSA's reckoning the revised Code will impose pay regulation on 2,500 firms as from 1 January 2011.

The Code will apply to all BIPRU firms, meaning that most brokers, investment managers and hedge fund managers (as well as banks and building societies) will be caught. Most, but not all, private equity firms and some UCITS firms will be exempt because they will not be subject to CRD3. All non-MiFID and exempt CAD firms will be exempt. For those who will be subject to the Remuneration Code there will be difficult issues to confront and affected firms may need to change their remuneration arrangements in order to comply.

For our note summarising the contents of the FSA's Remuneration Code and its potential impact on firms please see: http://www.traverssmith.com/assets/pdf/Legal_Briefings/pay_regulation_for_financial_services_firms.pdf.

Consultation closes on **8 October 2010** and, as outlined above, the new rules will be effective as **from 1 January 2010** (with some limited transitional relief for firms not currently subject to the Code). This gives very little time for firms and their trade associations to address the significant issues raised by the consultation paper and to respond to the FSA.

A copy of the FSA consultation paper is at:
http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_19.shtml

Travers Smith will be running a round-table Breakfast Workshop on 23 and 24 September 2010 to provide an update of the current status of the Remuneration Code proposals, guidance on what firms should be thinking about now and an opportunity to share views and to discuss the issues to be raised in consultation responses. If you would like to attend please contact Stacey.Lynch@traverssmith.com. Travers Smith will also be holding a further workshop on the Remuneration Code later this year on some of the outstanding issues, including the implications of the awaited further guidance from CEBS on the proportionality test (which is expected in October 2010).

Funds

As the Alternative Investment Fund Managers Directive (AIFMD) continued its fitful progress towards adoption and the implementation of the UCITS IV Directive next summer draws ever closer (1 July 2011), the summer just past saw a flurry of activity.

AIFMD

On 27 August 2010, the Belgian Presidency published a revised draft of the **Alternative Investment Fund Managers Directive (AIFMD)** by way of a compromise proposal. The revised text includes amendments to a number of issues which have been subject to considerable debate (including on depositaries and remuneration) but the "third country issue" (i.e. the extent to which funds and fund managers from outside the EU would be able to market into the EU) was omitted.

The trialogue sessions on the AIFMD between the Belgian Presidency, the European Commission and the Parliament's Economic and Monetary Affairs Committee (ECON) have resumed and are likely to continue for the rest of this month and into early October.

UCITS IV

Implementing legislation

On 1 July 2010 the European Commission adopted four pieces of legislation in its final package of **measures implementing the UCITS Directive (2009/65/EC)**, commonly referred to as "UCITS IV". The final texts of these were published in the Official Journal on 10 July 2010. The legislation is as follows:

- **Commission Regulation (EU) No 583/2010** - covers the content and form of the key investor information document and includes provisions governing the use of plain language and "investor-friendly" presentation of risk. The provisions of the Regulation are complemented by two CESR papers which were published on 1 July 2010:
    - **CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indication in the Key Investor Information Document**; and
    - **CESR's guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document**;

  CESR also subsequently published four consultation papers on the key investor information document (see below);

- **Commission Regulation (EU) No 584/2010** - sets out the standard documents and procedures which will be used for electronic transmission in the passport notification procedure to be used by a UCITS when it wishes to gain access to the market in another Member State. Annex I of the Regulation sets out the standard form model of the notification letter which a UCITS will have to provide to its home state authority. Annex II sets out the standard form of the UCITS attestation which competent authorities will provide verifying that the applicant UCITS fulfils all the conditions imposed by the UCITS Directive. The Regulation also contains common procedures for enhancing supervisory cooperation in their oversight of fund managers' cross-border activity. Annex II of the Regulation sets out the standard form of the UCITS attestation which competent authorities will provide;

- **Commission Directive 2010/42/EU** sets out certain investor protection measures in relation to fund mergers/master-feeders and establishes a common approach to the sharing of information between master and feeder UCITS. There are also detailed rules on the liquidation, merger or division of a master UCITS;

- **Commission Directive 2010/43/EU** which, in broad terms, aligns the organisational requirements and conduct of business requirements that will apply to UCITS management companies to those set out in MiFID. UCITS managers will be required to have robust systems and procedures in order to manage the risks which the UCITS may face.

The Regulations (which will have direct force in Member States and do not require transposition) will come into force on 1 July 2011. Member States must ensure transposition of the two implementing Directives by 30 June 2011 – and must ensure that the UCITS Directive is also transposed by that date.

The Treasury will be consulting on the statutory changes required to transpose the requirements of the UCITS Directive (and its implementing Directives). The FSA will also be consulting on changes required to the Collective Investment Schemes sourcebook (COLL). Both consultations are expected before the end of this year, although at this stage it is difficult to be more precise than that - the FSA's expected date for the COLL consultation is given as "Q3/Q4 2010".

Copies of the implementing legislation, together with the CESR guidelines, are available on the Commission's website at: http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm

CESR consultation paper on KII

On 20 July 2010, CESR published four consultation papers on the key investor information document under UCITS IV. These were:

- CESR's level 3 guidelines on the selection and presentation of performance scenarios in the Key Investor Information document (KII) for structured UCITS;

- a guide to clear language and layout for the KII;

- CESR's Guidelines for the transition from the Simplified Prospectus to the KII;
- CESR's template for the KII.

Copies of the consultations (which closed on 10 September 2010) are available on the CESR consultations page:
http://www.cesr-eu.org/index.php?page=consultation&mac=0&id=

CESR guidelines

On 28 July 2010, CESR published its **Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS**. The key purpose of the Guidelines is to provide firms with a harmonised definition of "global exposure" (although this only represents one element of the overall risk management process). The paper sets out detailed methodologies to be followed by UCITS when they use the commitment approach or the Value at Risk approach.

The CESR guidelines are available at:
http://www.cesr-eu.org/index.php

FSA project findings on how unregulated collective investment schemes are sold

Towards the end of July, the FSA published its project findings following its review of the way in which **unregulated collective investment schemes** are sold by small firms.

The key findings of the review were as follows:

- firms were unaware of the statutory restrictions on the promotion of unregulated collective investment schemes to the public. The FSA found that, out of 119 cases which it reviewed where unregulated collective investment schemes were promoted, in only 29 cases had the firm made use of the available exemptions under the Financial Services and Markets Act (Promotion of Collective Investment Schemes (Exemptions)) Order 2001 or COBS 4.12. This meant that in an alarming 76% of the cases firms had failed to use exemptions. Perhaps even more alarmingly, in 64% of cases, firms did not have an adequate understanding of what a financial promotion is. Although the FSA's sample was small (14 firms) the regulator is of the view that the findings are representative of a widespread non-compliance with promotion requirements within the small firms sector;
- firms may have sold unregulated collective investment schemes to customers for whom they may not be suitable.

The FSA has taken regulatory action against a number of the firms involved in the review including requiring a significant number of them to appointed a skilled person under section 166 FSMA to review their financial promotions and the quality of advice. A number of firms may be referred to the Enforcement and Financial Crime division.

The FSA's findings are available at:
http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/investment/ucis.shtml

The Bank Levy

On 13 July 2010, HM Treasury issued a **consultation on the implementation of the Bank Levy** as announced in the June 2010 Budget. The Bank Levy is intended, says the Government, to encourage banks to move away from riskier funding models and to reduce systemic risk.

In very brief outline, the key aspects of the Bank Levy, as consulted upon, are as follows:

- the Levy will apply to:
    - the global consolidated balance sheet of UK banking groups and building societies;
    - the aggregated subsidiary and branch balance sheets of foreign banks and banking groups operating in the UK; and
    - the balance sheets of UK banks in non-banking groups,
- where the relevant aggregate liabilities of the group or institution amount to £20 billion or more;
- the terms "bank" and "banking group" will be defined in accordance with the Bank Payroll Tax provisions at paragraphs 43 and (with some modifications) 45 respectively of Schedule 3 Finance Act 2010;
- the Levy will be based on total liabilities and equity as reported in relevant accounts but excluding Tier 1 capital, insured retail deposits, repos secured on sovereign debt and policyholder liabilities of retail insurance businesses within banking groups;

- the Levy will be set at 0.04% of total liabilities and equity for 2011 and then rise to 0.07% for 2012 and subsequent years. The Levy for longer-maturity funding will be set at half of the main rate;

- responsibility for processing and administration of the Levy will be with HMRC – in the context of banking groups, a single UK company group member will be responsible for returns and for the payment of the Levy on behalf of the group as a whole;

- the consultation paper also addresses anti-avoidance measures and mentions the risks of double taxation on foreign subsidiaries and branches of UK banks and the UK subsidiaries and branches of foreign banks. However, on double taxation there are no concrete proposals in the consultation paper other than that the Government "is considering the impacts and need for mechanisms to alleviate double taxation and will urgently take forward discussions with other countries that plan to introduce balance sheet levies".

The Government's plan, somewhat optimistically, is for the Levy to be introduced from 1 January 2011, with specific arrangements in respect of those banking groups which have periods of account which straddle that date.

The consultation ends on 5 October 2010. The Government proposes that draft legislation will be published in the autumn to allow for further comments and final draft legislation for inclusion in the 2011 Finance Bill will be published towards the end of this year. See our August 2010 International Tax Update for a discussion on the Bank Levy including the risk of double taxation:
http://www.traverssmith.com/assets/pdf/Legal_Briefings/international_tax_update_august_2010.pdf

A copy of the Bank Levy consultation paper is here:
http://www.hm-treasury.gov.uk/consult_bank_levy.htm

The MiFID review

As part of its contribution to the European Commission's review of MiFID, CESR published **a consultation paper on its technical advice on client categorisation** on 12 July 2010 (the consultation closed on 9 August 2010).

The consultation sought views on the following points:

- whether the scope of the definition of "per se professional" should be narrowed by introducing possible distinctions between certain types of entity falling within Annex II.I(1) of MiFID ("entities which are required to be authorised or regulated to operate in financial markets") – specifically paragraph (c) ("other authorised or regulated financial institutions"), (h) ("locals") and (i) ("other institutional investors"). In this regard, CESR notes that a motivation for revising Annex II.I(1) would be to strengthen investor protection by narrowing the range of regulated entities that can be categorised as per se professional;

- whether the reference to "public debt bodies" in Annex II.I(3) of MiFID requires clarification. CESR's concern is that in some Member States local authorities which manage public debt have been classified as per se professional clients on a broad interpretation of the term "regional governments". CESR's view is that it should be made clear that local authorities should not fall within the scope of public bodies that manage public debt and are therefore not per se professional clients;

- whether a "knowledge and experience" test ought to be introduced into per se professional client categorisation – CESR considers this to be particularly important in relation to unregulated undertakings who currently qualify to be considered as per se professionals simply by virtue of their size;

- whether the ability on the part of firms to use the eligible counterparty status of clients should be narrowed in certain circumstances – for instance in relation to transactions in highly complex products such as asset backed securities and non-standard OTC derivatives. Again, the thrust of this proposal appears to be based upon the view that some clients who are presumed to be sophisticated and capable of looking after their own interests do not necessarily understand the risks involved in complex instruments.

The CESR consultation paper is here:
http://www.cesr-eu.org/index.php?page=consultation&mac=0&id=

On 29 July 2010, CESR published a useful document which consolidates its **MiFID review technical advice** on a number of topics and its response to the European Commission's request for additional information. The document therefore includes the following sections:

- CESR's technical advice on equity markets;

- CESR's technical advice on non-equity markets transparency;

- CESR's technical advice on transaction reporting;

- CESR's technical advice on investor protection and intermediaries;

- CESR's responses to questions 15-18 and 20-25 of the European Commission request for additional information in relation to the review of MiFID.

A copy of the consolidated document is available on this page:
http://www.cesr-eu.org/index.php

Retail Distribution Review

The implementation of the Retail Distribution Review (RDR) regime draws ever closer. At the end of June 2010, the FSA published CP10/14: Delivering the RDR: Professionalism, including its applicability to pure protection advice, with feedback to CP09/18 and CP09/31. This consolidates and draws together the FSA's previous work on professional standards under the RDR. It also sets out the FSA's proposals regarding the supervision and enforcement of those standards.

CP10/14 includes the following:

- feedback on CP09/18: Distribution of Retail Investments: Delivering the RDR (June 2009) and CP09/31: Delivering the Retail Distribution Review (December 2009) as regards the supervision and enforcement of professional standards – the FSA confirms its decision to carry out supervision and enforcement of the new professional standards itself, with an enhanced role for accredited professional bodies and that it will not proceed with its previous proposal to establish a new Professional Standards Board;

- the FSA had previously consulted on a draft high-level code of ethics (in CP09/18). In CP10/12: Competence and Ethics (June 2010) (consultation on which closed on 6 September 2010) the FSA had also previously concluded that it should apply its proposals to all approved persons, not just those within the scope of the RDR. The FSA will not be publishing a further version of the CP09/18 code but will rely on the requirement for codes promulgated by accredited bodies to be consistent with APER (as amended);

- the FSA confirms the final list of appropriate qualifications that will appear in the Training and Competence sourcebook (TC) and explains how the requirements apply to existing advisers, new entrants and those who may wish to move to an advisory role in the future. Retail investment advisers will need to pass an appropriate examination by 1 January 2013. It should be noted that those persons who, before September 2010, already hold a qualification on the list of appropriate qualifications or who are in the course of studying for one may need to undergo a qualification "gap-filling" (previously referred to as "CPD top-up") since the qualification may not meet the updated RDR standards;

- retail investment advisers will be required to provide their firm with a Statement of Professional Standing (SPS) issued by an accredited professional body (although this will not relieve the firm of its obligations under TC). In order to receive accreditation from the FSA, the professional bodies will be required to agree to certain conditions regarding the basis on which they will check that advisers are achieving the required professional standards on an ongoing basis. In practice, the FSA will expect accredited bodies will require advisers to confirm that they have carried out relevant CPD activity and that they have adhered to the ethical requirements in APER.

Annex 2 of the consultation paper includes a table summarising the previous RDR policy papers. It also includes a table setting out the RDR implementation timetable. Three further consultations from the FSA are expected in Q3 2010 (on labelling of adviser services, on changes to transactional sales reporting and on platforms).

Consultation closes on 24 September 2010. The FSA intends to publish its final rules in December 2010.

The consultation paper may be found here:
http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_14.shtml

Investor Compensation

On 12 July 2010, the European Commission adopted a package of legislative proposals to reform the existing EU investor compensation regimes for banking and investment services and to introduce a new regime for the insurance sector. The legislative proposals consisted of the following:

A proposal to revise the Deposit Guarantee Schemes Directive (94/19/EC) (DGSD)

The proposed changes to the DGSD as set out in the legislative proposal include the following key elements:

- scope – the DGSD will apply to all credit institutions and all deposit guarantee schemes. All banks must join a deposit guarantee scheme (whether or not they are members of a mutual guarantee scheme);

- scope – only entirely repayable instruments will be covered by a deposit guarantee scheme. A deposit guarantee scheme will not cover instruments such as structured products, certificates or bonds;

- the coverage level will be confirmed at EUR 100,000 (this being the level which must be implemented by the end of this year under the "emergency" amending Directive 2009/14/EC). Member States will be given discretion to allow deposit guarantee schemes to cover deposits arising from real estate transactions and deposits relating to particular life events above the EUR 100,000 limit provided that the coverage is limited to 12 months;

- a deposit guarantee scheme must repay depositors within one week of a determination by the relevant competent authority determining that a bank will not be able to repay the deposit;

- in order to ensure that deposit guarantee schemes are sufficiently funded, the amending Directive will introduce provisions in relation to target levels, extraordinary contributions, borrowing from other schemes and alternative funding arrangements;

- before making a deposit, all depositors will be required to countersign an information sheet based on a new template set out in an Annex to the DGSD;

- the new European Banking Authority will have the power to collect information on the amount of deposits, settle disagreements between deposit guarantee schemes and confirm whether or not a particular deposit guarantee scheme may borrow from other schemes.

The general implementation deadline for the DGSD changes is 31 December 2012. The requirement for deposit guarantee schemes to pay out within a week will require implementation by 31 December 2013. The target deadline for deposit guarantee schemes to have reached the target funding level and for the mutual borrowing facility to be fully functioning is 31 December 2020.

A copy of the proposed amending Directive, together with some Frequently Asked Questions and other resources, can be found on the Commission's DGSD page at:
http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

A proposal for a Directive amending Directive 97/9/EC on investor-compensation schemes (ICSD)

The proposal includes the following elements:

- alignment with MiFID – ICSD would be amended to clarify that all investment services and activities covered under MiFID will be included and that if firms hold client assets (whether or not they are properly authorised to do so) then clients should be entitled to compensation under the ICSD. In addition, the classification of clients in the ICSD would be aligned with the MiFID definition of professional clients so that ICSD protection would not be available to per se professional clients;

- failure of a third party custodian – ICSD would be amended to allow investors to claim compensation in the event of a failure of a third party custodian;

- failure of a UCITS depositary – UCITS investors would be given the right to compensation in the event that assets cannot be returned to the UCITS because of the failure of the UCITS depositary or sub-custodian;

- exclusion of claims involving market abuse – the amended ICSD would explicitly exclude any claim for compensation where the investor has engaged in actions prohibited by the Market Abuse Directive;

- level of compensation – the compensation limit would be reset at EUR 50,000. It should be noted that the Commission's proposal is that this EUR 50,000 limit should be fixed across Europe in order to prevent different standards and to avoid arbitrage. A grandfathering clause of three years will be introduced in order to allow those Member States with higher limits to adapt to the EUR 50,000 level. In the case of credit institutions which may provide both deposit-taking and investment services, the ICSD will be amended to provide that, in cases of doubt as to whether the ICSD or the Deposit Guarantee Schemes Directive applies, the latter should apply (with its higher compensation limit of EUR 100,000);

- compensation limit – the Commission proposes to remove the option allowing Member States to limit the coverage of compensation to a specified percentage equal to or exceeding 90%.

A copy of the proposed amending Directive is available on the Commission's ICSD page at:
http://ec.europa.eu/internal_market/securities/isd/investor_en.htm

European Commission white paper on insurance guarantee schemes

In contrast to the investment and banking sectors, there is currently no European legislation governing insurance guarantee/compensation schemes and, indeed, of the 30 EU-EEA states, only 12 of them operate such protection. One of these is the UK.

As part of the overall compensation "package", therefore, the European Commission has published a White Paper on Insurance Guarantee Schemes (IGS) with a view to establishing a common European framework and minimum harmonisation of standards.

The key proposals set out in the White Paper are as follows:

- IGSs should cover both life and non-life insurance policies – however, the FAQs (but oddly not the White Paper itself) suggest that motor insurance policies should be excluded on the basis that they are sufficiently protected under EU and national legislation already);

- IGSs should cover natural persons and selected legal persons such as micro and small undertakings;

- the Commission proposes harmonising the geographical scope of IGSs on the basis of the *home country* principle, covering not only policies issued by domestic insurers but also those sold by branches of insurers based in other Member States – this principle is in line with the scope of the ICSD and the DGSD;

- IGSs should be funded on the basis of advance contributions by insurers, "possibly complemented by *ex-post* funding arrangements in the case of lack of funds";

- while the Commission is strongly in favour of continuity arrangements in the event of an insurer's collapse (e.g. by way of portfolio transfer) it argues that IGSs must, as a last resort and within a pre-determined amount of time, provide compensation to policyholders.

The White Paper has been issued for consultation. It is, in common with many White Papers, pitched at a high level with little detail. **Consultation closes on 30 November 2010**. According to the FAQs it is envisaged that a legislative proposal will be tabled in the course of next year.

The White Paper and other materials (including the Commission's FAQs) are available on the Commission's IGS page at:
http://ec.europa.eu/internal_market/insurance/guarantee_en.htm

PDMRs and broker sales

On 12 July 2010 the FSA published **Issue No.35 of its Market Watch Newsletter** which set out the regulator's views on broker disclosure of a sale of securities by a person discharging managerial responsibility and a number of transaction reporting issues.

As regards the first issue, the FSA took the opportunity to set out its views on market practice when a broker is mandated by a director of a quoted company to sell shares in that company. The guidance refers to "Persons Discharging Managerial Responsibility" ("PDMR") at the company, a term defined for the purposes of the Disclosure and Transparency Rules ("DTRs") to include directors and some other senior staff.

There has not before been guidance on whether it is acceptable for the broker to disclose to potential buyers of the shares the fact that the seller is a PDMR. Pursuant to Chapter 3 of the DTRs, the fact of the sale must be disclosed by the PDMR to the company and by the company to the market no later than the end of the business day after the sale. It is not uncommon for this announcement to trigger a fall in the price of the shares in some circumstances (depending, for example, on liquidity in the stock, the size of the block, the reasons for the sale and other news in the market) because director dealings can be regarded as leading indicators of performance of the company. For this reason, the buyer might well wish to know that the seller is a PDMR.

Practice in the City has been variable. Some brokers have considered it acceptable to disclose either the identity of the PDMR or the fact that the seller is a PDMR. Others have alluded to the fact that the transaction is "notifiable" (without specifying under which regime), or disclosed simply that they are the company's house broker (where that is the case), leaving potential investors to draw their own conclusions. Some brokers have refused to disclose (to the chagrin of some of their buy-side clients).

In Market Watch 35, the FSA gives a clear indication that, where the fact of the sale by the PDMR constitutes inside information, the broker must not disclose. To do so would constitute market abuse (improper disclosure contrary to s. 118(3) FSMA). The potential buyer would also be taken offside. Where the fact of the sale by the PDMR constitutes inside information, disclosure would only be lawful where there was an express obligation of confidentiality imposed on the potential buyer, and the disclosure was both "necessary" and "reasonable" (and therefore falling within the "proper disclosure" exemption described in MAR 1.4.5E). The FSA indicates that it has not been able to identify any situations where disclosure would be either necessary or reasonable.

The FSA observes that market convention is not sufficient to justify disclosure as either "necessary" or "reasonable".

Whether the fact of the PDMR sale constitutes inside information must be assessed on ordinary principles, including that a reasonable investor would take the information into account in forming his investment decision. The FSA urges caution around disclosure to buyers in circumstances in which the broker concludes that the information is not inside information. It "reserves the right" to take action against any broker which it considers to have disclosed improperly.

Market Watch 35 may be found here:
http://www.fsa.gov.uk/Pages/Library/Communication/NewsLetters/index.shtml

Regulatory capital

On 1 July 2010, the Committee of European Banking Supervisors (CEBS) published **CP40: consultation on guidelines to Article 122a of the CRD**. The Capital Requirements Directive or CRD is the term by which the Banking Consolidation Directive (2006/48/EC) and the Capital Adequacy Directive (2006/49/EC) are collectively referred. As amended by Directive 2009/111/EC it is commonly referred to as "CRD 2".

The amendments effected by Article 122a of the revised CRD relate to securitisations and exposures to transferred credit risk. The amendments have to be transposed by Member States by 31 October 2010 and to be applied in those Member States from 31

December 2010. They impose new requirements to be fulfilled by credit institutions when acting in a particular capacity (such as originator, sponsor and/or original lender) as well as when they are investing in securitisations. One of the significant requirements is that a credit institution may only be exposed to the credit risk of a securitisation position if the originator, sponsor or original lender has explicitly disclosed that it will retain a material net economic interest of not less than 5% (so called "skin in the game"). The amendments also include due diligence and risk management obligations. CEBS is called upon to elaborate guidelines for the convergence of supervisory practices with regards to Article 122a, including the measures taken in case of breach of the due diligence and risk management requirements.

Consultation on the draft guidelines closes on **1 October 2010**. Following that, CEBS says that it expects its members to adopt the guidelines into their national supervisory framework and apply them from 31 December 2010 – i.e. the date on which the requirements of CRD 2 itself come into force.

The CEBS consultation paper is at:
http://www.c-ebs.org/Publications/Consultation-Papers/All-consultations/CP31-CP40/CP40.aspx

Towards the end of July, CEBS published its **Implementation guidelines on Article 106(2)(c) and (d) of Directive 2006/48/EC recast** relating to exemptions under the large exposures rules of the CRD in respect of certain short-term exposures arising from the provision of money transmission, correspondent banking, clearing and settlement and custody activities. The amendments to the CRD by Directive 2009/111/EC (CRD 2) must be transposed into Member States' national law by 31 October 2010 and be applied from 31 December 2010. Correspondingly, CEBS expects Member States also to transpose the implementation guidelines into their national legal framework by 31 October 2010 and apply them by 31 December 2010 at the latest.

The Implementation guidelines are available at:
http://www.c-ebs.org/Publications/Standards-Guidelines.aspx

Retail client assets and title transfer collateral arrangements

One of the FSA's proposals in CP10/15: Quarterly Consultation No.25 (consultation closed on 6 September 2010) was that title transfer collateral arrangements (TTCA) should no longer be permissible in relation to retail clients. TTCAs are arrangements by which a client agrees that monies or assets placed with a firm are to be treated as collateral in respect of the client's existing or future obligations and that full ownership of such money or assets is unconditionally transferred to the firm. The current position (as derived from MiFID) is that where a client makes an absolute transfer of its funds or assets to a firm for the purpose of securing its obligations, those funds or assets should not be regarded as belonging to the client and therefore will not be subject to the client money and client assets protections.

The FSA has always taken the view that the use of title transfer collateral arrangements is not an approach that it thinks is likely to be appropriate in the context of retail clients. Its specific concern appears to be the use of such arrangements by spread betting firms and CFD providers. Despite this, the FSA proposes to apply the TTCA restriction comprehensively to all firms subject to CASS 6 (custody rules) and CASS 7 (client money rules).

The FSA says that it proposes to make the amendments effective within a short transitional period during which "we would expect firms to take all practicable steps to provide the protections of segregation for retail clients", after which the absolute requirement would come into force.

Spread betting firms and CFD providers are also the centre of the FSA's attention as regards the "money due and payable to the firm" provisions within CASS. According to the FSA, some spread betting and CFD providers use the CASS "money due and payable to the firm" provisions inappropriately to reduce the amount of money they segregate as client money for margin transactions, e.g. by deducting initial margin.

The FSA proposes to introduce new guidance reminding firms of their obligation to segregate client money in accordance with the standard method of internal client money reconciliation set out in CASS 7 Annex 1G (or in accordance with a different method that affords an equivalent degree of protection to the firm's clients in accordance with CASS 7.6.7R and CASS 7.6.8R).

The consultation paper is at:
http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_15.shtml

Online notifications

Over the summer, the FSA announced that the Firms Online system is to be decommissioned following the recent launch of Online Notifications and Applications (ONA).

The ONA system allows firms to submit online applications and notifications in connection with the following:

- approved persons;
- appointed representatives;
- variations of permission;
- passports;
- cancellations;

- waivers; and
- standing data.

However, the following application types do not use ONA (and neither is there any intention for these to be brought within the scope of ONA for the time being):

- applications for authorisation;
- transfer of business;
- change of controllers
- collective investment schemes.

The FSA will continue to accept applications through Firms Online until **4 October 2010**, after which date use of ONA will be mandatory. From 4 October the FSA will no longer accept applications submitted via Firms Online. It will also not accept paper applications and notifications after that date.

Firms Online will be switched off entirely at the beginning of next year. The FSA warns that if you have used Firms Online to submit applications in the past, you should check that you have printed off and retained paper copies for your records. Once the old system is switched off there will be no way to recover your historical applications/notifications.

Each firm will need to register for the new ONA system. The FSA urges firms to register to use ONA immediately, if they have not already done so.

The FSA's ONA page is here:
http://www.fsa.gov.uk/pages/Doing/Regulated/ona/index.shtml

Anti-money laundering

HM Treasury statement on money laundering controls in overseas jurisdictions

On 12 July 2010, HM Treasury published a revised **statement on money laundering controls in overseas jurisdictions**. This supersedes its previous statement which was issued on 15 March 2010. The latest statement follows the public statement made by the Financial Action Task Force (FATF) on 25 June 2010 pointing to serious deficiencies in Iran, The Democratic People's Republic of Korea and Sao Tome and Principe and a separate statement citing a number of countries which have strategic AML/CFT deficiencies for which they have developed an action plan with FATF.

In terms of changes since HMT's March statement, Angola, Ecuador, Ethiopia, Pakistan and Turkmenistan are no longer on the list of jurisdictions with "serious deficiencies" (Part A of the HMT statement) – although they all appear on the list of those which have strategic AML/CFT deficiencies (Part B of the HMT statement). The countries which appear in Part B of the HMT statement are:

Angola, Antigua and Barbuda, Azerbaijan, Bolivia, Ecuador, Ethiopia, Greece, Indonesia, Kenya, Morocco, Myanmar, Nepal, Nigeria, Pakistan, Paraguay, Qatar, Sri Lanka, Sudan, Syria, Thailand, Trinidad and Tobago, Turkey, Turkmenistan, Ukraine and Yemen.

All firms which do business – or may do business – with counterparties in any of the jurisdictions listed in the HMT statement should ensure that they apply enhanced CDD measures and enhanced ongoing monitoring on a risk-sensitive basis.

The HMT statement is available on HMT's "Counter Illicit Finance" page at:
http://www.hm-treasury.gov.uk/fin_money_index.htm

HMRC AML guidance for money service businesses

On 16 July 2010, HMRC published a revised version of its **AML guidance for money service businesses (MLR 8 MSB)**.

A copy of the revised guidance (along with other HMRC AML guidance) is available at:
http://www.hmrc.gov.uk/mlr/detailed-guidance.htm

HMRC's home page for money service businesses and the Money Laundering Regulations is at:
http://www.hmrc.gov.uk/mlr/getstarted/register/msb.htm

In August, HMRC issued a statement headed: "**External consultants cannot act as a Nominated Officer under Money Laundering Regulations**". The statement followed the FSA's findings against Simply Trading and three of its directors (see below) and specifically that the FSA had found that the directors had relied too heavily on external consultants for advice on how to run their business. HMRC stresses that, while it has no objection to firms taking advice from external consultants, the responsibility for complying with the MLRs remains with the firm and, in particular, an external consultant cannot be appointed as Nominated Officer.

The HMRC statement is here:
http://www.hmrc.gov.uk/mlr/news/external-consultants.htm

Settlement Finality and Financial Collateral Arrangements

On 13 August 2010, the Treasury published **A consultation on the implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements**. This set out the Government's proposals for the UK implementation of Directive 2009/44/EC (the amending Directive) which amends Directive 98/26/EC on settlement finality in payment and securities settlement systems (the Settlement Finality Directive (SFD)) and Directive 2002/47/EC on financial collateral arrangements (the Financial Collateral Directive (FCD)).

The Treasury's general approach is not to make any changes beyond what is required by the amending Directive (for instance, as regards interoperability between systems, clarifying what overnight settlement means and bringing Electronic Money Institutions within scope (in the SFD) and the disapplication of foreign insolvency law to the extent it would otherwise interfere with a valid financial collateral arrangement (in the FCD)). However, the Treasury does propose to go further than the amending Directive requires in two specific areas:

- first, it is looking into whether the FCD protections for floating charges need extending. The specific concern is that the system charge created by CREST members in favour of CREST settlement banks may not be within FCD protection (on the grounds that it does not satisfy the "possession and control" test required of a "security interest" as defined in the Financial Collateral Arrangements (No 2) Regulations 2003). The Treasury suggests that, given the extent of the exposures assumed by CREST settlement banks in reliance upon floating charges, there may be a case for bringing the system charge within FCD protection. One method of doing this, the Treasury suggests, would be to give protection to floating charges which qualify as "collateral security charges" under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999;

- second, the Treasury considers whether the SFD protection under the 1999 Regulations might be extended to UK participants in non-EEA settlement and payment systems, subject to designation by a UK competent authority or the satisfaction of certain criteria.

A draft statutory instrument is attached to the consultation paper.

Consultation closes on 29 October 2010. A copy of the consultation paper is available at:
http://www.hm-treasury.gov.uk/consult_fullindex.htm

Enforcement round-up

Here is a very brief overview of some of the more notable enforcement actions over the summer.

Upton & Co. Accountants Limited - unauthorised collective investment scheme

In July 2010, in what Margaret Cole referred to as a "fantastic result", the FSA secured £3.717 million in compensation for investors in an unauthorised collective investment scheme operated by **Upton & Co. Accountants Limited**. The unauthorised firm operated a scheme known as the "Currency Plan" which promised investors high rates of return. The FSA press release is at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/122.shtml

Royal Bank of Scotland Group - breach of MLRs

The summer saw the first fine imposed by the FSA under the Money Laundering Regulations 2007 (MLRs). On 3 August 2010, **The Royal Bank of Scotland Group** (The Royal Bank of Scotland Plc, National Westminster Bank plc, Ulster Bank Limited and Coutts & Company) was fined a total of £5.6 million for **breaches of regulation 20(1) of the MLRs** for failing to establish and maintain appropriate and risk-sensitive policies and procedures in order to prevent funds or financial services being made available to designated persons on the list of financial sanctions targets maintained by HM Treasury. The Group had failed properly to implement and oversee the systems used to screen customers and payments against the Treasury list and as a result there was a failure to screen:

- any incoming payments to customers;
- sterling payments made by customers (except those going to US based institutions); and
- any Euro payments made by customers (until 9 June 2008).

To compound the Group's failings, while an internal division had spotted the problem and had put forward a remedial plan, action was not taken quickly enough.

In addition:

- the Group's automated screening failed to screen the majority of trade finance SWIFT messages in the international trade transactions it carried out;

- the Group did not consistently record sufficient information relating to the directors and beneficial owners of its corporate customers; and

- the Group failed to ensure that the design and implementation of the "fuzzy matching" capabilities of the screening software – used to identify close (but not identical) matches with the Treasury list - continued to operate satisfactorily, with the result that they became less effective as time went by.

The case sends out a stark warning to all firms about the importance of checking against the Treasury list and not placing unthinking reliance upon an automated process. Clearly automated processes are required for firms undertaking a high volume of business, but it is imperative for a firm to undertake regular reviews of the appropriateness of the screening system to ensure that it remains up-to-date and effective. In the RBS Group case, the "fuzzy matching" logic for the payment and customer screening software was calibrated only once when it was initially installed.

The FSA press release (with a link to the Decision Notice) is available at:
http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/130.shtml

Zurich Insurance plc - loss of confidential customer information

In a Final Notice dated 19 August 2010, the UK branch of **Zurich Insurance plc** (a company incorporated in Ireland) was fined £2.275 million for failing to have adequate systems and controls in place to prevent the **loss of confidential customer information**. The UK branch had outsourced the processing of some of its general insurance customer data to a South African affiliate. That affiliate lost an unencrypted back-up tape during a routine transfer to a data storage centre. Sensitive personal details (including details concerning identity, bank accounts, credit cards and insured assets) for 46,000 customers were lost. The UK branch did not discover the loss until a year later, in August 2009 – and even then customers were not informed until October 2009. The FSA was clearly concerned about the UK branch's failure to oversee and manage the outsourcing arrangement (and its overreliance upon a group entity to comply with group procedures), the lack of reporting lines between South African and London, the failure to escalate and report data security incidents and the *potential* for loss or theft of customer data (there was no evidence of actual loss or theft).

The case will make instructive reading to many firms which rely on outsourcing arrangements, whether intra-group or otherwise, regarding customer data. As Margaret Cole commented: "Firms across the financial sector would do well to look at the details of this case and learn from the mistakes that Zurich UK made."

A copy of the press release (which links to the Final Notice) is available at:
http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/134.shtml

Société Générale - transaction reporting failures

Later in August, the London branch of **Société Générale (SocGen)** found itself joining a growing band of large institutions fined by the FSA for **transaction reporting failures** – Barclays, Credit Suisse, Getco Europe Limited, Instinet Europe Limited and Commerzbank AG. SocGen was fined £1.575 million for failing to provide accurate transaction reports across all asset classes. Between November 2007 (from the implementation of MiFID) and February 2010 SocGen failed to submit accurate transaction reports in respect of approximately 18.8 million transactions (80% of transactions). Four different structures existed within the SocGen reporting process and the FSA found that there was no system of complete oversight of the reporting process. The failures came about because of system errors and, in relation to some transactions, due to the use of obsolete codes (despite having been warned by the FSA that relevant codes were being changed).

The FSA press release (with a link to the Final Notice) is available at:
http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/135.shtml

Simply Trading Group - undue reliance on external compliance consultant

Finally, one of the findings of the FSA against **Simply Trading Group Limited** and three of its directors (Messrs Cole, Ryan and Yamoah) in July was that they had placed undue reliance on an external compliance consultant to manage the firm's business. It was this case which prompted HMRC to issue its statement that external consultants cannot act as a Nominated Officer under the Money Laundering Regulations 2007.

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