



Regulatory Roundup

2 March 2011

Issue 27

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More on FSA Reform: HMT consultation provides further detail on proposals for regulatory reform

Middle East Events: FSA publishes statement alerting firms to the possible impact of events on their AML and PEP procedures

Code of Market Conduct Change: Changes to MAR 1 following ECJ decision

Hedge Funds and Systemic Risk: FSA report reveals latest HFS and HFACS survey results including average returns, portfolio liquidity and counterparty exposures

FSA003: Guidance on lines 142 and 143 in relation to capital planning buffers

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If any of the topics discussed above raise questions or a need for guidance or support, please feel free to contact [Peter Carlisle](#).

More on FSA Reform



Useful links:

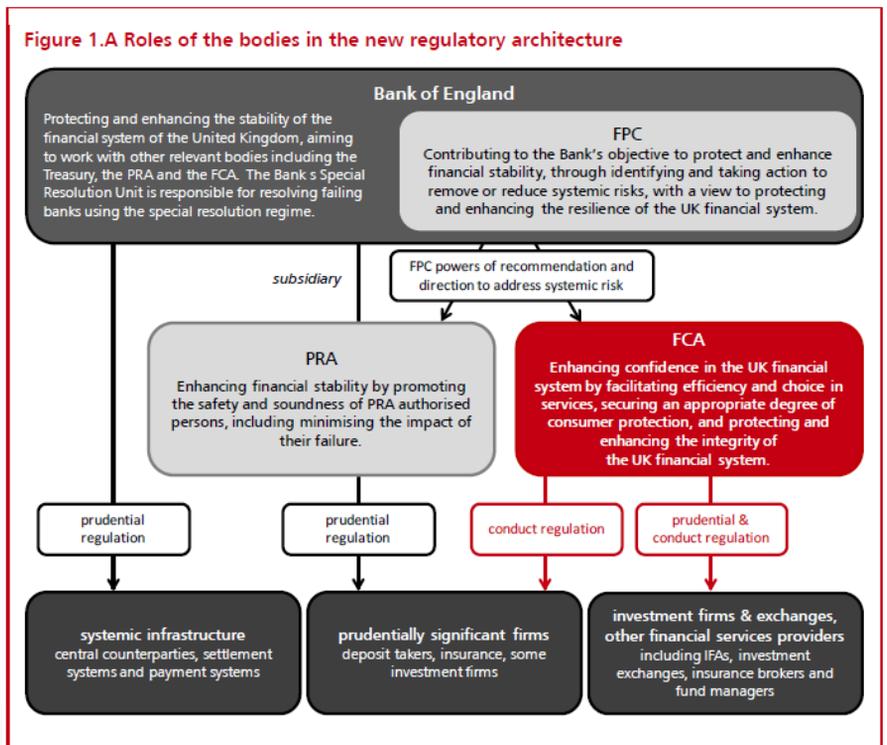
[HM Treasury Consultation](#)

[Reg Roundup 26](#)

The last **Regulatory Roundup (Issue 26)** contained articles covering the proposed revision of the regulatory system which would see the end of the FSA and the birth of the **Consumer Protection and Markets Authority (CPMA)** and the **Prudential Regulatory Authority (PRA)** - with the **Financial Policy Committee (FPC)** having responsibility for 'macro-prudential regulation'.

HM Treasury (HMT) has since released a consultation document: 'A new approach to financial regulation: building a stronger system' which adds more flesh to the proposals.

The **CPMA has disappeared** (it is explained that this was just a working title) and instead we are introduced to the **Financial Conduct Authority (FCA)**. The HMT consultation document provides an illustration of the new regulatory architecture on page 5 which is included below for ease of reference:



Source: HM Treasury

(cont.) 2

More on FSA Reform (cont.)



Although the PRA will be a new (limited company) subsidiary of the Bank of England, the FCA will be **established by adopting the legal corporate entity of the FSA**. The FCA's core purpose will be protecting and enhancing the confidence of all consumers of financial services, ranging from retail customers "to a hedge fund engaging in multi-million pound derivatives trades".

The paper sets out the strategic and operational objectives of both the PRA (section 3.6) and the FCA (section 4.14). The paper also addresses practical matters including **authorisations, variation of permissions (VoP)**, the **approved persons** process and **changes of control**.

In respect of **authorisations** it is proposed that for firms that will be regulated solely by the FCA (the vast majority of firms) the FCA will operate the process in much the same way as the FSA currently does. However things get a little more complicated for those firms that will be under the wing of the PRA for prudential regulation. It will be recalled from the last Regulatory Roundup that whilst such a firm may be subject to the oversight of the PRA, the FCA (or, as it was then, the CPMA) will be responsible for regulating its conduct of business activities. Therefore **dual-regulated firms** will need the consent of **both the PRA and the FCA** in order for permission to be given. The paper puts forward two ways of how this could work in practice.

In the same vein, both the PRA and the FCA would have similar powers re **VoPs** that the FSA currently has. For **dual-regulated firms** the PRA will have the power of veto when it comes to removing a key permission.

(cont.) 3



More on FSA Reform (cont.)



Useful links:

[Reg Roundup 15](#)

There will be no let up in the prior scrutiny given to those applying to perform **controlled functions**. As might be expected, for firms regulated only by the FCA, the FCA will have the power to designate controlled functions and to **approve individuals** to undertake those functions. For **dual-regulated firms** responsibility will be **split** between the PRA and the FCA in line with their objectives and with **both** being able to specify new controlled functions and approve (or prohibit) individuals. The PRA will lead on approvals relating to the prudential soundness of a firm (the paper gives as an example the Chief Executive Officer), consulting the FCA where it has an interest in a particular function. Similarly the FCA would lead on functions concerned with a firm's interface with customers (examples quoted are client assets and anti-money laundering), consulting the PRA where it has an interest. Both the PRA and the FCA would have the power to ban an approved person.

In the eyes of HMT, the main criteria for considering **changes in control** are primarily of a prudential nature. As a result, change of control applications will be considered by the relevant prudential supervisor. However the FCA will have the power to object to an application concerning a dual-regulated firm on money laundering or terrorist financing grounds.

On the international front, the PRA will hold the UK's voting seat on the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) whilst the FSC will sit on the European Securities and Markets Authority (ESMA) - see Regulatory Roundup 15 for an overview of the changes in European supervision. Unfortunately whilst EBA, EIOPA and ESMA each cover both prudential and conduct of business issues, each Member State only has one voting seat on each so a degree of cooperation will be needed. Therefore when ESMA discusses matters that fall within the scope of the PRA, the FCA will have to invite the PRA to the meeting as an observer and take account of the PRA's views in any vote.

The closing date for responses to the consultation is 14 April.



Middle East Events

Code of Market Conduct Change



Useful links:

[FSA Statement](#)

[Money Laundering Regulations 2007](#)

Following the recent developments in the Middle East the FSA has issued a short statement on the need for firms to be alert to the possible impact the events may have on their anti-money laundering procedures. They advise that the regulations relating to Politically Exposed Persons (PEPs) are particularly relevant.

As will be known, PEPs include persons, and their close associates/family members, who are (or were) heads of state, ministers, managers in state-owned enterprises etc. For more detail on PEPs please see Schedule 2(4) – in conjunction with s14(5) - of The Money Laundering Regulations 2007.

Useful links:

[Spector case](#)

[MAR amendment](#)

As will be known, the FSA's Code of Market Conduct is incorporated within MAR 1.

Following a decision by the European Court of Justice (ECJ) in the Spector case (see link to Spector Case C-45/08) the FSA will, effective from 6 March 2011, delete MAR 1.3.4E.

An important element of the case concerning insider dealing was the meaning of the word 'using' as in persons should be prohibited from using inside information in the trading of financial instruments.

The effect of the decision is that a person who holds inside information, and who trades in financial instruments to which that information relates, implies that the person has used that information for the purposes of insider dealing (this is without prejudice to a person's right to rebut that presumption). MAR 1.3.4E suggested that one had to consider a person's intention to prove insider dealing. Following the ECJ decision the FSA's view is that it is not necessary to provide evidence of a person's intention in order to prove insider dealing.

Hedge Funds and Systemic Risk



Useful links:

[FSA report on findings of HFS and HFACS](#)

[Reg Roundup 9](#)

The FSA has published the findings from the latest Hedge Fund Survey (HFS) and Hedge Fund as Counterparty Survey (HFACS). As will be known from earlier Regulatory Roundups e.g. issue 9, the FSA carry out these surveys every six months or so in order to analyse the systemic risk posed by hedge funds.

The HFS took in around 50 investment managers with just over 100 'qualifying funds' (QFs - for the purposes of the survey these are hedge funds with NAV of US\$500m+) whilst the HFACS covered 14 large FSA-authorized banks which have significant dealings with hedge funds. The FSA believe that the **HFS will capture around 20% of the global hedge fund industry AUM.**

The report shows that QFs produced **average returns of 2%** for the six months to end of September 2010 (vs. -0.6% return of the MSCI World equity index) with around **75%** of funds reporting **positive returns.**

Hedge funds report a high level of **portfolio liquidity** with an estimated 55% of aggregate portfolios capable of being liquidated in less than 5 days – although the FSA throw in some caveats including the possibility of market liquidity deteriorating significantly in a stressed market environment. The footprint of hedge funds (being the sum of long market value and short market value) remains generally low, although the firms surveyed are estimated to hold approximately 8% of the outstanding value of the global convertible bond market.

On the negatives hedge funds' **counterparty exposures remain concentrated** with five banks accounting for 60% of aggregate net credit counterparty exposure. By contrast the banks' exposures are relatively small with an average exposure of less than US\$50m.



Some BIPRU firms have been experiencing problems in the completion of their **FSA003** data return (capital adequacy).

The FSA003 now contains lines 142 and 143 in relation to capital planning buffers (CPB). The return cannot be validated without these data elements being completed.

A CPB is defined as the amount of capital, in addition to Pillar 2 calculated requirements, that a firm should hold in order to absorb losses or meet minimum regulatory requirements at all times, due to external circumstances.

CPB's are set by the FSA on the basis of stress tests submitted by a firm. All firms that have been set CPB's would have already had some dialogue or discussion with the FSA on this subject; this is likely to be relevant to large relationship managed firms or banks.

To overcome the problem, unless the firm has been set a CPB by the FSA lines 142 and 143 should be input as zero.



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If any of the topics discussed above raise questions or a need for guidance or support, please feel free to contact [Peter Carlisle](#)

Or for details of any other of Complyport's services, please contact [Philip Chapman](#)

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