



Regulatory Roundup – 12 March 2010 Issue # 10



Corporate Governance – Getting Serious

Following on from the release of CP10/3 (“Effective corporate governance”) – see Regulatory Roundup of 8th February – Graeme Ashley-Fenn spoke the other day at a BSA seminar on this very topic. He is the FSA’s Director of Permissions, Decisions and Reporting so his role encompasses responsibility for the approved persons regime; he informed the audience that he is ‘particularly interested in’ corporate governance.

Although corporate governance has always featured on the FSA radar, and is a feature of ARROW visits, it seems that the FSA is strengthening its interest in this area (‘our regulatory approach before the crisis underestimated the importance of governance’). The factors he quoted as contributing to the financial crisis were capital and liquidity with poor governance an important factor (oh, and a reference to ‘some failures in the regulatory system’).

In the FSA’s view effective governance means a board and executive that can interact effectively to deliver an agreed strategy, whilst managing the risks faced. Not for the first time mention was made of both the value of NEDs, effective challenge and succession planning.

As is always, proportionality is key here; what works for a 3 man firm will not necessarily work for a 30 man firm and vice versa. The message coming through is that corporate governance still remains relevant for firms and that it is seen as a risk mitigant; it wouldn’t be surprising if an FSA thematic was developed.

http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0303_gaf.shtml

FAIF

The acronym arises from the publication of PS10/3 - ‘Funds of Alternative Investment Funds’.

A FAIF will allow (albeit indirectly) the marketing to, and investment by, retail clients in hedge funds.

A FAIF will fall within the NURS (‘non-UCITS retail scheme’) regime so it will be an authorised fund – and so will provide investors with the comfort of oversight by the FSA - but with much greater investment powers e.g. there is no maximum limit on the amount of scheme property which can be invested in unregulated collectives (a NURS is limited to 20% whilst for a UCITS this would not be a permissible investment). Another feature is that Master/Feeder structures will be allowed; the Master will not have to



be based within FSA jurisdiction. Whilst there are spread requirements for FAIFs, this is waived for a feeder scheme which is dedicated to the units of a master scheme.

In reflection of the investments that a FAIF can invest in, COLL 6.2.19 is amended so that sales and redemptions of the FAIF need only be provided 'at least once in every six months'. By the same token, a FAIF will have up to 185 days to pay redemptions.

The FSA acknowledge that FAIF rules may need to be amended in the future depending on the outcome of the Alternative Investment Fund Managers Directive.

The FAIF structure could provide alternative investment managers with new possibilities; either with FAIFs as being potential new investors or even setting up their own FAIF.

The changes to COLL came into force on 6 March.

http://www.fsa.gov.uk/pubs/policy/ps10_03.pdf

Shorting

CESR has presented a report to the European Institutions that recommends the introduction of a pan-European short selling disclosure regime. There are two distinct differences between the existing disclosure requirements in MAR 1.9 and the new CESR Proposals.

Firstly, in MAR 1.9, the short selling disclosure requirements apply only to UK financial sector stocks and securities which are the subject of a rights issues. CESR's proposed short selling disclosure regime has no such restrictions (although see below) and applies to any transaction which provides economic exposure to a particular share - therefore exchange traded and OTC derivatives as well as short positions in cash markets will be covered by the disclosure requirements. Secondly CESR's proposed short selling regime allows for private (to the regulator) disclosure in respect of small positions whereas MAR requires disclosure on a RIS.

The disclosure thresholds are also different.

The current position in the UK for required disclosure currently start at 0.25%, and thereafter in increments of 0.1%, and must be made via a RIS no later than 3:30pm the following business day.

In the CESR proposals a net short position reaching the threshold of 0.2% would trigger a disclosure obligation to the relevant authority, and every 0.1% thereafter would trigger further disclosures. Should a short position reach the threshold of 0.5% (and for further steps of 0.1% thereafter), then disclosure to the market as a whole, in addition to the regulator, would be required. When the short position threshold is reached, the disclosures would need to be made by the end of the following trading day.

The CESR disclosure rules would apply to net short positions in all shares that are admitted to trading on an EEA regulated market and/or an EEA Multilateral Trading Facility (MTF) *but not* when the primary market of those shares is located outside the EEA. Market making activities would be exempt.

Click [here](#) to view the CESR report which also provides further insight into intraday positions and the basis of calculating short positions.

Short selling *limitation* rules have been of news recently in the US.



After the SEC eliminated all short sale price tests and freely allowed short selling in 2007, then temporarily banned short selling on many stocks for 14 trading days during the financial crisis, the SEC has now finalised Rule 201 and amended Regulation SHO to place additional limitations on traders that restrict short selling again in limited circumstances (Regulation SHO was enacted in 2005 to ensure broker-dealer stock availability and transaction delivery).

This newly adopted rule contains a 'circuit breaker' for when a stock drops more than 10% and a price test, the 'alternative uptick rule'. The alternative uptick rule allows short selling only at a price above the current national best bid.

Rule 201 will apply on the day of the 10% drop in price of the stock and also the day after. It will apply to all equities listed on exchanges and the OTC market, and will become effective 60 days from the date of publication of the release in the Federal Register (i.e. roughly 2 months from now) giving six months for market participants to comply.

A link to the Amendments to Regulation SHO can be found at:

<http://www.sec.gov/rules/final/2010/34-61595.pdf>

Financial penalty-setting

In keeping with the FSA's 'credible deterrence' approach, it has published PS10/4 – 'Enforcement financial penalties' - with a view to establishing a consistent and more transparent framework for the calculation of financial penalties. The associated press release states that as a result enforcement fines could treble in size.

A link to PS10/4 is below and includes the changes to the Decision Procedure and Penalties manual (DEPP).

Fines will be linked more closely to income and could be up to 20% of a firm's relevant revenue and, for non-market abuse cases, 40% of an individual's salary/benefits/bonuses. Serious market abuse cases will start with a minimum of £100K.

DEPP 6.5D defines 'serious financial hardship' (income falling below £14K and capital below £16K) below which the FSA may consider reducing a penalty. It also introduces the concept of paying fines by easy instalments (although there is no option to pay now breach later).

The new penalty regime came into force on Saturday 6 March and applies to any breaches which occur on or after that date.

http://www.fsa.gov.uk/pubs/policy/ps10_04.pdf

ICAAP Submissions

The FSA has issued a paper setting out its observations on ICAAPs that have been submitted by Limited Licence firms. Areas commented on include:



- Lack of clarity in terms of presentation of key information
- Insufficient analysis of wind-down costs
- Firms need to demonstrate that the ICAAP is integrated into the management decision-making process
- Some ICAAP submissions not formally signed off by board etc.

The paper also includes some brief case studies for the benefit of firms.

The last page contains comments on Pillar 3 disclosure; the FSA suggest that making a P3 'on request' does not meet with their approval.

The links below will take you to the paper as well as to the last published ICAAP observations that were published in 2007.

<http://www.fsa.gov.uk/pubs/other/icaap.pdf>

http://www.fsa.gov.uk/pages/About/What/International/pdf/pil2_observations_inv.pdf

Financial Risk Outlook

Somewhat later than usual the FSA has published its 2010 Financial Risk Outlook. The FSA's 2010/11 Business Plan ('BP') will follow in the next few days. It should cover the period 1/4/10 to 31/3/11, although page 73 of the FRO does refer to 2011/12.

The purpose of the FRO is for the FSA to set out what it sees as the main risks facing firms and the regulatory system and identify challenges. The BP in turn will explain the priorities arising from the FRO and the resourcing requirements. As such the documents will tell us the areas the FSA will be concentrating on.

The first two sections concern themselves with macroeconomics and the prudential challenges facing banks and building societies. The third section looks at market risks. Market abuse features with a warning that the FSA will continue to undertake both enforcement measures and work on prosecuting criminal actions. The regulator emphasises the importance of suspicious transaction reports and transaction reporting in its fight against market abuse and reminds us of the fines against Mark Lockwood and Barclays for failures in these areas. The FSA also notes that it continues to see leaks of inside information during public takeovers. Other areas touched on in this section include high frequency trading (which is estimated to account for 30-50% of equity trading volume in the EU); the impact of EU regulation on credit rating agencies (some ratings produced by external agencies will not be allowed to be used for calculating capital requirements under the CRD); and the need to improve post-trade transparency in OTC markets.

http://www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2010.pdf

Digestif

And to round off a heavy FRO 2010 the FSA recommend the Asset Management Sector Digest 2010.



There are nine key messages in the publication, four of which are deemed 'priority risks' being:

- Controls over client money and assets;
- The valuation of assets in funds;
- Platforms; and (of course)
- The Alternative Investment Fund Managers Directive

The Regulatory Roundup of 8 February covered the subject of client money & assets with a warning that the FSA are likely to conduct further visits. Since that time two or three of our client firms have been approached by the FSA who have requested, and with fairly short notice, various documentation prior to a thematic visit. If you are a Complyport client firm where it is felt that such a visit may occur then please do get in touch with your normal Complyport contact who will be pleased to discuss with you the type of information that you are likely to be asked for.

The FSA comments on the valuation of assets in funds applies equally to regulated and unregulated funds, and in respect of the latter recognises the responsibility may lie with a fund administrator. The example on page 9 of pricing discrepancies in respect of certain corporate bonds makes interesting reading. A brave asset manager of an offshore fund may feel insulated from this if the administrator has been appointed by the fund rather than the firm but then again may not.

The comments on the AIFMD will not come as a surprise. There is a summary on page 11 of the estimated costs of the original AIFMD across Europe on Hedge funds; Private equity; Venture capital; Real estate; and Investment Trusts. Below is also a link to the full impact document.

http://www.fsa.gov.uk/pubs/plan/sdg_am.pdf

http://www.fsa.gov.uk/pubs/other/Impact_of_AIFM_Directive.pdf

ONA

The Regulatory Roundup of 16 October 2009 contained an article on the new FSA reporting system – Online Notifications and Applications – which would be used for the submission of applications/notifications re: Approved Persons; Appointed Representatives; Variations of permissions; Passports; Cancellations; Waivers; and Standing Data. Mandatory use of ONA was going to be 'Autumn 2009' (CP09/20), which slipped to 'before the end of December 2009' (website). The current website advises 'this winter' – although as the web page is dated October 2009 it wasn't clear whether 'this winter' meant another failed deadline or an aspiration for the end of 2010. At a presentation given by Sharon Campbell, FSA Head of Permissions Department, the other day the subject of ONA arose. We were advised that it is being used internally and could 'possibly' go live for external usage in Q3 of this year.

<http://www.fsa.gov.uk/Pages/Doing/Regulated/ona/index.shtml>

Radar & Smaller Firms

At the same seminar mentioned above there was also a speech by Linda Woodall, FSA Head of Savings &



Investments Department. The subject matter included 'Intensive Supervision' and what it means for smaller firms. In the eyes of the FSA the latter are part of the fabric of financial services and we were informed that no small firm will fall under the FSA radar. Intensive Supervision encompasses focus on outcomes and taking a more proactive approach when looking at the robustness of business models. For larger firms this could include challenging senior management, which of course is not practical as far as small firms are concerned and which make up the majority of authorised firms. To overcome this the FSA has been putting together a profile of firms based upon returns submitted plus environmental considerations. The idea is to get a risk map for each small firm or type of firm which will make it easier for them to spot outliers. Because of the area that Ms Woodall works in it is tempting to think that this will only apply to retail firms. However as the audience represented a mixture of wholesale and retail it was taken as read that this was the FSA speaking to all small authorised firms.

Business Continuity

Firms may be interested to know that the FSA will be holding a Business Continuity Conference this coming 30 April. Details are not yet available but if this would of use to your firm then you can register interest in attending by sending an email to claire.tatchley@fsa.gov.uk

If any of the topics discussed above raise questions or a need for guidance or support, please feel free to contact Peter Carlisle at peter.carlisle@complyport.co.uk

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Complyport Ltd. 4 Cavendish Square, London, W1G 0PG. Tel: +44 (0)20 7399 4980. www.complyport.com