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In Principle

A Newsletter from Bingham's Financial Regulatory Practice

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BINGHAM'S UK FINANCIAL REGULATORY PRACTICE

Bingham's Financial Regulatory Practice provides both UK- and US-based clients with advice on all aspects of the UK financial services regulatory framework.

Praised by *Legal 500* for our "*speed of response and down-to-earth approach*", the London team is recognised as a market leader in FSA investigations and enforcement proceedings with a particular focus on retail markets. The team has an active advisory practice which advises on a wide spectrum of issues. The team acts for both regulated institutions and regulators.

The Financial Regulatory Practice expands the international resources of Bingham's premier securities practices, which provide clients with a fully integrated set of legal services focused on securities law and regulation. Dedicated lawyers from the broker-dealer, investment management and financial institutions/ securities litigation practice groups and our financial regulatory practice provide counselling, regulatory compliance and defence services to broker-dealers, investment advisers, investment managers, investment banks, mutual funds, hedge funds and other private investment funds, accounting firms, insurance companies, public companies, and officers and directors.

Our team's practical experience, coupled with our transatlantic capability, differentiates us from other firms.

From the Financial Regulatory Practice

Welcome to the latest edition of *In Principle*, a newsletter focusing on issues of relevance to those subject to the regulation of the Financial Services Authority. Our leading regulatory partners, Peter Bibby and Helen Marshall were both previously heads of enforcement at the FSA, responsible for conducting major investigations and leading the development of the FSA's approach to regulatory enforcement.

In our first edition for 2011, our lead article takes a look at a series of substantial reforms to the UK regulatory sector announced in June 2010 under the UK's new coalition government. We describe the proposed new regulatory structure and discuss its interaction with the newly created European regulatory framework which looks set to bring about fundamental changes over the next two years.

In September 2010, the FSA published a Consultation Paper proposing changes to its requirements relating to complaints handling covered by the compulsory jurisdiction of the Financial Ombudsman Service. The aim of the proposals is to ensure that firms resolve complaints promptly and fairly and that when consumers are not satisfied with the firm's response, they can access the FOS. This article outlines the main proposals and briefly considers some of their potential implications for authorised firms.

The eagerly awaited text of the Alternative Investment Fund Managers Directive is now anticipated to come into force in early 2011, paving the way for a significant change in the way that alternative funds and their managers are regulated. Member States will be required to implement its provisions into their national laws by the end of 2013, presenting a major challenge for firms who will now need to review and adapt their business models and structures. We summarise the key directive requirements, including the dual marketing regime for non-EU AIFM and non-EU alternative investment funds, as well as briefly discussing the practical implementation of the Directive.

In the wake of the global financial crisis, public concern over corporate accountability has intensified. As a result, governments across the world have responded by turning their focus to the implementation and effectiveness of their anti-bribery enforcement regimes. This article focuses on the UK's new Bribery Act which will come into force in April 2011. We discuss recently published draft guidance in relation to the corporate offence and consider some of the most important implications of the new regime for authorised firms.

Since Autumn 2008, many EU Member States have implemented restrictions and disclosure requirements in respect of short selling. However, the approach taken by the Member States has not been consistent, causing a degree of practical difficulty for market participants. This article explores the key rules and likely implications of the European Commission's published draft legislation for the pan-European regulation of short selling European securities, intended to come into force on 1 July 2012.

We conclude this edition of *In Principle* with a summary of the final rules published by the FSA on the proposed removal of the mobile phones and mobile communications exemption from FSA taping requirements. The removal of this exemption is intended to enhance market confidence by providing an extra source of voice and electronic communication evidence.

We hope you find our newsletter useful.

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The UK's New Regulatory Framework

In his first speech to the City of London as Chancellor of the Exchequer in June 2010, George Osborne announced a series of substantial reforms to the UK regulatory system, indicating that the Financial Services Authority ("FSA") will "*cease to exist in its current form*." The following month the Government initiated a consultation on its proposals, the results of which were published in the last week of November 2010. This article describes the proposed new regulatory structure and discusses the interaction of the new regulatory framework with the newly created European regulatory framework. The Government has indicated that it intends to ensure passage of the necessary primary legislation to implement the new regulatory framework by 2012. To this end, it intends to publish a draft bill for consultation in early 2011.

THE NEW REGULATORY FRAMEWORK

The proposed new regulatory system will see the dismantling of the FSA and the creation of three new regulatory bodies: (i) a new Financial Policy Committee ("FPC") of the Bank of England which will be responsible for maintaining financial stability; (ii) the Prudential Regulation Authority ("PRA"), a subsidiary of the Bank of England which will be responsible for the macro-prudential regulation of banks, insurers and broker-dealers/investment banks (although the government intends to retain flexibility in the legislation to extend the scope of the PRA's responsibility to "*shadow banking*" institutions if it is deemed necessary); and (iii) the Consumer Protection and Markets Agency ("CPMA") which will take on the FSA's responsibility for consumer protection and conduct of business regulation, regulating all firms (including hedge fund managers pursuant to the AIFM Directive), both retail and wholesale, including those regulated prudentially by the PRA. The CPMA will also be responsible for all market conduct regulation, and its markets division will be the lead authority representing the UK in the European Securities and Markets Authority ("ESMA").

The core objectives, functions and powers that the Government intends to allocate to each of these new regulatory bodies is set out below.

The Chancellor of the Exchequer will be accountable to Parliament for the crisis management strategy of the FPC, PRA and CPMA. The PRA will be responsible for making rules about and approving bank recovery and resolution plans. The Government will consider whether the new authorities require any additional "*tools and powers*" to promote financial stability and to protect the interests of the taxpayer.

The Government additionally intends to legislate to create mechanisms to ensure close cooperation between each of the FPC, PRA and CPMA. The chief executives of both the PRA and CPMA will each sit on the board of the other authority as a non-executive director and will each be committee members of the FPC.

THE FINANCIAL POLICY COMMITTEE

The FPC will be a committee of, and will be directly accountable to, the Court of Directors of the Bank of England. The FPC will be required to report every six months to Parliament and the Chancellor of the Exchequer. Members of the FPC will include the Governor of the Bank of England, the Deputy Governor for Monetary Policy, the Deputy Governor for Financial Stability and the Deputy Governor for Prudential Regulation.

The FPC's primary objective will be to protect financial stability by: (i) identifying and addressing aggregate risks and vulnerabilities across the financial system with a view to improving its resilience; and (ii) enhancing macro-economic stability by addressing imbalances through the financial system. The FPC will not directly regulate firms, but will be empowered to: (i) decide whether macro-prudential tools should be used to address specific vulnerabilities and imbalances; (ii) direct the PRA and CPMA on regulatory tools that should be deployed in pursuit of macro-prudential policy and how they should be formulated; (iii) make recommendations to PRA and CPMA where it believes that specific regulatory actions (including amendments to rules) are required in order to protect financial stability; (iv) make recommendations to the Court of the Bank of England in relation to other areas of the Bank of England's activities that the FPC believes necessary to protect financial stability; (v) make recommendations to the Treasury on any changes the FPC believes necessary to the regulatory perimeter; and (vi) make recommendations to the Treasury on any necessary changes to the FPC's macro-prudential tools.

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FSA Pushes for Further Improvements in Firms' Complaints Handling Standards

On 30 September 2010, the FSA published Consultation Paper CP 10/21 ("CP 10/21") proposing changes to its requirements relating to complaints handling covered by the compulsory jurisdiction of the Financial Ombudsman Service ("FOS"). The aim of the proposals is to ensure that firms resolve complaints promptly and fairly and that where consumers are not satisfied with the firm's response they can access the FOS. CP 10/21 forms part of the FSA's wider work on the framework for consumer redress, which to date has included the publication of firm-specific complaints data and a review into complaints handling in banking groups.

This article discusses the main proposals in the FSA's CP 10/21 and briefly considers some of their potential implications for authorised firms.

KEY PROPOSALS

Increase in FOS award limits

CP 10/21 proposes to increase the FOS award limit from £100,000 to £150,000, effective for any complaint referred to the FOS on or after 1 January 2012. The proposal, the main objective of which is to allow an increased number of consumers' access to the FOS, is based on the fact that the FOS award limit has not changed to reflect inflation since the formation of the FOS (CP 10/21 points out that the protection afforded to customers by the FOS has declined "*in real terms*" since the FOS' establishment) and the perceived need to prevent firms from denying redress in cases where it potentially exceeds £100,000 on the basis that, if the consumer takes the matter to the FOS, they will only be eligible for an award up to £100,000.

Abolition of the two-stage complaints handling process

A further key proposal set out in CP 10/21 is the abolition of the existing rule allowing firms to operate a two-stage procedure when handling complaints in favour of a new rule which states that all firms must operate a single-stage process. Under the current procedures, when a firm, which has chosen to operate a two-stage complaints handling procedure, sends a complainant a written response within eight weeks of receiving the complaint, it does not have to provide a subsequent final response unless the complainant indicates, within eight weeks, that they remain dissatisfied. The new rules will mean that all firms must provide the complainant with a final response within eight weeks of receiving the complaint. A final response is a written response which accepts the complaint and, where appropriate, offers redress or remedial action;

offers redress or remedial action without accepting the complaint; or rejects the complaint and gives reasons for doing so and which encloses a copy of the FOS' standard explanatory leaflet and informs the complainant that if he remains dissatisfied with the response, he may refer his complaint to the FOS within six months. The existing rule, that the FOS can consider a complaint if a respondent has already sent the complainant a final response or if eight weeks have elapsed since the respondent received the complaint, will remain in place.

The FSA considers that the new rules will result in a higher quality of decisions by forcing firms to focus their attention on providing responses to complaints at the first point of contact with the customer. CP 10/21 describes the existing two-stage process as "*inherently prone to misuse*," in particular because "*it effectively gives firms an incentive to deal with complaints to a lower than satisfactory standard at the first stage on the basis that only a relatively small number of consumers will take their complaint further and the firm then has a second chance to rectify any shortcomings in the original complaint handling*."

Root cause analysis

The current complaints handling rules require firms to identify and remedy any recurring or systemic problems revealed by their complaints handling operation. They also suggest that a firm has regard to Principle 6 of the FSA's Principles for Businesses (Customers' Interests) when they identify problems, root causes or compliance failures and to consider whether they ought to act on their own initiative with regard to the position of customers who may have suffered detriment from, or been potentially disadvantaged by, such factors, but have not complained. CP 10/21 proposes to supplement the existing rules with

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AIFM: The New Environment for Alternative Investment Funds

After 18 months of intense debate, lobbying and uncertainty, agreement has finally been reached among the European Union Member States, European Commission and European Parliament on the text of the Alternative Investment Fund Managers Directive (the "Directive"). It is now anticipated that the AIFM Directive will come into force in early 2011 and that Member States will be required to implement its provisions into their national laws by the end of 2013.

Although many of the worst aspects of the original proposal have now been removed or watered down, the Directive, in its final form, still represents a significant change in the way that alternative funds and their managers are regulated and a major challenge for those firms who are affected and who will now need to review and adapt their business models and structures.

KEY DIRECTIVE REQUIREMENTS

Scope

The Directive applies to all alternative investment fund managers ("AIFM") established in the EU managing "*any collective investment undertaking…which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors*" and which is not authorised pursuant to the UCITS regime ("Alternative Investment Fund") and to AIFM established outside the EU managing Alternative Investment Funds domiciled in Europe or Alternative Investment Funds domiciled outside Europe where the latter are marketed to EU investors. The definition of AIFM is wide, covering any legal person whose regular business is managing (i.e., providing at least portfolio and risk management services to) one or more Alternative Investment Funds.

Accordingly, a broad range of investment managers are likely to fall within the scope of the directive (including all UK or EU based hedge or private equity managers, many UK or EU based institutional asset managers and other non-EU managers of Alternative Investment Funds) (including, in principle, US market fund managers) unless they fall within an exemption in the Directive itself (e.g., on the ground that the Alternative Investment Fund assets under management do not exceed €100 million, or €500 million for private equity or are pension funds) or via subsequent delegated acts/implementing measures.

Authorisation

EU domiciled AIFM will have to be authorised by the Member State in which they are established, pursuant to a harmonised procedure. It is currently envisaged that London managers would be authorised by the Consumer Protection and Markets Agency, which will be created during the restructuring of the UK financial regulatory landscape as the FSA is dismantled over the next 18 months. Non-EU AIFM marketing Alternative Investment Fund to EU investors follow a different procedure which involves making a notification to its Member State of Reference (broadly, the Member State where its primary activities take place — see below).

Operational, Capital and Other Requirements

Minimum capital requirements on the AIFM remain (€300,000 for self-managed Alternative Investment Funds and €125,000 for externally appointed AIFM, plus 0.02 percent of total assets under management in excess of €250 million) subject to a cap of €10 million. However, Member States now have scope to impose a mandatory separation of portfolio and risk management functions only where it is proportional to the risks run by the authorised firm.

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The Bribery Act 2010

The Bribery Act, which will come into force in April 2011, will reform the criminal law of bribery, replacing it with a new consolidated scheme of bribery offences covering bribery in both the United Kingdom ("UK") and abroad.

The Act creates four principal offences: two general offences covering paying and receiving bribes; a discrete offence of bribing a foreign public official; and, in what marks a significant departure from the existing law, a new, strict liability corporate offence of failing to prevent bribery, which places a burden on corporate entities to demonstrate that they have sufficiently robust anti-bribery procedures in place.

In this article, we discuss the main provisions of the new Act and recently published draft guidance in relation to the corporate offence. We also consider some of the most important implications of the new regime for authorised firms.

BRIBERY ACT OFFENCES

General offences — paying and receiving bribes (ss. 1–5)

The new Act makes it an offence for either an individual or a corporate entity to either:

(a) offer promise or give a financial or other advantage with the intention of inducing a person to perform a "*relevant function or activity*" "*improperly*," or to reward them for doing so (active bribery) (s. 1); or

(b) requests, agrees to receive or accepts a financial or other advantage intending that a "*relevant function or activity*" should be performed "*improperly*" as a result (passive bribery) (s. 2).

"*Relevant function or activity*" includes any function of a public nature, any activity connected with a business or any activity performed in the course of a person's employment where the person performing it is expected to do so in good faith and/or impartially or is in a position of trust by virtue of performing it (s. 3). Significantly, this extends the existing offence of bribery to cover private sector business. "*Improper performance*" will be judged by whether it breaches the expectation of what a reasonable person in the UK would expect in relation to the performance of the type of function or activity concerned (ss. 4 and 5), although the function or activity need not have any connection with the UK (s. 3(6)).

"*Financial or other advantage*" is not defined and is, therefore, left to be determined as a question of fact. It is likely, however, that this will capture normal kinds of business conduct, such as hospitality and promotional expenditure. Some guidance on this issue has been provided by the Ministry of Justice in a recent consultation paper, published under s. 9 of the Act, guidance about commercial organisations preventing bribery ("CP 11/10"). According to the guidance, the question as to whether a particular item of expenditure or hospitality constitutes a bribe will depend on all the surrounding circumstances. Reasonable and proportionate expenditure and hospitality is unlikely to trigger an offence. It is, however, for individual businesses to fulfil any expectations as regards the establishment and dissemination of any appropriate standards for hospitality and promotional expenditure.

Bribery of foreign public officials (s. 6)

The Act creates a discrete offence for the bribery of a foreign public official. The offence is committed where a person offers, promises or gives a financial or other advantage to a foreign public official or to another person at their request or with their assent or acquiescence with the intention of influencing the official in the performance of his or her official functions (ss. 6(1) and 6(3)). The person offering, promising or giving the advantage must also intend to obtain or retain business or a business advantage by doing so (s. 6(2)). However, the offence is not committed where the official is permitted or required by the applicable written law (which includes any constitution, provision made by or under legislation

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EU Proposal for a Short Selling Regulation

Many EU Member States have had restrictions and disclosure requirements in place in respect of short selling since the Autumn of 2008. For example, in the UK, following the lapse of the temporary prohibition on short sales, short positions of 0.25% or more in financial sector companies and companies subject to a rights issue are required to be disclosed to the public. However, the approach taken by EU Member States has not been consistent, causing a degree of practical difficulty for market participants.

In September 2010, the European Commission published draft legislation for the pan-European regulation of short selling of European securities (the "Draft Short Selling Regulation") which it intends shall come into force on 1 July 2012 following its formal adoption during the course of 2011.

The Draft Short Selling Regulation contemplates the following key rules in respect of short selling:

- prohibition of naked short selling of the shares of any company, the shares of which are admitted to trading on a European market and where the principal venue for the trading of the shares is located in the EU (a "European Traded Company");
- prohibition of naked short selling of the sovereign debt of EU member states or the EU itself ("EU Sovereign Debt") (including entering into credit default swaps in respect of EU Sovereign Debt which do not hedge against either a long position in that EU Sovereign Debt or the debt of any issuer which has a high correlation with that EU Sovereign Debt);
- requirement for short orders to be identified as such when made (and a requirement for trading venues to publish a daily summary of the volume of orders marked as short orders);
- private disclosure to regulator of net short positions in the shares of a European Traded Company which reach, exceed or fall below 0.2%;
- public disclosure to market of net short positions in the shares of a European Traded Company which reach, exceed or fall below 0.5%;
- private disclosure to regulator of short positions in EU Sovereign Debt which reach, exceed or fall below a "*notification threshold*" to be determined in respect of each member state by the Commission; and
- a "*circuit breaker*" that will empower national regulators to prohibit for a period of 24 hours the short sale of a share that has suffered a 10% decline in value in a single trading day.

If implemented, the Draft Short Selling Regulation will also empower the European Securities and Markets Authority

("ESMA") and national regulators to temporarily prohibit or impose conditions on short selling of shares or bonds of European Companies or of the sovereign debt of EU member states in "*emergency*" circumstances.

The Draft Short Selling Regulation mandates ESMA to develop various detailed technical standards in respect of the Regulation, including the arrangements that a seller must make to borrow the shares or sovereign debt instrument at the time of settlement of the short trade so that it is not regarded as 'naked' for the purpose of the regulation. In this regard, it appears likely that it will be necessary for the seller to have entered into a legally binding contractual arrangement with a securities lender for borrowing securities and, prior to entering into a short sale trade, to have reserved sufficient shares to be able to settle the trade.

The Draft Short Selling Regulation purports to have extra-territorial effect and states that it will apply to any action carried on outside the Union so far as it relates to sovereign debt of a Member State or the shares or bonds of a European Traded Company. However, it is unclear what particular steps could be taken to enforce the Draft Short Selling Regulation outside the EU. It is currently envisaged in the draft that competent Member State authorities will be able to conclude cooperation agreements with their counterparts in Third Countries (such as the US) relating to information-exchange and enforcement, with ESMA coordinating the development of cooperation agreements in order to maximize their efficacy.

It is likely that many market participants will welcome a consistent approach to short selling across the EU and, indeed, the fact that short positions of between 0.2 and 0.5 per cent will be disclosed on a private rather than public basis. However, some concerns remain about exactly what will constitute a 'naked' short in both company and sovereign debt and the extent to which credit default swaps can be used, as they currently are, to hedge against country risk. <

Regulatory Update — Mobile Phone Taping

In March 2010, the FSA's Consultation Paper 10/7 proposed the removal of the mobile phones and mobile communications exemption from FSA taping requirements. The FSA has now published its final rules in relation to the taping of mobile phones.

The FSA's Policy Statement, PS 10/17, issued in November 2010, confirmed that, from 14 November 2011, it would remove the exemption for "*mobile phones and other handheld electronic communication devices that are issued by firms for business purposes*." Firms will be required to record "*relevant communications*" made on such devices and store the recordings for six months.

"*Relevant communications*" is defined as "*voice conversations and other electronic communications that involve the receipt of client orders and negotiating, agreeing and arranging transactions in the equity, bond, and financial and commodity derivatives markets*."

The FSA will also introduce a new rule requiring firms to take "*reasonable steps*" to prevent the use of private devices, including mobile phones, handheld mobile electronic communications devices and fixed-line electronic communications devices, to make relevant communications.

The FSA has not prescribed what it expects would constitute "reasonable steps." Rather, firms must themselves decide what is necessary to comply with the provisions.

The FSA considers that the removal of the exemption will provide an extra source of voice and electronic communication evidence which can be used to help counter market abuse and contribute to its efforts to promote cleaner markets which should, in turn, enhance market confidence.

The "*discretionary investment*" exemption will remain in place. <

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THE PRUDENTIAL REGULATORY AUTHORITY

The PRA will be established as a subsidiary of the Bank of England, with its own legal personality and its own board, chaired by the Governor of the Bank of England. The PRA will have operational independence from the Bank of England for day-to-day regulation and supervision of firms, but will be accountable to the Court of the Bank of England, the Government and Parliament (the PRA will be required to produce an annual report that will be laid before Parliament by the Treasury). Shortly after the announcement of the new structure, it was announced that Hector Sants, current Chief Executive of the FSA, will be the Chief Executive of the PRA (and will also be Deputy Governor of the Bank of England for Prudential Regulation).

The PRA will directly regulate banks and other deposit-takers, broker-dealers (or investment banks), and insurers. However, the Government has indicated that it may expand the perimeter of the PRA's authority to include "*shadow banking*" institutions if deemed necessary by the FPC or to take account of other innovations in the banking sector. It is possible therefore that asset managers deemed to be systemically important may ultimately become subject to the rules of the PRA.

The Government intends that the PRA's primary objective will be to promote the stable and prudent operation of the financial system through the effective regulation of financial firms and to minimise disruption of firms that do fail, although it will also be required to "*have regard*" to a range of secondary factors which are to be determined, but are likely to include the objectives of other regulatory authorities, principles of good regulation and "*important matters which relate to the public interest*." Hector Sants has subsequently emphasised in a speech that the purpose of the PRA will not be to pursue a "*zero failure regime*", but will instead seek to make sure that when failure occurs, it occurs in a way that minimises disruption to the financial system as a whole.

The PRA will, therefore, be responsible for making prudential rules for the firms it regulates, covering all issues affecting the safety and soundness of individual firms (including, for example, remuneration) and will conduct supervision and, where necessary, enforcement of all of its policies and rules.

THE CONSUMER PROTECTION AND MARKETS AUTHORITY

The CPMA will be independent of the Government, will take the corporate form of a company limited by guarantee

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and will be financed by the financial services industry (it is likely that, in fact, the CPMA will adopt the legal corporate entity of the FSA).

The CPMA will regulate all firms currently regulated by the FSA (including those to be regulated by the PRA) with the objective of ensuring confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity. The key functions of the CPMA will be to: (i) make rules which govern the conduct of financial firms, in both the retail and wholesale spheres, and the prudential rules for those firms not regulated by the PRA; (ii) grant permissions for all regulated activities classified as "*non-prudential*," and supervise and enforce compliance with conduct of business rules and of the prudential activity that sits within its remit; (iii) approve individuals to perform conduct related controlled functions within financial firms that are also prudentially regulated by the PRA and approve all controlled functions where firms are solely regulated by the CPMA; (iv) regulate the conduct of participants in organised financial markets (investment exchanges and MTFs), OTC financial markets, and in relation to all financial instruments and derivatives traded on those markets; and (v) perform key administrative functions, including raising levies to fund the PRA and CPMA and collecting fees on behalf of the Financial Ombudsman Service, the Financial Services Compensation Scheme and the Consumer Financial Education Body.

Following the conclusion of its consultation, the Government has also decided that the CPMA will retain the FSA's current responsibility for prosecuting criminal offences involving insider dealing, market abuse and other criminal law breaches and that it will house the UK Listing Authority (and that the Government would not pursue its original proposals of creating a stand-alone "*companies' regulator*" or an economic crime agency).

INTERACTION WITH EUROPE

One of the interesting aspects of the Government's original consultation paper was that it did not discuss the interaction of the new regulatory framework with Europe other than to note that the markets division of the CPMA will represent the UK in the newly created European Securities and Markets Authority ("ESMA"). ESMA will have wide-ranging rule-making and emergency powers, and the creation of ESMA represents a significant transfer of power from national regulators to the European authorities.

Although the consultation paper indicates that CPMA will "*make rules which govern the conduct of financial firms, in both the retail and wholesale spheres*," in reality this power will be limited to implementing in the UK rules that have previously been made by ESMA. Most of ESMA's decisions will be taken by simple majority, on the basis of one country, one vote. As a result, the UK will have the same weighting as Malta or Latvia (i.e., just one of 27 voices). The main exception is for decisions on technical standards, where qualified majority voting will be used (and the UK has 8.4 percent of the votes, rather than 3.7 percent). Similarly, many of the rules "*which govern the performance of regulated activities*" by deposit-takers, broker-dealers and insurers to be made by the PRA will in fact merely be the implementation of rules promulgated by the European Banking Authority ("EBA") on which the UK will have similar voting influence as it does in ESMA.

Furthermore, ESMA has further powers that will give it direct jurisdiction over firms in the UK in "*emergency situations*." ESMA may adopt individual decisions requiring national authorities, such as the CPMA, to take specific action to address risks. In the event that the CPMA (or any other national regulator) does not comply, ESMA can also adopt individual decisions addressed directly to a financial market participant. For the first time, therefore, individual firms in the UK will be subject to direct EU financial supervision, if not on a day-to-day basis.

In the paper that it published following the consultation period, the Government did acknowledge the importance of the new European structures and agreed with respondents that it was vital that the PRA and CPMA engaged effectively with them. The Government indicated that it will take steps to ensure that effective coordination between the PRA and CPMA in the European sphere is supported in legislative and practical terms.

CONCLUSION

The Government's announcements to date, including the initial consultation paper and its responses, provide only the outlines of a new regulatory framework with limited detail. However, it is certain that the UK's regulatory framework (and the underlying legislation) will be fundamentally changed in the next two years. Although it has not been openly discussed by the Government, it is also clear that the recent creation of the European System of Financial Regulators represents a significant transfer of regulatory power from the FSA and other national regulators to ESMA, the EBA and other European bodies and that these bodies will now have the determinative voice on the content of the rulebook to which financial institutions are subject. <

FSA Pushes for Further Improvements continued from page 2

guidance setting out what management processes the FSA would expect firms to demonstrate in order to meet their obligations, which include processes to: identify the root causes of complaints and collect and analyse management information on the root causes and the products and services they relate to; prioritise dealing with the root causes of complaints; consider whether the root causes identified may affect other processes or products; decide whether root causes discovered should be corrected and, if so, how this should be done; report regularly to senior personnel where information on recurring or systemic problems may be needed for them to play their part in identifying, measuring, managing and controlling risks of regulatory concern; and keep records of analysis and decisions taken by senior personnel in response to management information on the root causes of complaints.

Consideration of whether to undertake a remediation exercise

One key aspect of the proposed guidance as regards firms' obligations in relation to root cause analysis is that it suggests that, where a firm identifies (from its complaints or otherwise) recurring or systemic problems in its provision of (or failure to provide) a financial service, it should consider whether it ought to take action in respect of customers who may have suffered detriment as a result of the problems, including those customers who have been potentially disadvantaged, but have not complained. Where a firm considers that it should take action, the proposed guidance provides that the firm should take "*proportionate measures to ensure that those customers are given appropriate redress or a proper opportunity to obtain it*." The guidance states that, in particular, a firm should ascertain the scope and severity of the consumer detriment that may have arisen and consider whether it is "*fair and reasonable*" to "*undertake proactively a redress or remuneration exercise, which may include contacting customers who have not complained*."

Senior management oversight of complaint handling

The FSA already expects firms to have management structures in place to ensure complaint handling is given appropriate priority within the firm, however CP 10/21 proposes to go one step further and require that all firms allocate overall responsibility for complaints handling to a nominated senior individual within the firm. Under the FSA's preferred option, this would be someone who undertakes a governing function within the firm (i.e., holds one or more of the "significant influence" controlled functions set out in the Supervision part of the FSA Handbook, which include director, chief executive and partner functions, amongst others). The purpose of this measure is to ensure that somebody of sufficient seniority is responsible for reviewing the firm's complaints handling processes. CP 10/21 does not propose that firms should notify the FSA of the name of the nominated individual, but states that firms should be able to provide either the FSA or the FOS with this information on request, and the nominated individual should be able to answer questions about the firm's complaint management practices.

The proposal will apply to firms of all sizes, but will exclude firms which have claimed exemption from the FOS funding rules and complaints handling rules on the basis that they do not conduct business with eligible complainants and have no reasonable likelihood of doing so.

Taking account of FOS decisions

The existing complaints resolution rules require firms to assess complaints "*fairly, consistently and promptly*" taking account of "*all relevant factors*." Relevant factors may include "*relevant guidance published by the FSA, other relevant regulators, the [FOS] or former schemes*" and "*appropriate analysis of decisions by the [FOS] concerning similar complaints received by the respondent*." This requirement means that firms should have arrangements in place to determine patterns of FOS decisions relating to their own firm, together with any guidance published by the FSA, the FOS and other relevant regulators. CP 10/21 proposes to add specific guidance as to the types of management processes it would expect firms to operate in order to ensure that the lessons learned as a result of determinations by the FOS are effectively applied in future complaint handling, including processes to ensure that: FOS decisions are fed back to the individual complaint handlers and used in their training and development; FOS decisions are summarised, analysed and communicated to complaints handling units; and that guidance produced by the FOS, the FSA and other regulators is analysed and communicated to complaint handling units. CP 10/21 recognises that firms vary greatly in size and the number of complaints they handle each year and therefore makes it clear that the FSA will not expect every firm to follow the guidance in the same way. Rather, firms will be encouraged to follow it in the best way suited to their own specific circumstances.

When does the FSA propose to implement these changes?

The period for responses to CP 10/21 ends in December 2010, and the FSA intends to publish a Policy Statement in April 2011. It is anticipated that the new guidance relating to taking account of FOS decisions and root cause analysis would come into force in August 2011, together with the

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Other ongoing requirements include compliance with conduct of business rules, periodic valuations of assets, liquidity management controls (so that redemption requests can be met), and requirements regarding management and disclosure of conflicts of interests. Some rules will only apply to AIFM that employ certain strategies in the management of their Alternative Investment Funds, such as the systemic use of a high degree of leverage. The details of these ongoing requirements will, to a large extent, be set out by the European Commission in consultation with national experts via secondary legislation during the course of 2011 (see Timing, Implementation and Technical 'Level 2' Acts below). Note that these requirements will apply to EU AIFM of EU Alternative Investment Funds, non-EU AIFM of EU Alternative Investment Funds and EU AIFM and non-EU AIFM of non-EU Alternative Investment Funds marketed in the EU via the "*passport*" (see below).

Marketing to EU Investors

EU AIFM managing EU domiciled Alternative Investment Funds will be permitted to market such funds across the EU using the passport, following a process of pre-filing and clearance by their regulators. The treatment of AIFM of non-EU Alternative Investment Funds is more complex, however.

The accord reached envisages the introduction of a passport regime for "*third country*" (non-EU) based Alternative Investment Funds with a two-year transition phase (meaning entry into force around 2015) and in which the new European Securities and Markets Authority ("ESMA") is to play a significant role. Managers of non-EU Alternative Investment Funds can continue to benefit from national private placement regimes until 2018/2019 however, which is helpful as utilising private placement will involve complying with fewer conditions than for obtaining a passport. This is particularly the case for non-EU AIFM, although non-EU AIFM will still need to comply with, *inter alia*, the onerous transparency/disclosure obligations when marketing under existing private placement regimes (see Dual Marketing Regime for Non-EU AIFM and non-EU Alternative Investment Funds below).

For non-EU AIFM wishing to market Alternative Investment Funds in the EU under the passport, the Directive introduces an authorisation and supervision mechanism to appoint a *de facto* EU Member State of Reference as the home supervisor in the EU. The Directive introduces a range of provisions to ensure effective coordination between that Member State, other Member States where the funds are marketed and the third country where the AIFM is established. ESMA is given peer-review powers to ensure that the authorisation is consistent across the EU. For a more detailed explanation of the marketing regimes, please see Dual Marketing Regime for Non-EU AIFM and non-EU Alternative Investment Funds below.

Depositary

A single depositary will generally be required to hold the assets of the Alternative Investment Fund that the AIFM is managing, monitor the cash flow of the Alternative Investment Fund, ensure that transactions involving Alternative Investment Fund shares or units comply with national law, and act in the best interests of the Alternative Investment Fund and its investors. Whilst the originally proposed depositary liability provisions were strict and allowed for only a very limited pool of entities to act as depositaries, these provisions have since been liberalised. In particular, the Directive allows for the discharge of the depositary's liability for loss of financial instruments by a sub-custodian, as well as allowing the depositary to exclude liability for loss of financial instruments in certain limited circumstances. Further, a prime broker acting as counterparty to an Alternative Investment Fund could now act as depositary if it has functionally and hierarchically separated its depositary functions from its tasks as prime broker, properly identified and managed potential conflicts of interest, and disclosed these to investors.

For non-EU Alternative Investment Funds, the depositary must no longer necessarily be established in the third country where the AIF is established, but can also be established in the home Member State of the EU AIFM or, as the case may be, in the non-EU AIFM's Member State of Reference. Unfortunately the single depositary requirement remains, subject to provisions for sub-delegation (see below), which will in practice increase systemic risk. Having said this, EU AIFM marketing non-EU Alternative Investment Funds via private placement regimes will not have to comply with many of the depositary requirements (see Dual Marketing Regime for Non-EU AIFM/Alternative Investment Funds below).

Surprisingly, depositary liability is more onerous under the AIFM Directive than under the current UCITS regime, ostensibly in response to the Madoff affair. That said, even under the AIFM Directive, depositaries should only be responsible for losses which are within their control. They will be permitted to delegate to sub-depositaries meeting certain standards, but where no delegate in a particular

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third country meets such standards, and the law of that country requires the depositary to use a local entity, the decision to invest will be at the risk of the investors, not at the risk of the depositary. Ultimately, the Commission intends to bring UCITS IV in line with the Directive, so that the same standard of depositary liability applies across the board, and the same standard of risk management generally.

Remuneration

In response to political pressure, the Directive also contains various remuneration "*principles*" applying to senior management, risk takers and others having a material impact on the Alternative Investment Funds they manage. These principles include deferral of 40 or 60 percent of variable remuneration over at least three years, and require that the fixed component represents a sufficiently high proportion of the total remuneration and, in certain circumstances, that 50 percent of variable remuneration should be paid in shares or share-like instruments. For UK investment firms (which will include many London AIFM), the Directive's remuneration principles have been pre-empted by the binding principles contained in the Third Capital Requirements Directive ("CRD III") and which has been implemented in the UK as of 1 January 2011 (via the FSA's Remuneration Code). CRD III contains similar remuneration principles to those in the Directive. The FSA and CEBS are currently in the process of finalising their policy statements and guidance on the CRD III principles, and are using the principle of proportionality to ensure that the principles applied to investment firms are not unduly burdensome.

Disclosure/Transparency

EU AIFM, and non-EU AIFM marketing to EU investors, will have a number of onerous disclosure obligations with regard to investors for each Alternative Investment Fund they manage, including information on the planned investment strategy, use of leverage, procedures to change the investment strategy, as well as rules applying to leverage, details of fees and expenses, valuation procedures and details on the depositary. An AIFM will also have to inform investors where the Alternative Investment Fund it manages are established.

They will also have to report to the relevant authorities in the Member State in which they are established on a number of issues, including risk and liquidity management, special provisions relating to redemption in case of illiquid assets, the main categories of assets in which the Alternative Investment Fund under management invest, particular concentrations of such assets and risks connected to the use of leverage.

Private Equity

Onerous disclosure and notification obligations, as well as anti-asset-stripping controls, will apply to private equity houses within scope, i.e., AIFM which manage one or more Alternative Investment Funds which individually or jointly acquire control of a non-listed company ("*control*" being defined as more than 50 percent of voting rights in the company), and AIFM which cooperate with other AIFM to jointly manage Alternative Investment Funds that acquire control of a non-listed company. These provisions do not apply where the Alternative Investment Fund acquires control of small or medium enterprises (less than 250 employees and less than €50 million turnover/€43 million assets) or of real estate special-purpose vehicles.

An AIFM must notify its home regulator when the voting rights in the company held by an Alternative Investment Fund managed by the AIFM reach, exceed or fall below 10, 20, 30, 50 and 75 percent. An AIFM must also notify the company and its shareholders when control is acquired. These parties must be provided with information on the AIFM, its conflict of interests policy and its communication policy regarding the company. Additionally, the company, its shareholders and its employees must be provided with information on the AIFM's future intentions regarding the company and the likely repercussions for employees. The AIFM must also ensure that the board of the company provides this information to the employees of the company or their representative, and that relevant past and likely future developments are taken into account in the company's annual report.

The AIFM Directive also prohibits an AIFM from, in the period of 24 months from the acquisition of control of a non-listed company, facilitating, supporting or instructing any capital reduction, any share redemption, any distribution to shareholders/own share purchase where the net assets of the company fall short of its subscribed capital and non-distributable reserves, and any distribution to shareholders which would exceed the amount of available profits.

Delegation by AIFM

The Directive permits the delegation of an AIFM's functions provided that the AIFM notifies the competent authorities of its home Member State before the delegation arrangements become effective and meets specified requirements. The fact that such delegation has occurred must not prevent the AIFM from being effectively supervised, and the AIFM must be able to demonstrate that its delegate is qualified and capable of undertaking the functions in question; that it was selected with all due care; and that the AIFM is in a position to monitor

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effectively at all times the delegated activity, to give further instructions to the delegate and to withdraw the delegation with immediate effect when this is in the interests of investors. Where the delegate is not within the EU, there is an additional requirement that there be cooperation between the competent authority of the EU Member State of the AIFM and the supervisory authority of the delegate. The AIFM's liability to the Alternative Investment Fund and its investors cannot be affected by the delegation of its responsibilities. Sub-delegation of functions by a delegate is permitted provided that certain specified criteria are met.

DUAL MARKETING REGIME FOR NON-EU AIFM AND NON-EU ALTERNATIVE INVESTMENT FUNDS

Whilst EU AIFM of EU Alternative Investment Funds can market cross-border as long as they comply with the Directive, additional rules apply for non-EU Alternative Investment Funds. This is ostensibly on investor protection grounds, but in reality, these rules have been inspired by the desire of certain Member States, led by France, to encourage on-shoring of funds and generally to put additional pressure on off-shore tax havens to become more transparent and consistent with G20 objectives.

EU AIFM or non-EU Alternative Investment Funds

EU AIFM will be able to rely on existing private placement regimes until 2018/19, provided they comply with the Directive in full, except for certain provisions relating to depositaries. Further, appropriate cooperation arrangements for the purpose of systemic risk oversight (and in line with international standards) must be in place between the AIFM's home Member State and the Alternative Investment Fund's supervisory authority. To this end, we note that the FSA already has a similar agreement in place with the Cayman Islands. Finally, the non-EU Alternative Investment Fund's country of establishment must not be listed as a Non-Cooperative Country and Territory (an "NCCT") by the Financial Action Task Force on anti-money laundering and terrorist financing.

From around 2015, AIFM would be able to obtain the passport to market cross-border if they fully comply with the Directive. In addition to appropriate cooperation arrangements being in place and the non-EU Alternative Investment Fund's country not being listed as a NCCT, its country must have signed an agreement with the AIFM's home Member State and with each other Member State in which the non-EU Alternative Investment Fund is proposed to be marketed, which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention.

Non-EU AIFM or non-EU Alternative Investment Funds

In order to continue marketing pursuant to national private placement regimes (until 2018/19), a non-EU AIFM will need to comply with the onerous transparency and reporting requirements and, if appropriate, the private equity requirements. In addition, appropriate cooperation arrangements must be in place (see above). Further, the country where the non-EU AIFM is established must not be listed as a NCCT.

Once passporting is available, a non-EU AIFM must first be authorised to obtain a passport, by meeting each of the following requirements: (i) the non-EU AIFM must have a legal representative established in its Member State of Reference; (ii) appropriate cooperation arrangements must be in place; (iii) the country where the non-EU AIFM is established must not be listed as an NCCT; (iv) the country where the non-EU AIFM is established must have signed an agreement with the Member State of Reference, which fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention; (v) the effective exercise by the competent authorities of their supervisory functions under the Directive must not be prevented by the laws, regulations or administrative provisions of the country governing the non-EU AIFM (nor by limitations in the supervisory and investigatory powers of that country's supervisory authorities); and (vi) the non-EU AIFM will need to comply with the Directive in full, except where the non-EU AIFM can demonstrate that it is impossible to combine compliance with adhering to a mandatory provision in the law to which the non-EU AIFM and/or, as the case may be, the non-EU Alternative Investment Fund marketed in the EU, is submitted. Where this is the case, the non-EU AIFM will have to show that the law to which the non-EU AIFM and/or the non-EU Alternative Investment Fund submits provides for an equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant Alternative Investment Fund; the non-EU AIFM and/or the non-EU Alternative Investment Fund must also comply with that equivalent rule.

TIMING, IMPLEMENTATION AND TECHNICAL 'LEVEL 2' ACTS

The deadline for Member State implementation of the Directive into their national laws is currently likely to be January 2013. The AIFM Directive has now reached the end of the first stage of the four-stage "*Lamfalussy*" process and will now enter the second stage, during which technicians from the various Member States and the Commission will prepare detailed "*delegated acts*"

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applicable to the country concerned, or any judicial decision evidenced in published written sources) to be influenced by the advantage (ss. 6(3)(b) and 6(7)). "*Foreign public official*" includes both government officials and those working for public international organisations (s. 6(5)).

Consent or connivance (s. 14)

The Act provides that, where either of the general bribery offences or the offence of bribery of a public official is committed by a corporate entity, any senior officer of the corporate entity (or person purporting to act in such a capacity) who consented to or connived in the bribery will have committed an offence (ss. 14(1) and 14(2)). "*Senior Officer*" includes a director, manager or company secretary (s. 14(4)). To be guilty of the offence, the individual must have a "*close connection*" with the UK (s. 14(3)) by, for example, being a British citizen, British overseas territories citizen or an individual ordinarily resident in the UK (s. 12(4)). Note that if an individual is found guilty of consent or connivance, they are found guilty of the same offence as the corporate entity — the Act does not create a separate offence of "consent or connivance."

Failure of commercial organisations to prevent bribery (ss. 7–9)

This is an entirely new offence and can only be committed by relevant commercial organisations (companies and partnerships (s. 7(5))). There will be an offence where a person "*associated*" with a commercial organisation bribes another person (i.e., commits one of the offences under the Act) with the intention of either obtaining or retaining business or a business advantage for the commercial organisation (s. 7(1)).

An "*associated person*" is a person who performs services for or on behalf of the principal (s. 8). The meaning of "*performing services*" is vague, however, it is clear that it does not matter in what capacity the person performs the services (s. 8 (2)), and that, therefore, an associated person could be an organisation's agent or subsidiary, as well as its employee (s. 8(3)).[1]

This is a strict liability offence and the only available defence is for the commercial organisation to show that it had "*adequate procedures*" for the prevention of bribery in place when the offence was committed (s. 7(2)).

"*Adequate procedures*" is not defined in the Act, however, CP 11/10 sets out the Ministry of Justice's draft guidance on its meaning. The guidance, which is based on six broad management principles, emphasises the need for firms to establish a robust, firmwide risk management framework with clear anti-bribery policies and procedures, sponsored by senior management. It also stresses the need for firms to ensure that they "*move beyond paper compliance*" to embed anti-bribery policies and procedures in all internal controls, recruitment and remuneration policies, operations, communications and staff training. However, the main focus of the guidance is on corporate culture, which it stresses must be one of zero tolerance in relation to bribery. The guidance places heavy emphasis on the role of senior management in creating such a culture, and of ensuring that the firm's message on bribery is clearly communicated to all staff in all jurisdictions.

Extra-territorial application (s. 12)

All of the offences under the Bribery Act will have extra-territorial application, which means that they may be prosecuted both where the offence is committed in the UK and where the offence is committed outside the UK by a person with a "*close connection*" to the UK, such as a British national or an individual ordinarily resident in the UK (s. 12(4)). This significantly extends the scope of the law of bribery.

Penalties (s. 11)

The Act increases the maximum jail term for bribery by an individual from seven years to 10 years (s. 11(1)). A corporate entity convicted of failing to prevent bribery will be subject to an unlimited fine (s. 11(3)).

Key points for authorised firms

We consider that authorised firms should take into account the following key points:

- Strong systems and controls in relation to the prevention of bribery will be essential when the new Act comes into force in April 2011. A lack of robust procedures will leave firms vulnerable to the new corporate offence and leave both senior management and the firm vulnerable to regulatory action by the FSA.
- The government's final guidance on the "*adequate procedures*" requirement will not be published until the second quarter of 2011, which will allow firms only a short period in which to ensure their systems are compliant before the Act comes into force in April. It is, therefore, important to undertake as much as possible as soon as possible, such as carrying out risk assessments to identify areas of business where bribery could be an issue and reviewing existing monitoring frameworks, business practices and due diligence procedures.

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1 Note that where the person is an employee of the organisation, it will be presumed, unless the contrary is shown, that they perform services for or on behalf of the organisation (s. 8(5)).

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- Given the emphasis in the draft government guidance, it is essential that anti-bribery policies and procedures are sponsored by senior management and that senior management take an active role in establishing a strong anti-bribery culture across the firm.
- It is important that firms which have operations carried out by other individuals or entities on its behalf, particularly overseas, ensure that the third party is aware of and committed to the firm's anti-bribery policies and procedures, understands the anti-bribery culture, and is subject to appropriate due diligence and monitoring.

Conclusion

When it comes into force, the Bribery Act will constitute one of the toughest pieces of anti-corruption legislation in the world. This is partly due to the severity of the penalties it may impose, but also to its extensive jurisdiction. The new Act comes into force in April 2011, and it is essential that authorised firms act now to ensure that they are prepared for the legislative changes and able to implement them in time. <

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which help flesh out key definitions and provisions. It is, therefore the case that, although the AIFM Directive has now been finalised, the industry is faced with the need, during the course of 2011 and 2012, to keep abreast of this detailed implementing legislation.

Simultaneously "Level 3" cooperation among national regulators to ensure consistent interpretation and implementation of the rules at Member State level will ensue. Thus, the next 18 months will see various EU and Member State consultations and engagement with industry as the provisions of the Directive and its delegated acts and guidance are brought to life. Finally, "Level 4" will see monitoring, compliance and enforcement of all measures led by the Commission to ensure consistent implementation, with a review by the Commission to take place in due course. <

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new rule requiring firms to nominate an individual with responsibility for complaints handling.

The rules abolishing the two-stage process are anticipated to come into force in July 2012. Given that the FSA is proposing to allow firms over a year for transition, it does not propose any transitional provisions, except on the complaints reporting rules. These will allow firms with reporting periods ending on or after 1 July 2012 to include complaints closed under the two-stage process before that date.

Conclusion — key points for market participants

Much of what is being proposed is a codification or clarification of what is currently expected in terms of complaint handling. However, the proposal to remove the two-stage process will have the most significant impact on authorised firms and, in particular, on firms with a large retail client base. If this proposal comes into force, firms currently relying on a two-stage complaints handling process will need to adapt their operating models to accommodate a single-stage process, which may require a significant amount of change. Firms should, therefore, act now to consider the action that will be required by the changes should they come into force. Further, the specific guidance proposed in relation to root cause analysis and the analysis of FOS decisions means that firms should consider whether their existing processes and procedures meet the expectations of the FSA. <

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