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# In Principle

## A Newsletter from Bingham's Financial Regulatory Practice

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## BINGHAM'S UK FINANCIAL REGULATORY PRACTICE

Our team advises UK- and US-based clients on the UK financial services regulatory framework, including FSA investigations and enforcement proceedings, with a particular focus on retail markets. The team also has an active advisory practice. Clients include both regulated institutions and regulators.

Working in collaboration with Bingham's premier global securities practice, we also 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.

# From the Financial Regulatory Practice

Welcome to the latest edition of *In Principle*, a newsletter focusing on issues of relevance to those subject to Financial Services Authority (FSA) regulation.

Last year saw a radical restructuring of the European institutions responsible for shaping EU financial services, and in our first edition for 2012, we look at the role of the European Securities and Markets Authority (ESMA) within the new European financial regulatory architecture and how ESMA and the other European supervisory bodies will have a significant role in shaping the detailed rulebooks to which UK financial services firms are subject.

In June 2011, the HM Treasury published a white paper setting out the government's widely reported regulatory reform, including the draft Financial Services Bill which assigns responsibility for protecting and enhancing the stability of the UK financial system to the Bank of England, and introduces three new regulatory institutions to replace the FSA. We discuss the new regulatory structure and main features of the new regulators.

The FSA has continued to pursue its objective of credible deterrence, using its full range of enforcement powers to take robust action against individuals and firms. We examine some of the FSA's key actions in 2011 in relation to market abuse and insider dealing. We also discuss the EU short selling regulations anticipated to come into effect by the end of the year. When they come into force, the regulations will have direct effect and will replace, or override, the UK's existing rules on short selling that can be found in Part 8A of FSMA and the FSA's Financial Stability and Market Confidence Sourcebook.

Our next article focuses on the requirements of the European Market Infrastructure Regulation (EMIR). There has been much discussion around EMIR which is intended as the EU's fulfilment of the agreement between G-20 leaders that all standardised OTC derivative contracts should be cleared through central clearing counterparties by the end of 2012, while non-centrally cleared contracts should be subject to higher capital requirements and be reported to trade depositories.

Another of the key changes in the draft Financial Services Bill is the introduction of new powers for regulators and requirements for authorised firms following a number of changes to the Financial Services and Markets Act 2000. We outline the main features of the new powers and how they relate to product intervention and financial promotion.

We conclude this edition of *In Principle* with an article that discusses a recent enforcement case in the US where the Securities and Exchange Commission (SEC) published an order instituting administrative and cease-and-desist proceedings against a Portuguese bank. This action served as a reminder by the SEC that non-US entities need to comply with US regulatory requirements and reiterates the SEC's view that its jurisdiction extends outside the US when non-US entities engage in transactions with US investors using US jurisdictional means.

We hope you find our newsletter useful.

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# The Role of ESMA Within the New European Financial Services Regulatory Architecture

The significant majority of UK financial services law and regulation is derived from European legislation, and 2011 saw a radical restructuring of the European institutions responsible for shaping EU financial services.

In January 2011 the three existing "Committees of Supervisors" were replaced with three "European Supervisory Authorities" ("ESAs") each sitting beneath the European Systemic Risk Board ("ESRB") of the European Central Bank. The European Securities and Markets Authority ("ESMA"), the European Banking Authority ("EBA") and the European Insurance and Occupational Pensions Authority ("EIOPA") each have similar functions and roles within their respective industry sectors in that they are responsible for developing and implementing legislation to be applied across Europe. They are each additionally required to report any developing risks within their sector to the ESRB which has a mandate to set the regulatory agenda with a view to mitigating systemic risk within the European financial services industry. This article will mainly focus on ESMA.

ESMA has widespread powers and responsibilities that it must exercise with a view "*to protect[ing] the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system*"[1]. ESMA is required to cooperate with each of the EBA and EIOPA so as to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability and to ensure confidence in financial services as a whole.

ESMA is governed by a board of supervisors comprising the heads of the national authorities from each EU Member State (i.e., currently, the FSA in the UK). Representatives from each of the European Commission ("Commission"), ESRB, EBA and EIOPA sit on the board in a non-voting capacity. Most 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 per cent of the votes, rather than 3.7 per cent)[2]. (For comparison, it is interesting to note that the UK accounts for 36.3 per cent of the EU's wholesale finance market[3].)

ESMA has key powers in respect of:

(i) **Decisions and Technical Standards**
ESMA is responsible for providing draft technical (implementing and regulatory) standards for endorsement by the Commission and for making certain key decisions under the directives for which it has responsibility.

(ii) **Powers of Investigation and Enforcement**
ESMA has general powers to investigate allegedly incorrect applications of law (including technical standards) and enforce compliance. Moreover, it may do so both on its own initiative and at the request of the European Parliament ("Parliament"), European Council ("Council"), European Commission, a stakeholder group, or one or more national authorities. Furthermore, where "*the orderly functioning and integrity of the markets*" is under threat[4], or even merely "*to maintain or restore neutral conditions of competition in the market*", ESMA has the power to require market participants in a particular jurisdiction to take or refrain from taking particular action in the event that a national authority has first failed to comply with a request from ESMA to impose such a requirement[5]. This power is separate from the 'emergency powers' discussed below, and has a lower trigger point.

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1 *See* Article 1(4) of the regulation establishing ESMA ("ESMA Reg").

2 *See* http://europa.eu/institutions/inst/council/index_en.htm

3 *See* "The Importance of Wholesale Financial Services to the EU Economy 2009" at p. 38 (London Economics analysis, 2008, based on Eurostat data) available at http://217.154.230.218/NR/rdonlyres/DF649F73-2F5D-4C3E-AA24-E491A280A9B5/0/BC_RS_ImportanceofWholesaleFStoEUEconomy09.pdf.

4 *See* Article 6a(5) ESMA Reg.

5 *See* Article 9(6) ESMA Reg.

# UK Regulatory Reform — New Regulatory Architecture

The government's reform of the regulatory architecture of the UK has been widely reported on, and the form of the new institutional structure was set out in the HM Treasury White Paper published in June 2011 ("June White Paper"). The June White Paper sets out the draft Financial Services Bill ("Bill") which is expected to come into force by the end of 2012. The Bill provides the framework for a new regulatory structure for financial regulation in the UK and amends existing legislation, including the Financial Services and Markets Act 2000 ("FSMA").

The Bill assigns the responsibility for protecting and enhancing the stability of the UK financial system to the Bank of England. In addition, the Bill introduces three new regulatory institutions which shall replace the Financial Services Authority ("FSA"). We outline below the new regulatory structure and main features of the new regulators. We discuss in a subsequent article in this newsletter the main features of the new powers in relation to product intervention and the making and monitoring of financial promotions.

## NEW REGULATORY BODIES

### Financial Policy Committee

The Financial Policy Committee ("FPC") will be a macro-prudential regulator within the Bank of England. The FPC will be established as a committee of the court of the Bank of England[1] and will be concerned with protecting and enhancing the stability of the UK financial system. The FPC has been tasked with identifying and monitoring systemic risks and taking action to remove or reduce the same.

### Prudential Regulation Authority

The Prudential Regulation Authority ("PRA") will be a subsidiary of the Bank of England, but will be operationally independent of the Bank. The general statutory objective of the PRA is "*promoting the safety and soundness of PRA-authorised persons*" and the insurance objective of the PRA is to contribute to the "*securing of an appropriate degree of protection for those who are or may become policyholders*".

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1 Section 9B, Bank of England Act 1998.

# Key FSA Enforcement Actions in 2011 in Relation to Market Abuse and Insider Dealing

2011 has seen the FSA continuing to pursue its credible deterrence objective, using its full range of enforcement powers to take robust action against individuals and firms.

The FSA has continued its commitment to using criminal powers to target insider trading. In February, the FSA concluded its sixth successful insider dealing criminal prosecution. Christian Littlewood, Angie Littlewood and Henry Olmar Sa'id pleaded guilty to eight counts of insider trading in a number of different LSE- and AIM-listed shares, contrary to Section 52 of the Criminal Justice Act 1993[1]. All three received substantial custodial sentences, with Christian Littlewood receiving a record sentence of three years and four months. The case is the latest in a line of prosecutions involving professionals working in financial institutions. This suggests that the FSA is starting to address criticisms regarding perceived past failures to tackle institutional insider dealing. It was also the first case in which the FSA sought an extradition (Mr Sa'id, a Singaporean national, was extradited from the French territory of Mayotte in the Comoros Islands pursuant to a European arrest warrant issued at the FSA's request), which underlines the FSA's determination to use its full suite of powers to secure convictions for insider trading.

During the course of 2011, the FSA also imposed financial penalties on a number of individuals for market abuse. Senior equity research analyst Christopher Gower[2] was fined £50,000 for making misleading and inaccurate disclosures to the market via a Bloomberg instant message. The case shows that the FSA includes research analysts among those who can, in principle, influence the market and is an important reminder that Bloomberg and other instant-chat messages can be distributed far more widely than their intended audience. Staff should take care to remember this. Samuel Kahn[3] was fined £1,094,900 after being found to have coordinated a scheme to deliberately inflate the share price of a PLUS-quoted company. Kahn successfully perpetrated repeated impersonations and succeeded in placing trading orders on their behalf, which emphasises the importance of robust customer identity procedures so that firms know and are able to verify exactly who they are dealing with and have procedures in place to verify customer identity before taking telephone orders. Kahn also saw the FSA exercise its powers under FSMA to obtain for the first time a final injunction restraining Kahn from committing further market abuse. The FSA took a similar approach against Barnett Michael Alexander[4], an experienced trader and former private client stockbroker found to have manipulated the price of shares on the LSE. In addition to obtaining an interim injunction against him (which the High Court later made permanent) the FSA imposed a £700,000 financial penalty and separate restitution and prohibition orders. Alexander was, at the time of his abuse, operating on a self-employed basis dealing in shares and retail derivatives products from his home address, placing his orders using a direct market access ("DMA") provider. The FSA published concerns in relation to order book conduct and the intentional pattern of behaviour known as "spoofing" or "layering"[5] in 2009 and has recently decided to impose an £8 million financial penalty on Swift Trade Inc for similar behaviour[6]. Alexander highlights the need for DMAs to ensure adequate monitoring is in place to identify abusive trading strategies and to ensure that they meet suspicious transaction reporting requirements.

Several market abuse cases were considered by the Upper Tribunal (Tax and Chancery Chamber) ("Tribunal"). The Tribunal directed the FSA to impose a prohibition order and financial penalty of £150,000 on David Massey[7], having found that he had committed the market abuse offence of insider dealing by short selling shares in an

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1 FSA press release, "*Investment banker, his wife and family friend sentenced for insider dealing*", 2 February 2011.

2 Final Notice for Christopher William Gower, 12 January 2011.

3 Final Notice for Samuel Kahn, 24 May 2011.

4 Final Notice for Barnett Michael Alexander, 14 June 2011.

5 Fixing the market in certain shares.

6 Decision Notice for 7722656 Canada Inc formerly carrying on business as Swift Trade Inc, 6 May 2011. Following an amendment to Section 391(4) FSMA in 2010, the FSA has the power to publish Decision Notices, as it did in this case.

7 Final Notice for David Massey, 2 February 2011.

# Short Selling

The increased power and influence of European regulatory bodies can be observed in the number and scope of European directives and regulations affecting the financial services industry, which have been under discussion in 2011, and which are expected to come into force in 2012. These include a regulation which seeks to introduce restrictions on short sales of shares, sovereign debt and sovereign debt-related credit default swaps ("CDSs"). The EU Short Selling Regulations ("Regulations") are anticipated to come into effect by the end of 2012. When they do come into force, the Regulations will have direct effect (meaning that they will be legally binding on all market participants, without the need to be implemented by laws in each of the Member States of the EU). Accordingly, when they do come into force the Regulations will replace, or override, the UK's existing rules on short selling that can be found in Part 8A of FSMA and the FSA's Financial Stability and Market Confidence Sourcebook.

The Regulations will apply to the short selling of the shares listed on an exchange or a market in the EU ("Relevant Shares"), even where the actual trading may take place outside the EU, although, as discussed below, there is a limited exemption for shares whose principal listing is outside the EU.

The Regulations also restrict the short selling of derivatives that relate to Relevant Shares and cover debt instruments issued by or on behalf of one or more EU states ("Sovereign Debt"), as well as CDSs issued for the purpose of hedging against risks associated with Sovereign Debt ("Relevant CDSs").

## DISCLOSURE REQUIREMENTS

A person engaged in short selling Relevant Shares will be subject to two levels of notification requirements under the Regulations — private and public. When a short position reaches or exceeds the relevant 0.2 per cent of issued share capital and upon changes to such positions of 0.1 per cent or more (i.e., at 0.3 per cent, 0.4 per cent, etc.), that position will be required to be notified to the relevant EU regulator on a confidential basis.

However, when the position exceeds 0.5 per cent, disclosure will be required to the market as a whole.

A person engaged in short selling Sovereign Debt and Relevant CDSs is required to notify the relevant regulator of its short position if it exceeds a threshold that is to be set by ESMA. There is no related public disclosure obligation.

The notification and disclosure obligations described above expressly apply to persons domiciled or established within or outside the EU.

## NAKED SHORT SELLING

Naked shorting of Relevant Shares, Sovereign Debt or Relevant CDSs is not permissible under the Regulations.

A person engaging in short selling of shares will be regarded as engaging in naked short selling where he has not borrowed or otherwise made reasonable arrangements to ensure that settlement can be effected when due. ESMA will be required to implement technical standards as to what amounts to a "reasonable arrangement".

A person shall be considered to be engaging in naked short selling in respect of Sovereign Debt if he enters into a Relevant CDS which is not being used to hedge against either the risk of default where that person has a long position in the Sovereign Debt to which the Relevant CDS relates, or against the risk of a decline in the value of Sovereign Debt if that person holds assets, or is subject to liabilities, the value of which is correlated to the value of the relevant Sovereign Debt. It is expected that there will be secondary legislation or guidance issued by ESMA which will define the meaning of "correlated" for this purpose.

A central counterparty in an EU state responsible for clearing short-sale

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# European Market Infrastructure Regulation

Throughout 2011 there have been continued negotiations between the European Commission, Parliament and the Council of Ministers in respect of the European Market Infrastructure Regulation ("EMIR") which have most recently manifested themselves in the form of a compromise text proposed by the Polish presidency of the EU in August 2011[1].

EMIR is intended as the EU's fulfilment of the agreement between G-20 leaders that all standardised OTC derivative contracts should be cleared through central clearing counterparties ("CCPs") by the end of 2012, while non-centrally cleared contracts should be subject to higher capital requirements and be reported to trade depositories. This agreement was reached in the aftermath of the 2007/8 financial crisis and was intended to address perceived weaknesses in the derivatives market, particularly regarding transparency around a derivative trader's cumulative positions and exposure which makes it difficult for both counterparties and regulators to monitor and assess risk.

Although EMIR has still not been finalised, it is clear that it will require that (i) "eligible" OTC derivatives (that is, contracts which have met pre-defined eligibility criteria) will have to be cleared through CCPs; (ii) certain details of non-eligible OTC derivative transactions will need to be reported to registered trade repositories; and (iii) financial counterparties and non-financial counterparties who exceed the clearing threshold that enter into an OTC derivative contract which is not cleared by a CCP will be required to ensure that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational and credit risk. Each of these requirements is discussed in more detail below.

EMIR will also establish mechanisms for the authorisation and supervision of the CCPs themselves, in particular requiring that the CCP has sufficient liquidity and capital to ensure the effective operation of the market.

1 Proposal for a regulation of the European Parliament and of the Council on OTC derivative transactions, central counterparties and trade repositories. Presidency Compromise, 29 August 2011 ("Draft EMIR Regulation").

## THE CLEARING OBLIGATION

EMIR will require ESMA to maintain a public register (accessible on its website) that "unequivocally" identifies the classes of derivatives eligible for central clearing and the CCPs that have been authorised to clear them[1]. ESMA will be required to determine whether to admit a class of derivatives to this register when (i) it has been informed by a national regulator that it has authorised a CCP to clear a particular type of contract in accordance with implementing technical standards to be adopted by the Commission (following advice to be delivered by ESMA by July 2012); or (ii) it has identified a particular class of contracts that may be suitable on its own initiative. In either case such determination may only be made following a public consultation and following endorsement by the Commission of implementing standards prepared by ESMA that take account of the overarching aim of reducing systemic risk and criteria for assessing the same. These standards include the degree of standardisation of the relevant class of contracts, the volume and liquidity of those contracts, and the availability of fair and generally accepted pricing information[2].

Once ESMA has determined that a class of derivatives should be cleared centrally, all financial counterparties (that is, all banks, insurance companies and investment firms, including investment funds authorised pursuant to UCITS or the Alternative Investment Fund Managers Directive, authorised within the EU) will be required to clear any transactions in that class of contracts (other than intragroup transactions) that are entered into with either

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1 *See* Article 4b of the Draft EMIR Regulation.

2 *See* Article 4 of the Draft EMIR Regulation.

# Increased Powers for Regulators — Changes to the Financial Services and Markets Act 2000

The HM Treasury White Paper published in June 2011 includes the draft Financial Services Bill ("Bill"), which sets out a number of changes to the current framework of financial regulation in the UK. The bulk of the changes is attributable to the changes in the regulatory architecture, including the creation of the successor entities to the FSA, the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority ("PRA"). However, the Bill also introduces certain new powers and requirements applicable to authorised firms and the new regulators by introducing a number of changes to the Financial Services and Markets Act 2000 ("FSMA"). We discuss below the main features of the new powers in relation to product intervention and the making and monitoring of financial promotions.

## PRODUCT INTERVENTION

The new Section 137(c) of FSMA as set out in the Bill grants the FCA new product intervention powers, allowing the FCA to make rules prohibiting or restricting authorised persons from exposing consumers to certain financial products.

The FCA will be able to restrict or prohibit consumer exposure to certain products by making rules that ban or restrict (e.g., by exposing conditions or specific requirements) an authorised person from (i) entering into such agreements as the FCA may specify in its rules ("specified agreement") with any person or with persons specified by the FCA in its rules (e.g., retail customers), (ii) entering into a specified agreement without having complied with the specified conditions or requirements imposed by the FCA in the rules, (iii) taking any action which could result in the entry into a specified agreement by the persons specified by the FCA or such persons holding an economic interest of any kind in a specified agreement, or (iv) taking any action described above in (iii) without having complied with the specified conditions or requirements imposed by the FCA in the rules.

The FCA may determine that, similar to the existing provisions on unenforceability of agreements resulting from unlawful financial promotions, agreements or obligations created in breach of the product intervention rules may be unenforceable against the consumer, and that the money or property paid by the consumer under the relevant agreement or obligation may be recovered by the consumer, and that the authorised person in breach of the product intervention rules must pay compensation for any loss incurred by the consumer as a result of acquiring the product.

The product intervention rules will be effective irrespective of whether the entering into a "specified agreement" itself constitutes a regulated activity, and whether the specified agreements are with the relevant authorised person or with another person.

The FCA may exercise its power to make product intervention rules when it deems that an intervention is "necessary or expedient" for advancing its consumer protection, or efficiency and choice objectives, that is, broadly, to prevent significant consumer detriment. This gives the FCA wide discretion to determine when to invoke its powers to ban or restrict the sale and distribution of products.

The Bill expressly states that the power to make product intervention rules can only be used to advance the FCA's integrity objective by a separate order of the Treasury, in relation to which the new Financial Policy Committee of the Bank of England may advise the Treasury. This reflects the concerns expressed in the consultation responses that the product intervention power is unlikely to be appropriate to the protection of professional or wholesale customers

## TEMPORARY PRODUCT INTERVENTION RULES

The FCA will also be able to make temporary product intervention rules, valid for up to 12 months, without prior consultation or a cost-benefit analysis[1]. However, such temporary rules may only be made in previously established circumstances in accordance with a published policy statement. The FCA will be required to consult on the policy statement. The FCA may also not use its temporary product intervention powers to re-issue rules which have lapsed after the expiry of the 12-month period, or to issue rules which have substantially similar content or effect as that of the lapsed rules. If the FCA wishes to extend a temporary rule beyond the 12-month period, it must carry out a prior public consultation and a cost-benefit analysis.

## SCOPE

The FCA's product intervention power is sufficiently wide to capture all types of exposure by consumers to the specified product, including selling, arranging and

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1 Section 138N, FSMA as set out in the Bill.

# Non-US Entities Are Reminded of Stern US Regulatory Regime

As 2011 drew to a close, the US Securities and Exchange Commission ("SEC") continued to assert its jurisdictional reach and the application of US securities laws to non-US entities engaging in securities activity in the United States. Specifically, in October 2011, the SEC published an order instituting administrative and cease-and-desist proceedings ("Order") against a Portuguese bank, Banco Espirito Santo S.A. (the "Bank" or "Banco Espirito Santo"), in connection with the Bank's alleged violations of US securities laws[1]. Specifically, the SEC's Order referenced laws requiring broker-dealer and investment adviser registration as well as the laws requiring that certain securities be registered prior to being sold to the public in the United States. The Bank, without admitting or denying the allegations, settled this matter with the SEC and agreed to terms that include ceasing and desisting from committing or causing any violations and future violations of the relevant securities laws, and payment of disgorgement of US$1,650,000, prejudgment interest of US$363,518 and a civil money penalty of US$4,950,000.

The SEC's action serves as a reminder that the SEC staff firmly believes that the US securities laws require a non-US entity (e.g., bank, broker-dealer, investment adviser) to comply with US regulatory requirements, including registration of securities offerings and registration of non-US entities as a broker-dealer and/or investment adviser, unless the US rules or laws provide an exemption from such regulation and registration.

## SUMMARY OF THE ORDER

In its Order, the SEC alleged that Banco Espirito Santo engaged in extensive activities with US resident individuals from outside the United States without the appropriate broker-dealer or investment adviser registration or applicable exemptions therefrom. Specifically, the SEC alleged that the Bank:

- Mailed marketing materials to persons in the United States
- Operated a customer service call center outside the United States with dedicated employees servicing US customers and offering financial products, including securities, to US residents
- Had personnel offering securities services who were not associated with, or registered with, a US-registered broker-dealer

- Offered broker-dealer services through a US-based affiliate that was not registered as a broker-dealer and the employees of which were not associated persons of or registered with a US-registered broker-dealer
- Used a US-based affiliate that was not a registered broker-dealer from time-to-time to act as point of contact for the Bank's investment activities with the US residents
- Offered securities and provided advice regarding investments in securities to 225 affluent US residents through a dedicated division in Portugal, none of the employees of which were registered as investment adviser representatives or as representatives of a broker-dealer, or associated with a US-registered broker-dealer or investment adviser
- Had personnel who were members of the dedicated division and who conducted annual visits to the United States for two to three weeks at a time meeting with US-resident clients and also servicing these clients in the US by telephone, facsimile and email. The Bank personnel allegedly discussed the US clients' accounts and financial products, including securities; helped to effect transactions in financial products; and urged the clients to buy, sell or hold certain financial products.

In addition to the above, the SEC alleged that the Bank offered and sold a variety of securities to US residents and provided investment advice to approximately 3,800 US residents. Registration statements were not filed or in effect for securities that were issued or sponsored by the Bank or its affiliates and sold to US residents (which are described as debt and other group-guaranteed securities issued by the Bank and its affiliates as well as interests in Portuguese analogs to mutual funds sponsored by the Bank and affiliated entities). There is no discussion in the Order about whether the purchasers of these securities were accredited investors or qualified purchasers.

The fees and commissions the Bank received from the accounts and transactions were approximately US$1,650,000. This is the amount that the Bank agreed

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1 Banco Espirito Santo S.A., Administrative Proceeding File No. 3-14599 (24 October 2011). The link to the SEC's Order is: http://www.sec.gov/litigation/admin/2011/33-9270.pdf.

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to disgorge in its settlement, plus prejudgment interest on this amount. In addition to these payments and the civil money penalty of US$4,950,000 to be paid to the US Treasury, the Bank agreed to pay each US resident interest on securities purchased through the Bank, less any payments, other than principal payments, received pursuant to the terms of the securities, and to compensate each US resident for any realised or unrealised losses with respect to securities purchased through the Bank, plus interest until maturity or sale.

A year prior to the Banco Espirito Santo Order, the US Supreme Court ruled in *Morrison et al. v. National Australia Bank Ltd. et al.*, 130 S. Ct. 2869 (2010), that §10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 promulgated thereunder—the antifraud provisions of the Exchange Act—apply only to cases involving either the purchase or sale of securities listed on US securities exchanges or the purchase or sale of any other securities into the United States. While *Morrison* seemed to limit the SEC's presumed jurisdiction over non-US entities acting completely outside the United States, the Order demonstrates that the *Morrison* case does not appear to have dampened the SEC staff's view as to the scope of its enforcement authority regarding securities activities involving US investors and the use of US jurisdictional means.

The SEC's Order against Banco Espirito Santo and the *Morrison* case are reminders that non-US financial institutions should take the time to structure carefully their activities that touch the United States. While the up-front costs may seem significant, they pale in comparison to the back-end cost and potential reputational harm of defending an SEC investigation and incurring disgorgement, interest, penalties and restitution deemed necessary to conclude the matter with the SEC.

## FOCUS AREAS

While it is clear that non-US financial institutions must focus on compliance with US securities laws overall, based on the SEC's Order and the authors' recent experience, the following are items we believe to be of particular concern to US regulators:

- **Broker-dealer definition**. Non-US entities must remember, regardless of how their business is characterised in their home jurisdictions, *if the activities they engage in touch US persons or use US jurisdictional means and would be deemed brokerage activities under US securities laws, they will be considered "broker-dealers" for US securities law purposes*. As a result, such non-US entities will be required to register as broker-dealers under US securities laws or operate pursuant to the safe harbors in Rule 15a-6 adopted under the Securities Exchange Act of 1934 ("Exchange Act") as described in more detail below.
- **Pre-existing relationships**. Where a non-US bank or other financial services entity opens accounts outside the United States for non-US persons who subsequently move or relocate to the United States, *those customers become US residents and their accounts must be serviced by a US-registered broker-dealer or a non-US broker-dealer operating pursuant to an exemption*. Regardless of whether the non-US entity had a pre-existing relationship with the customer, once the account holder moves into the United States, it is very difficult to avoid the use of US jurisdictional means to maintain the investor relationship, and thus the US laws likely will apply.
- **Marketing to individual investors**. As noted below, Rule 15a-6 only allows transactions with US individual investors on an *unsolicited* basis. Following an unsolicited transaction, there may not be any ongoing investment relationship established between the non-US entity and US individual investors. A non-US entity may not market to individuals in the United States or otherwise pursue individual investors living in the United States without becoming subject to the SEC's jurisdiction. The SEC is particularly attuned to the solicitation and marketing efforts of non-US entities as it pertains to *individual investors*.
- **Regulation of securities offerings**. Any offering of securities in the United States is subject to the Securities Act of 1933 ("Securities Act") and rules thereunder as well as the relevant state law requirements applicable to securities offerings. That is, in addition to requiring the use of a registered broker-dealer when conducting a securities business using US jurisdictional means, a non-US entity must only offer securities in a manner that complies with relevant laws, rules and regulations.
- **Investment adviser registration requirements**[2]. Non-US entities engaging in securities activity with US persons or using US jurisdictional means also must be aware that certain activities may cause them to cross into the investment adviser regulatory regime under the Investment Advisers Act of 1940 ("Advisers Act"). While the core definition of "investment adviser" has not changed, the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] significantly changed the exemptions from investment adviser registration

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2 For more information, please see the following alerts on bingham.com:
- "SEC Adopts Rules Implementing Certain Dodd-Frank Act Provisions and Delaying Investment Adviser Registration Requirements", 27 June 2011
- "Proposed SEC Rules Expanding U.S. Investment Adviser Registration: Key Implications for Non-U.S. Advisers and Fund Managers", 3 December 2010
- "SEC Proposes Rules Implementing Dodd-Frank Act Provisions on Investment Adviser Registration", 23 November 2010.

3 Pub. L. No. 111-203 (21 July 2010).

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and added one exclusion in the definition. Therefore, investment adviser status and applicable exemptions must be considered when engaging in advisory activity on behalf of US person investors or when using US jurisdictional means to conduct such activity (and, in any event, reliance on the private adviser exemptions requires a US filing).

## HOW TO MAINTAIN COMPLIANCE

### Broker-Dealer

In considering potential broker-dealer activity in the United States or with US investors, a non-US firm must either register as a broker-dealer in the United States or conduct its activity pursuant to Rule 15a-6. However, Rule 15a-6 only provides a safe harbor from the broker-dealer registration requirements under certain circumstances with specific parties. In general terms, Rule 15a-6 applies to, among other things, isolated unsolicited transactions effected for US investors, including individuals; transactions with certain defined classes of persons deemed not to require intermediation at any point by a US broker-dealer; and solicitation of and effecting of brokerage transactions with "Major US Institutional Investors" and "US Institutional Investors"[4].

More specifically, pursuant to Rule 15a-6(a)(1), a foreign broker-dealer may effect transactions in securities with or for US investors on an unsolicited basis without being required to register as a US broker-dealer. This safe harbor is viewed very narrowly by the SEC, as permitting a foreign broker-dealer contacted by a US client on an *unsolicited* basis, to execute the requested transaction without triggering the US registration requirements and related regulation regardless of whether the US client contacts the broker-dealer from the US or abroad. However, continued communications with the US person, whether solicited or not, is viewed by the SEC as establishing a regular brokerage relationship such that registration of the broker-dealer entity is required. Furthermore, the SEC's action against Banco Espirito Santo discussed earlier in this article illustrates that transactions with individuals are fraught with danger, because the SEC may seek to find a basis for determining that it should have regulatory jurisdiction over any such activities in the name of investor protection.

In addition, Rule 15a-6(a)(4) provides an exemption for foreign broker-dealers engaging in transactions with certain classes of persons. For example, pursuant to this exemption, registration requirements would not apply to a foreign broker-dealer outside the US dealing with (i) registered brokers and banks acting in a broker-dealer capacity; (ii) certain international organisations, regardless of their location; (iii) foreign persons temporarily present in the US with whom the foreign broker-dealer had a bona fide, pre-existing relationship before the foreign person entered the US; (iv) foreign agencies or branches of US persons; and (v) US citizens resident abroad, as long as the transactions occur outside the US and the foreign broker-dealer does not direct selling efforts to identifiable groups of US persons (e.g., military personnel).

Finally, Rule 15a-6(a)(2) sets forth an exemption for non-US broker-dealers providing research to Major US Institutional Investors, while 15a-6(a)(3) allows a non-US broker-dealer to induce or attempt to induce the purchase or sale of a security by US Institutional Investors or Major US Institutional Investors (neither of which include individual investors) pursuant to the strict terms set forth in the rule (and as supplemented by SEC interpretive letters).

### Securities Offerings

Often, a non-US issuer offering its securities in the United States does so pursuant to a private placement by a registered broker-dealer to existing contacts and not by a general solicitation to the public. There are limitations on the number of investors that may partake in such an offering, unless all investors meet the definition of "accredited investor" under the Securities Act (and even then the number must remain below 500 investors or otherwise the issuer is deemed to have made a public offering and becomes subject to Exchange Act reporting requirements). Depending on the basis for the private placement (e.g., the safe harbor under Regulation D), the SEC and some states require a filing regarding the offering to be made on Form D. In addition, where securities products are proprietary products of the selling entity or an affiliate, regulatory scrutiny will be greater, as recent FINRA guidance has shown[5].

A non-US issuer or broker-dealer should engage US-qualified counsel and a reputable US-registered broker-dealer to collaborate on any securities offering to US investors in the United States in order to ensure that

*continued on page 10*

4 "Major US Institutional Investors" means those institutional investors (or any other entity) with over US$100 million in assets or assets under management. See *Cleary, Gottlieb, Steen & Hamilton*, SEC No-Action Letter (9 April 1997).
A "US Institutional Investor" means an investment company registered with the SEC under Section 8 of the Investment Company Act of 1940; or a bank, savings and loan association, insurance company, business development company, small business investment company or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act; a private business development company defined in Rule 501(a)(2); an organisation described in Section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3) of Regulation D; or a trust defined in Rule 501(a)(7) of Regulation D.

5 *See e.g.*, FINRA Regulatory and Examination Priorities Letter (31 January 2012), Regulatory Notices 11-04, 09-27 and Notice to Members 07-27.

*Non-US Entities Are Reminded of Stern US Regulatory Regime*
*continued from page 9*

the offering and related communications comply with the requirements of the Securities Act. All communications and offering activity should be managed by the US broker-dealer either directly on behalf of the issuer or pursuant to a 15a-6 agreement with a non-US broker-dealer such that the non-US broker-dealer is in compliance with the requirements of the Exchange Act safe harbors provided by Rule 15a-6. This should prevent both a non-US issuer and its non-US broker-dealer from finding themselves, like Banco Espirito Santo, the subject of an SEC action alleging violations of the Securities Act and the Exchange Act.

**Investment Adviser Activity**

An investment adviser generally is any person who, for compensation, provides advice as to the value of securities or the advisability of buying or selling securities, or that issues reports or analyses regarding securities. Such a person may be subject to the registration requirements under the Advisers Act.

If a non-US entity meets the definition of investment adviser, it must register as an investment adviser or consider if and how the exemptions/exclusions from registration might apply to its activities. The following activities generally are exempt or excluded from adviser registration if all of the elements of the particular exemption/exclusion are met:

- Any foreign private adviser[6], which is defined as an adviser with no place of business in the US; having fewer than 15 clients and aggregate assets under management attributable to clients in the US and investors in the US in private funds of less than US$25 million; and which does not hold itself out as an adviser and does not advise a registered investment company or business development company
- A private fund adviser with its principal office and place of business outside the United States that acts as an adviser to US qualifying funds, attributes all assets managed in the United States to private fund assets and has a total value of such private fund assets of less than US$150 million
- A family office with no clients, other than family clients, that is wholly owned and exclusively controlled by family clients and does not hold itself out to the public as an investment adviser
- An adviser to one or more venture capital funds
- An adviser registered with the Commodity Futures Trading Commission as a commodity trading adviser whose business does not consist primarily of acting as an investment adviser and who does not advise a registered investment company or business development company[7]

Note that although a non-US investment adviser may be exempt from registration under the Advisers Act, certain filings, recordkeeping and/or examination requirements likely will apply to its activity effective 30 March, 2012, when regulatory changes take effect.

Registration and regulation of investment advisers is separate and distinct from that of broker-dealers. As in the case of Banco Espirito Santo, a non-US entity can engage in activities that require both broker-dealer and investment adviser registration and, as a result, risk finding itself in violation of both the Exchange Act and the Advisers Act.

## CONCLUSION

We have seen the SEC take an active interest in the operations of non-US entities over the past several years. The recent SEC action against Banco Espirito Santo reiterates the SEC's view that its jurisdiction extends outside the United States when non-US entities engage in transactions with US investors using US jurisdictional means. However, we do note that the *Morrison* case leaves open the question of whether the SEC's jurisdiction is in fact as broad as the SEC has traditionally asserted.

Now, more than ever, non-US financial entities should evaluate their activities and any potential nexus of their activities to the United States. To the extent a non-US financial entity is using US jurisdictional means to conduct a securities business with or for US investors, it should cease any such activity immediately until an infrastructure is in place to guard against SEC assertions of potential violations of the US securities laws. <

6 For more information on Foreign Advisers of Private Investment Funds, please see our legal alerts on bingham.com and, in particular, the alert titled "SEC Adopts Rules Implementing Certain Dodd-Frank Act Provisions and Delaying Investment Adviser Registration Requirements", 27 June 2011.

7 For more information, please see the following alert on bingham.com: "Recent CFTC Amendments to CPO/CTA Registration and Reporting Requirements Will Significantly Affect Investment Advisers and Registered Investment Companies", 24 February 2012.

*The Role of ESMA continued from page 1*

(iii) **Dispute Settlement**
ESMA is empowered to settle disputes between national authorities by taking a decision requiring them to take or refrain from specific action. It can do this either on the request of an authority, or on its own initiative, and its mediation role is legally binding.

(iv) **Monitoring and Assessing Market Trends**
ESMA will be able to seize the regulatory initiative as a result of its responsibility for monitoring new and existing financial activities and collecting information from national authorities. As it will inform the ESA, EIOPA, ESRB, Parliament, Council and Commission about relevant micro-prudential trends, potential risks and vulnerabilities, it will set the regulatory agenda. It shall report on the impact of potential market developments on participants and the need to prohibit or restrict certain types of financial activities, and it may conduct inquiries into particular financial activities. It is therefore likely that ESMA will propose future regulatory initiatives.

(v) **Third-Country Issues**
ESMA will take the lead role with respect to third-country issues. It will be responsible for the registration and withdrawal of alternative investment fund managers ("AIFMs") from outside the EU, mediating any difference among national authorities in respect of non-EU AIFMs' compliance and conduct, recognising non-EU central clearing counterparties ("CCPs"), and registering and withdrawing registration of depositories located in third countries approved by the Commission.

(vi) **Emergency Powers**
ESMA has further powers that will give it direct jurisdiction over firms in the UK in 'emergency situations'[6]. ESMA may adopt individual decisions requiring national authorities, such as the FSA, to take specific action to address risks. In the event that the FSA (or any other national regulator) does not comply, ESMA can also adopt individual decisions addressed directly to a financial market participant.

Although the effects have not been fully felt by the industry, this summary of the powers granted to ESMA may help to illustrate why the creation of the ESAs may have been even more momentous for the UK's financial services industry than the changes to the UK regulatory framework that are proposed to come into force in 2012 (which are discussed later in this edition). It is clear that ESMA and the other ESAs will have a significant role in shaping the detailed rulebooks to which UK financial services firms are subject and that, indeed, their creation paves the path to a common European rulebook. <

6 An emergency situation is defined (under Article 10(1) ESMA Reg) as: "*adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets, or the stability of the whole or part of the financial system in the EU*". However, no definition of "*adverse developments*" exists, and "*there are no indications of how the ESAs would use the emergency powers, or to what end*".

*UK Regulatory Reform* *continued from page 2*

The PRA will be responsible for micro-prudential regulation[2] of financial institutions that are deemed systemically significant due to the size of the risks they carry on their balance sheets and that require a sophisticated level of prudential regulation. This will include banks and insurance undertakings as well as complex investment firms. A number of firms will therefore be dual regulated by the PRA and by the Financial Conduct Authority ("FCA", discussed below) for conduct purposes. It is still unclear exactly which firms will be regulated by PRA.

The Treasury will be empowered to issue secondary legislation designating certain kinds of activities as "PRA-regulated activities" and to allow the PRA in due course to develop its own designation criteria to determine which firms should properly be supervised by it. It is expected that at least deposit-taking activities and insurance activities will fall within the remit of the PRA. It will be necessary to wait for the secondary legislation in order to confirm the scope of the activities regulated by the PRA. For example, although the PRA will be the lead regulator, the Society of Lloyd's and the Lloyd's managing agents, Lloyd's members agents and Lloyd's brokers are expected to be FCA-regulated firms.

The Bill provides that the PRA shall be the lead regulator in respect of dual-regulated firms subject to the supervision by both the PRA and the FCA. The PRA would be permitted to veto an action to be taken by the FCA if it is likely to lead to the disorderly failure of a firm under its supervision or threaten the stability of the UK financial system[3].

2 Section 2A, FSMA.

3 Section 3H, FSMA.

**Financial Conduct Authority**

FCA will be a company limited by guarantee, like the FSA. The operational objectives of the FCA are the "*securing of an appropriate degree of protection for consumers*", "*protecting and enhancing the integrity of the UK financial system*", and "*promoting efficiency and choice in the market*"[4]. The strategic objective of the FCA is "*protecting and enhancing confidence in the UK financial system*"[5].

The regulatory remit of the FCA will include conduct of business supervision across the spectrum of regulated persons, and it will regulate also the conduct of the banks, insurers and complex investment firms which fall under the prudential supervision of the PRA. However, as noted above, the exercise by the FCA of its supervisory powers will be subject to the veto rights of the PRA with respect to PRA-authorised firms[6]. Although the FCA will be the sole regulator of firms which are not PRA-authorised firms, if the FCA-regulated firm's immediate group (i.e., the firm's parent and subsidiary undertakings and any subsidiary of its parent undertaking or vice versa) includes a dual-regulated firm, the FCA may need to consult with the PRA in certain circumstances.

In addition, the FCA will be the prudential regulator for all entities required to be authorised and regulated which are not supervised by the PRA. The FCA will also be responsible for matters such as short selling and market abuse. The FCA will succeed the FSA as the UK listing authority. <

4 Section 1C, Section 1D and Section 1E, FSMA.

5 Section 1A, FSMA.

6 Section 3H, FSMA.

*Key FSA Enforcement Actions continued from page 3*

AIM-listed company on the basis of inside information concerning the availability of discounted shares. Massey's reference to the Tribunal was dismissed, save that the financial penalty was reduced to reflect the amount of profit made through the trading, plus 50 per cent. As a result of the Tribunal's decision regarding Massey, information that is consistent with or similar to information concerning an issuer or a security which is already generally available may nevertheless be inside information if it is not in fact information which is generally known to the market. For non-public information to constitute inside information, it is probably necessary to know that it would, if made generally available, be likely to have a significant effect on price in "*a particular direction*", that is, it may not be inside information if its effect on price is likely to be significant, but it is genuinely not clear whether the effect would be positive or negative. Regarding the statutory defence to market abuse, it is probably not sufficient for the firm or individual concerned simply to believe genuinely that a particular course of conduct does not constitute market abuse — objectively reasonable grounds for that belief are required.

The Tribunal also published its decision regarding whether it was appropriate for the FSA to impose a financial penalty on Graham Betton[8] for his involvement in a share-ramping scheme. The FSA had originally determined the appropriate financial penalty to be £500,000 but had reduced this to £100,000 to take into account the economic impact of the prohibition order also imposed on Betton. The Tribunal took the view that, due to Betton's financial position, this should be further reduced to £25,000. The Tribunal found that the fact that Mr Betton made nothing out of the share-ramping exercise and was not well off in no way excused his actions and the seriousness of the behaviour demanded a penalty, but that an amount of penalty that "*forces him into bankruptcy*" would be "*disproportionate and unproductive*".

The Tribunal also reduced the penalty imposed by the FSA on Oluwole Fagbulu[9] on the grounds of financial hardship[10]. However, it unanimously decided to raise the £1.7 million fine imposed on Michiel Visser[11] and held that it would have also raised Fagbulu's penalty had it not been for his financial circumstances. Visser and Fagbulu were the chief executive and chief finance officer of a UK FSA-authorised company that managed a hedge fund domiciled in the Cayman Islands. Fagbulu was also responsible for compliance oversight. They were found to have manipulated the market in order to bolster the fund's net asset value ("NAV"); falsely inflated the fund's NAV; and breached the fund's mandate. The case is one of the first in which the FSA has taken action against a hedge fund manager and sends a clear message that FSA-approved persons operating hedge funds will face serious consequences if they disguise the performance of their fund. FSA-authorised hedge fund managers should review their systems and controls in order to ensure that they are not at risk of individuals fundamentally misleading them, and investors, about the value of the fund.

The Tribunal disagreed with the FSA's proposed action against Jason Geddis[12], a trader with responsibility for London Metal Exchange ("LME") trading on behalf of his firm and its clients. The FSA had sought to impose a prohibition and financial penalty on Geddis for committing market abuse by securing the price of lead contracts on the LME at an abnormal and artificial level. However, the Tribunal determined that, while Geddis' conduct in creating a disorderly market fell below the proper standard of care, it was not the result of a premeditated plan to act improperly. The Tribunal therefore concluded that a public censure was appropriate. The Tribunal also rejected the FSA's finding that Geddis was not fit and proper and so should be prohibited. On the contrary, the Tribunal found him to be a person of integrity. The case underlines the importance of the independent scrutiny of FSA disciplinary decisions that the Tribunal affords. <

8 Final Notice for Graham Betton, 26 August 2011.

9 Final Notice for Oluwole Fagbulu, 20 September 2011.

10 *See* also the Tribunal's more recent decision in the case of David Bedford, where Mr Bedford's financial penalty was reduced by half. Final Notice for David Bedford, 3 October 2011.

11 Final Notice for Michiel Visser, 20 September 2011.

12 Final Notice for Jason Geddis, 2 September 2011.

*Short Selling continued from page 4*

transactions must ensure that there are arrangements in place for a buy-in of shares if the person selling short cannot settle within four days of the due settlement date. To the extent the buy-in is not possible, the buyer must receive a payment as compensation (i.e., market price of shares plus losses arising from failure to settle). The person selling short must be liable for the buy-in costs or payments made to the buyer. A person engaged in short selling who fails to settle as agreed must also be liable to make daily payments for each day of failed settlement until buy-in or compensation.

By contrast to the transparency requirements, the prohibition on naked short selling is not expressed to be applicable to persons domiciled or established outside the EU. Furthermore, as the restriction is phrased so as to apply to the person who enters into the relevant transaction, it is arguable that the regulation does not restrict a person in the EU (i.e., a London-based asset manager) advising, or dealing as agent for, a non-EU entity (i.e., a Cayman fund vehicle) in respect of naked short positions. It is expected that guidance to be issued by ESMA may clarify this position.

## SUSPENSION OF RESTRICTIONS

As partial recognition of concerns expressed by market participants that restricting the use of Relevant CDS would make it more difficult for Member States to sell bonds, the Regulations permit a national regulator to temporarily suspend the naked short selling restrictions on Sovereign Debt for an initial period of six months, subject to further renewals, if the liquidity of relevant Sovereign Debt falls below a certain threshold. A national regulator may also temporarily suspend the naked short selling restrictions on Relevant CDSs for an initial period of 12 months, subject to further renewals, if it believes that the restrictions may damage the sovereign debt market in the relevant EU state, e.g., by increasing the cost of borrowing.

It is unclear whether the Regulations are intended to have extraterritorial applicability to prevent naked short selling of Sovereign Debt within and outside the EU, or if the EU intends to rely on cooperation agreements with non-EU regulators to enforce the naked short selling restrictions.

## EXEMPTIONS

An exemption from the disclosure and notification obligations, as well as from the ban on naked short selling, is available for Relevant Shares (but not for Sovereign Debt or Relevant CDSs) where the principal trading venue of the Relevant Shares is an exchange or market outside the EU. The Regulations specify that the turnover of the Relevant Shares on different exchanges or markets will be assessed in order to determine the "principal trading venue".

The Regulations also provide a market-making exception in respect of Relevant Shares, Sovereign Debt and Relevant CDSs. In addition, authorised primary dealers of Sovereign Debt are exempt from the notification obligations and the naked short selling restrictions regarding Sovereign Debt and Relevant CDSs. Both of these exemptions are subject to a requirement on the person intending to short to notify the relevant regulator of his intention prior to entering into a naked short selling transaction, and to the regulator not prohibiting the use of the exemption by that person.

Certain other exemptions are also available, notably in relation to lawful stabilisation and buy-back activities. Persons operating under an exemption are liable to provide information to the relevant regulator at the regulator's request.

## EXCEPTIONAL CIRCUMSTANCES

The Regulations grant wide powers to national regulators to determine that certain financial instruments or certain classes of financial instruments are subject to the disclosure and notification obligations and the naked short selling restrictions. A national regulator may also suspend all shorting of such specified financial instruments or classes of financial instruments in exceptional circumstances, i.e., where there are adverse events of developments which constitute a serious threat to financial stability or market confidence in the state of the relevant regulator or in one or more other EU states, and where the measure is necessary to address the threat.

National regulators may also temporarily suspend short selling activities of Relevant Shares in the case of significant falls in the price of the Relevant Shares over a trading day. A significant fall in value is described as 10 per cent or more of share value for liquid shares. A significant fall in value is yet to be determined in relation to illiquid shares.

In addition, ESMA may, if there is a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the EU, and there are cross-border implications, require persons who have short positions on specific financial instruments or a class of financial instruments to notify the relevant national regulator or publicly disclose the position(s), or prohibit persons from entering into short positions on certain financial instruments, or impose conditions on certain persons' short selling activities in order to address such threat. <

*European Market Infrastructure Regulation continued from page 5*

another financial counterparty or any entity established outside the EU that would be subject to the clearing obligation if it was established in the EU through a CCP[3]. A non-financial counterparty may also become subject to the obligation to clear its contracts through a CCP to the extent that its cumulative derivative positions exceed a "clearing threshold" that will be determined by ESMA on a periodic basis. If its cumulative positions fall below that threshold for at least 30 days in a three-month period, it will no longer be subject to the requirement[4].

## THE REPORTING OBLIGATION

EMIR will introduce a requirement for certain details of OTC derivative transactions that are not eligible for central clearing to be reported to registered trade repositories with a view to ensuring that information in respect of the risks associated with those contracts will be centrally stored and easily accessible to ESMA, regulators and relevant central banks. Accordingly, financial counterparties will be required to report the details of any OTC derivative contract entered into, modified or terminated to a registered trade repository. The report should be made no later than the working day following conclusion, modification or termination of the contract. The information that is to be contained in the report remains to be determined (by the Commission following a recommendation from ESMA) but is likely to include the parties to the contract and a description of its main characteristics (including the underlying reference asset or contract, maturity and notional value)[5].

3 *See* Article 3 of the Draft EMIR Regulation.

4 *See* Article 5 of the Draft EMIR Regulation.

5 *See* Article 7 of the Draft EMIR Regulation.

## ARRANGEMENTS TO MEASURE, MONITOR AND MITIGATE OPERATIONAL AND CREDIT RISK

EMIR will additionally require counterparties, whether or not they are financial counterparties, that enter into OTC derivative contracts which are not eligible to be centrally cleared to ensure that they put in place appropriate procedures and arrangements to measure, monitor and mitigate operational and credit risk including at least the timely confirmation of the terms of the OTC contract and "*robust, resilient and auditable processes in order to reconcile portfolios, to manage the associated risk and to identify disputes between parties early and to resolve them and to monitor the value of outstanding contracts*"[6]. This requirement is clearly (and is clearly intended as) a significant disincentive to use contracts that have not been approved by ESMA for central clearing. <

6 *See* Article 6 of the Draft EMIR Regulation.

*Increased Powers for Regulators continued from page 6*

providing investment advice in respect of the specified product. The product intervention rules may apply to all types of circumstances, agreements, arrangements or products, including to circumstances or products resulting in indirect exposure to the product, e.g., exposure to a product through a complex product chain, or through a trust arrangement.

It is the government's intention that the definition of "specified agreement" be sufficiently wide to capture all arrangements, and there is an express provision which specifies that references to an "agreement" include "arrangements", such that the product intervention rules can, if appropriate, cover collective investment schemes, described in FSMA as "arrangements", and other ways of structuring the provision of or exposure to the product which might not otherwise fall within the general definition of an "agreement".

## FINANCIAL PROMOTIONS

The Bill allows the FCA to make rules, subject to restraints determined by the Treasury, if any, applying to authorised persons in respect of financial promotions, pursuant to the prohibition on financial promotions by unauthorised persons other than where the financial promotion has been approved by an authorised person[2].

In addition, if the FCA considers that there has been, or is likely to be, a contravention of financial promotion rules in respect of a communication, or an approval of a communication, the FCA will, under the Bill, have the power to give a direction to an authorised person, in respect of a communication to be made by another person, to (i) withdraw a communication it has made or to refrain from making a communication it is intending to make, or (ii) withdraw the approval it has given, or refrain from approving a communication it is intending to approve. In addition, a direction given by the FCA may also require the authorised person to make public details of the FCA's direction and to do anything else that the FCA specifies in the direction in relation to the communication or approval.

Therefore, an authorised person who has issued or approved a communication that breaches the FCA's rules on financial promotions may be directed to actively withdraw such communication from the market and/or make a public announcement stating it is withdrawing the material and, if required by the FCA, take other steps, e.g., contact customers or distributors or other intermediaries to inform them of the withdrawal of the communication or approval and explain reasons for such withdrawal, and to contact consumers who have acted upon the promotion. An authorised firm must also not make or approve a financial promotion that is effectively the same as the financial promotion in relation to which the FCA has previously made a direction.

The purpose of giving the FCA this power is to allow the FCA to intervene without delay to avoid or minimise detriment or loss to consumers, including preventing consumers from being misled.

The FCA is required to give written notice to the authorised person receiving a direction relating to a communication. The notice must be given to the authorised person and, if the direction relates to an approval, also to the person whose communication the approval relates to. The notice must include details of the direction, state that the direction is immediately effective, note the FCA's reasons for giving the direction and state that the authorised person is entitled to make representations to the FCA within a certain time period.

## PUBLISHING DIRECTIONS

During the time period when the authorised person may make representations, the FCA cannot make public that it has given such notice. After the period for making representations has expired, the FCA must amend, revoke or confirm its original direction. Actions required by the FCA for the authorised person to take, set out in the direction, are effective immediately, except for any requirement for the authorised person to publish information about the direction, a requirement which will be effective at such time as the FCA makes a final decision regarding the direction.

Once the FCA has decided which action to take, it must publish such details of the direction and the action it has taken as it considers appropriate. Obliging the FCA to publish directions made under the new power is an attempt to increase the visibility of the FCA's activities and to make public instances of poor and good market practices.

Certain provisions in the Bill will afford a measure of protection to authorised persons from reputational damage as a result of regulatory action. In addition to the requirement that the FCA must give written notice setting out certain matters as discussed above, the FCA will also have discretion as to the contents of the direction that it will publish (although the FCA does not have discretion to decide not to publish the direction) and, where it deems it appropriate, the published direction may include, for example, the firm's representations (or a description or summary of the same) where it challenges the direction. <

2 Section 137P, FSMA as set out in the Bill.

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