

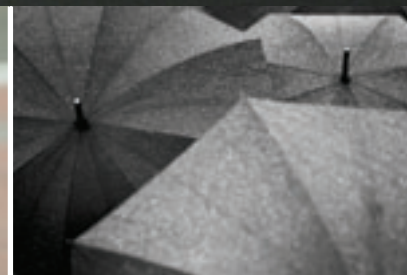
# Fit and Proper

DLA Piper's Newsletter from the Financial Services Regulatory Group



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# Editorial

2005 proved to be a successful year for the UK's financial services industry, with the banking sector in particular thriving. The industry's regulator, the Financial Services Authority ("FSA"), was kept busy throughout, from dealing with enforcement issues and addressing criticisms from the regulated community, to implementing European initiatives at local level, and continuing its work on its key priorities.

In this edition of Fit and Proper, we include a financial crime update focussing on the Joint Money Laundering Steering Group's revised guidance, recently approved by the Treasury. The author of this piece, Daren Allen, is a Partner in DLA Piper UK LLP's Financial Services Regulatory Group, and advised the JMLSG on the revisions.

Other articles in this issue include an update on the Consumer Credit Bill and where we are with M&G regulation one year on. We also give a round-up of enforcement themes since the last edition, and look at the FSA's position regarding hedge funds. Europe continues to be a key influence on the legislative process in the UK, and we outline some of the key initiatives in our European Update, and separately deal with the status of implementation of the Markets in Financial Instruments Directive.

Finally, we also look at how TCF can impact when dealing with commercial customers.

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## DLA Piper's Financial Services Regulatory Group

The Group is led by Partners, Daren Allen, Eva Heffernan and John Ahern. Daren and Eva both focus on contentious financial services matters, including internal and regulatory investigations, and advise a range of clients from banks and other financial institutions to market participants and individuals approved by the FSA under the Approved Persons regime. John Ahern advises on all aspects of financial services regulation in both retail and in the capital market.

# Review of 2005, and the year ahead

2005 was yet another eventful year in the financial services industry. As a result of becoming responsible for the regulation of mortgage business and the sale of general insurance products, the Financial Services Authority ("FSA") saw the number of firms it regulates doubling - bringing the number of authorised firms to over 28,000.

With the intended additions to the FSA's regulatory responsibilities of Self Invested Personal Pensions ("SIPPs"), home reversion plans and Ijara home purchase plans, and its continued focus on existing themes and priorities, the year ahead also seems likely to keep the regulator on its toes - but will it be able to cope under the pressure?

Sir Callum McCarthy, the Chairman of the FSA, seems reluctant to increase the FSA's remit, saying<sup>1</sup>: "any further broadening of the FSA's responsibilities beyond the modest extensions resulting from [recent Treasury decisions]... would run the risk that we lose focus and hence effectiveness". Sir Callum cited responsibilities for consumer credit and the payment services directive as candidates which had been suggested should be added to the list of FSA responsibilities. The FSA certainly had a busy time in 2005, and set out below is a round-up of key events from last year, followed by some crystal ball gazing for 2006.

## Last year's highlights

The FSA continued to focus throughout the year on its three strategic aims, being: (i) promoting efficient, orderly and clean markets; (ii) helping retail consumers achieve a fair deal; and (iii) making the FSA easier to do business with and a more effective organisation. These have been carried forward for the 2006/07 period.

Last year's Business Plan (released in January 2005) outlined some of the steps the FSA would take to achieve these aims, which were, in the main, pursued during the course of the year. Some examples are set out below.

### *Promoting efficient, orderly and fair markets*

- Existing projects were taken forward, including a review of the effectiveness of the industry's response to initiatives on investment research and softing and bundling.
- The FSA also continued to focus on hedge funds and, last June, published two companion discussion papers, looking at the perceived risks posed by the hedge fund sector and the steps which the FSA has taken to date to mitigate these, and the regulatory regime applicable to sophisticated investment products (which are increasingly using similar techniques to those used by hedge funds and others). The FSA plans to publish its feedback on both papers in March and intends to develop its policy on hedge funds during the course of the year.

### *Helping retail consumers achieve a fair deal*

- The FSA continued with consumer education and its focus on Treating Customers Fairly ("TCF") and on improving the quality, clarity and relevance of information provided to consumers (for example, through the Key Facts documents).
- The FSA also stepped up its work on financial promotions - identifying and countering mis-selling, and taking enforcement action when it considered that consumers had not got a fair deal. This year the FSA will consult on overhauling and simplifying the requirements, placing much greater reliance on the principle that financial promotions should be clear, fair and not misleading.

- The full implementation of the depolarised advice system took place last June, which includes the "menu" designed to explain to consumers the cost of advice, and the basic advice regime for stakeholder products was introduced in April 2005.

### *Improving business capability and effectiveness*

- The FSA continued with its aim to enhance its operations and improve performance against service standards, including progressing its programme to simplify its Handbook and remove unnecessary rules and guidance. For example, in June the FSA launched 14 sector-specific tailored handbooks for small firms.

In July 2005, the FSA released a Consultation Paper (CP 05/10) proposing radical changes to the Handbook, focused on simplification and streamlining. The proposals for change are, in summary:

- to delete the Money Laundering Sourcebook altogether, replacing it with a limited number of high-level provisions in the Senior Management, Systems and Controls Sourcebook ("SYSC"). These changes will now come into effect in March;
- to streamline, and in some cases cut back, the Approved Persons regime with a proposal to reduce the current 29 Controlled Functions and to remove the need for Approved Person status for individuals who only deal with wholesale customers. This latter proposal has received a very mixed response from the regulated community, with many contesting that it threatens the success and integrity of the UK industry;

<sup>1</sup> In his Foreword to the FSA's Business Plan for 2006/07 released on 1 February 2006

- to reduce the scope of the detailed rules on training and competence, so that they do not apply to individuals who deal solely with wholesale customers; and
- to introduce a new, simplified structure for the whole of the Conduct of Business Sourcebook ("COB").

Owing to the high level of uncertainty surrounding the impact that the Markets in Financial Instruments Directive ("MiFID") Level 2 measures could have on the approved persons and training and competence regimes, the FSA has decided not to publish its response to the feedback it received until the MiFID Level 2 measures have been finalised and the FSA has had the opportunity to assess them.

#### *Enforcement*

Last year was also an active period in the enforcement arena - although fewer fines were levied than in 2004, there was an increase in the average size of penalty. Following criticism levelled at the FSA during the Legal & General case, it announced last February that it would conduct a review of its enforcement process, focusing on the decision-making process for supervisory and enforcement actions, with particular attention to the role of the Regulatory Decisions Committee ("RDC"). This became known as the Strachan Review, and the results and recommendations were reported in July, with changes to the process being introduced from October last year. The main aims are to improve checks and controls during the investigation stage, increase transparency and bring greater clarity by more fully separating those who investigate a case from those who decide it.

#### *M&GI*

In its first full year of responsibility for the regulation of the mortgage and general insurance sectors, the FSA carried out several reviews to check that firms were authorised when they needed to be, and on the general application of the new rules, in particular, adequacy of disclosure. Results were mixed, but, in general, showed that firms were failing in their provision of disclosure documentation to customers.

The FSA has said that it will continue to monitor this area closely and will, during 2006, carry out a full-scale review, focusing on how far the new rules are delivering the intended outcome for customers.

The FSA also identified Payment Protection Insurance as a priority because of a relatively high potential risk of consumer detriment, and concluded in November that the market must take urgent action to address poor selling practices and a lack of proper compliance controls. For more information on M&GI regulation, please see "M&GI - one year on" below.

#### *Europe*

The FSA was also busy on European initiatives (see "European Developments" below). Both the Market Abuse and the Prospectus Directives came into effect on 1 July 2005, and the FSA continued to play an active role in determining how various Directives, including MiFID, will be implemented across the EU, including locally.

### **The year ahead**

#### *Government initiatives*

Some insight into what the industry would need to focus on in 2006 was given in last year's Pre-Budget Report ("PBR"), issued on 5 December, when the Government announced "a ten-point action plan to reduce regulatory burdens in the financial services industry" which was drawn up alongside the FSA's own Better Regulation Action Plan issued on 2 December. The Government's action plan mainly deals with modernising the scope of FSA regulation and improving the regulatory framework by better coordination with other bodies - for example, better joint working between the FSA and the Office of Fair Trading ("OFT") to improve consumer credit regulation. In addition, the plan includes action to further enhance the FSA's risk-based regulation by making changes to the Financial Services and Markets Act ("FSMA") which should remove or reduce regulatory burdens and remove inconsistencies and anomalies (for example, relaxing the FSA's requirement to consult on proposed rules, guidance and other matters, thus cutting compliance burdens, and avoiding burdening industry with consultation).

HM Treasury, therefore, launched a consultation on proposed changes to FSMA, responses to which must be received by 5 March.

#### *The FSA's Business Plan and Budget for 2006/07*

The best insight into what the FSA will focus on in the year ahead, and what firms should be studying carefully, can be gleaned from its own Business Plan which was released on 1 February 2006, covering the financial year 1 April 2006 to 31 March 2007. This links closely with the FSA's Financial Risk Outlook published the week before, and it appears that much of the FSA's work in 2006/07 will be a continuation of projects and themes already in progress. The priorities that the FSA has planned for 2006/07 include:

- Thematic work - To begin or complete priority thematic work such as payment protection insurance and subsequent follow-up work, including enforcement investigations, with individual firms; the review of the handling of client money within general insurance brokers; and the study carried out during the first half of 2005 into current market practice on the identification and management of conflicts of interest.
- The "ARROW" process - The FSA aims to begin the roll-out of the improved "ARROW 2" process (the way in which the FSA assesses risk and applies its resources accordingly) from March 2006.
- Directive implementation - To implement MiFID and the Capital Requirements Directive to a high standard whilst continuing international leadership on Solvency II. The Business Plan includes a revised timetable for the publication of FSA consultation papers on MiFID, bringing the anticipated release date of the main consultations to the second and third quarters of 2006.
- Financial capability - The FSA will continue its leadership role, driving forward, in particular, work in the areas of schools, higher education or training in the workplace.

- **Enforcement** - The FSA intends to begin new enforcement cases as well as implementing the remaining recommendations from the Strachan Review of enforcement processes. It will continue to adopt a risk-based approach to enforcement and will also seek to ensure that the sanctions which it imposes (including financial penalties) are fixed at levels sufficient to deter potential wrongdoers.
- **Services standards** - The FSA will aim to improve significantly its performance against its service standards.
- **"Better regulation"** - Changes will be necessary to implement the FSA's Better Regulation Action Plan, the overarching aims of which are for the FSA to become a more principles-based regulator, to improve its risk-based approach, to understand better the cost of regulation and to make the FSA easier to do business with. To achieve these, various steps have been set out including: a review of the regulatory reports required and the provisions of the Supervision manual, with a view to reducing the burdens imposed on firms; the continued promotion and support of market-based solutions where possible; and the implementation of a range of initiatives such as "personalised handbooks" and "key rules" for smaller firms.

All of the proposed activities in the Business Plan are ultimately aimed at achieving the FSA's three strategic aims, and high on the list of priorities is to take further steps to ensure retail customers achieve a fair deal. The TCF principle will undoubtedly be high on the FSA's to-do list, as it expects firms to incorporate the components of TCF into their day-to-day operations.

The FSA has also published its budget for 2006/07, along with a consultation on its fees. The budget for 2006/07 will be £276.1m, an increase of 3.25% on last year. Two million pounds of this will be used to fund improvements to the enforcement process recommended by the Strachan Review. It is expected that approximately 82% of firms will see a change of less than  $\pm 3\%$  in their periodic fee in 2006/07, whilst minimum fee-payers will pay fees that are no more than 2.5% higher than those paid in 2005/06.

## Conclusion

As the Business Plan confirms, much of the work to be done will be a continuation of projects or themes already in process in 2005, with the underlying principles of the FSA remaining unchanged - to regulate only where there is both a market failure and the probability that the costs of regulation are outweighed by the benefits; and a recognition that it is neither practicable nor desirable to seek to avoid all failures.

The regulated community can learn a lot from the Business Plan, and should be assessing what they need to focus on and where resources need to be allocated in order to pre-empt any regulatory enquiries. The FSA expects this now - and it is much better to be ahead of the curve than lagging behind. However, it remains to be seen whether the FSA has increased its resources sufficiently to cope with what is already a significant workload, and we will need to wait until the end of the year, when it publishes its Performance Account for 2005/06, to assess whether it has bitten off more than it can chew.

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# European developments

The implementation of the European Commission's ("EC") Financial Services Action Plan ("FSAP") continued apace throughout 2005. Since our last edition of Fit and Proper, the EC published its White Paper on financial services strategy for the next five years in December, which follows on from its Green Paper published in May 2005.

The EC has recognised that, following the flurry of legislative activity of recent years, the next five years is likely to be a period of consolidation. This will mean ensuring that the various FSAP initiatives are effectively implemented in the Member States (which may result in enforcement action being taken against certain states) and monitoring the effect of implementation on the markets. The EC also wants to see further steps taken towards financial integration of the EU markets.

To the extent that there will be new initiatives, these are likely to concentrate on the retail sector rather than the business-to-business environment. Proposals have been made in relation to cross-border bank accounts, credit intermediaries, asset management, and clearing and settlement.

In an attempt to help stakeholders plan for regulatory changes driven by international initiatives, the FSA published its first International Regulatory Outlook ("IRO") in January 2005, and released a further update in November. This contains useful information on the FSAP implementation timetable, a sector-specific analysis of the impact of the FSAP and the FSA's approach to implementation. In the preface to the November update, John Tiner identified three key messages arising from the report:

- firms that underestimate the continuing heavy implementation challenge arising from EU measures during 2006-2008 are likely to incur significant last-minute costs and/or additional compliance risk;
- if stakeholders wish to influence the development of international policy initiatives, it is important that they do so as early in the process as possible and are alert to consultation documents as they are published; and
- to maximise the scope for effective policy-making, stakeholders should support calls for international bodies to develop a better regulation agenda focused on transparent, evidence-based policy-making that incorporates adequate time for consultation and market failure analyses and cost-benefit analyses.

This is a clear call to the industry to help the FSA influence and control European and international policy.

Progress reports on some of the key initiatives since our last update are set out below.

## *Markets in Financial Instruments Directive ("MiFID")*

MiFID will replace the Investment Services Directive and will have major implications for investment firms' conduct of business requirements and cross-border activities.

The timetable for the implementation of MiFID slipped during 2005, but is currently still scheduled for 1 November 2007.

However, because of the delay in the publication of the EC's formal proposals for Level 2 implementing measures (which were not published until early February this year), the FSA has delayed the publication of its four Consultation Papers on MiFID implementation as follows:

- The Systems and Controls paper will now be published in the second quarter of 2006.
- The consultation covering market transparency, transaction reporting, authorisation and permissions, and enforcement and cooperation (but excluding conduct of business and financial promotions) has been put back to the third quarter of 2006.
- The conduct of business and financial promotion consultations will be published in the fourth quarter of 2006.

HM Treasury issued its consultation on UK implementation on 15 December 2005 concerning the legislative changes required to transpose MiFID into UK law. For further information on MiFID and local implementation, please see "MiFID - where are we now?" below.

## *Transparency Directive*

This Directive deals with financial reporting, disclosure of interests and securities, and information to be provided to major shareholders of listed companies (not including AIM-listed companies). The FSA anticipates making substantial revisions to Chapter 9 of the Listing Rules as a result of the Directive. The DTI will be responsible for making amendments to the Companies Act. The Directive must be implemented by 20 January 2007 and the FSA expects to publish a Consultation Paper in March 2006.





### *Capital Requirements Directive/Solvency 2 Project*

The Capital Requirements Directive ("CRD") seeks to introduce a risk-based prudential framework for credit institutions and investment firms, whilst the Solvency 2 Project seeks to achieve a similar goal for insurance firms. The European Parliament approved the CRD in September 2005 and the FSA intends to produce its second Consultation Paper on UK implementation in February 2006 with a view to having final rules in place by the third quarter of 2006. HM Treasury also intends to issue a Consultation Paper during March 2006. All firms must adopt the Directive by 1 January 2007, although an extended transitional provision will apply with regard to credit risk until 1 January 2008.

The Solvency 2 Project is still in its infancy and a formal proposal for a framework directive is not expected until mid 2007. However, the FSA has decided to try to implement certain of the principles of Solvency 2 in advance of the European timetable because of significant weaknesses in the Solvency 1 Regime for life insurers.

### *Payment Services Directive*

This Directive, which seeks to create a single payment market in the EU and will require payment services providers to be authorised, has been formally proposed by the EC as of 1 December 2005. Providers are likely to include banks, building societies, credit unions, e-money issuers, mobile phone operators and ATM operators. The decision on who will be made the competent authority has not yet been made and HM Treasury is to take the UK lead on the Directive.

### *Third Money Laundering Directive*

This Directive was adopted in September last year and published in the Official Journal on 25 November 2005. It builds on and expands existing EU legislation on money laundering and will replace the first and second Money Laundering Directives. Implementation by Member States must be completed by 15 December 2007. The EC published a revised working document in late February 2006 setting out draft technical measures and clarification on certain definitions and technical criteria.

### *Consumer Credit Directive*

This Directive is designed to develop a single market in relation to unsecured consumer credit. The scope of the Directive has been subject to considerable debate, but it appears that it will not now interfere with the existing UK regime of mortgage regulation. The revised EC proposal was published in October 2005 but has not yet been adopted.

A separate discussion is also under way at European level in relation to cross-border mortgage provision within the EU.

### **Conclusion**

The FSAP is entering a new phase where implementation, monitoring and refinement become higher priorities than further expanding the scope of EU influence. The FSA has voiced concerns, most notably with regard to MiFID, that certain elements of the FSAP had not undergone a sufficient cost-benefit analysis or market failure analysis. The Commission seems to have at least paid lip service to these concerns, and has stated its intention to thoroughly address cost-benefit issues. However, implementation of MiFID remains high on the list of concerns for the UK regulated community, and it is still seen as one of the most controversial EU directives, with much focus on costs outweighing benefits.

The FSA recognises that it faces significant resource demands from implementation of FSAP legislation, and this will be particularly pronounced during the next three years because of the roll-out of changes to implement MiFID and the CRD. Firms should heed FSA guidance and prepare themselves for a busy and costly period of implementation ahead.

Our strategic communications practice, Upstream, can assist in all elements of European and national law and policy-making. For further information, please contact Pete Digger, Upstream, on 020 7796 6218 or Jacqui Brooks Longman, Senior Professional Support Lawyer, on 020 7796 6334.

# MiFID - where are we now?

The Markets in Financial Instruments Directive ("MiFID") is now expected to be implemented by member states by 1 November 2007, and regulated firms are realising that it will have a fundamental impact on their businesses, not least requiring significant changes to the conduct of business rules for investment services, and also resulting in changes in other significant areas such as trading transparency.

This article looks at what has changed over the last few months, and the current status of MiFID, as at February 2006, and attempts to highlight a few areas of uncertainty and concern in the retail sector.

## FSA encourages firms to begin planning for MiFID

In an attempt to raise awareness levels among senior management at regulated firms, the FSA issued a guide in November entitled "Planning for MiFID", encouraging them to start preparing for implementation of MiFID. The guide highlights the main areas which will be affected by the directive and also outlines the likely main practical implications for regulated firms.

The FSA has advised senior management to earmark sufficient resources to assess the likely impact of MiFID on their firm, and to consider how to respond to the business, operational and compliance issues that will arise.

The key messages from the FSA are:

- MiFID will significantly alter financial services regulation in the UK and most FSA-regulated firms carrying out investment business are likely to be affected by the changes in some way;
- MiFID extends the coverage of the current Investment Services Directive regime and introduces new and more extensive requirements to which firms will have to adapt, in particular in relation to their conduct of business and internal organisation; and
- so as to avoid last minute costs and/or additional compliance risks the FSA is recommending that firms start preparing for MiFID implementation now.

The document is not, however, a consultation or guidance on interpreting MiFID and does not contain any FSA proposals on implementation.

FSA consultation on local implementation of MiFID has been delayed and will follow during 2006 (see timetable below).

## HM Treasury consults on UK implementation of MiFID

Ahead of the FSA, HM Treasury published a consultation document in December 2005 setting out the changes it plans to make to UK legislation in order to implement MiFID. These changes will take the form of amendments, primarily to FSMA and to the Regulated Activities Order. The consultation paper also includes a useful guide, in Chapter 2, to the main provisions of MiFID. HM Treasury's consultation period ends on 31 March 2006.

## European Commission publishes formal drafts of MiFID Level 2 measures

Most significant in the period, was the publication on February 6 by the European Commission of formal drafts of the Level 2 implementing measures for MiFID. They consist of a regulation (covering record-keeping obligations, transaction reporting, market transparency and admission of financial instruments to trading) and a directive (covering organisational requirements and operating conditions for investment firms) - resulting in the consolidation of the five draft documents previously published by the Commission into just two.

A regulation is directly effective in member states, whereas a directive requires to be separately implemented by local legislation. The Commission approach has been to use the regulation wherever possible in an attempt to avoid "gold-plating" by member states. Implementation by regulation also has the advantage of avoiding any delay in transposition into member state law, ensuring greater consistency of interpretation and simpler and more effective use of the passport. Accordingly, scope for interpretation at local level is limited.

The publication of the formal drafts marks a key stage in the life of MiFID. The European Parliament has a period of up to three months in which to consider them and express an opinion, and the European Securities Committee ("ESC") will then vote on whether to approve them. Once approved by the ESC, the Parliament has a further month to decide whether they are consistent with the powers provided for them in MiFID. The measures can then be formally approved and entered in the EU's Official Journal.

There is some clarification in the drafts relating to information provisions and suitability and appropriateness tests, which includes the following:

### *Investment advice*

The Level 2 directive clarifies the way in which investment advice is to be regulated. MiFID itself defines investment advice as the provision of *personal recommendations* in respect of one or more transactions in financial instruments. The draft directive clarifies when a recommendation will be considered to be personal. It also confirms that a personal recommendation that does not relate to particular financial instruments (that is, "generic" investment advice) will not be investment advice for this purpose.

### *Client agreements*

The draft implementing measures do not impose any requirements relating to the form or content of client agreements, although MiFID and the draft directive contain various information requirements for clients. If member states decide to impose their own requirements for client documentation (which currently exist in the UK in COB 4 of the Handbook), it could result in a branch of an investment firm or credit institution having two sets of terms of business: one which complies with host state requirements for use with customers in the country of the branch; and one which complies with home

state requirements for use elsewhere. This is not particularly helpful in achieving the aim of harmonisation.

#### *Suitability*

Firms which provide portfolio management or investment advice will be required to obtain sufficient information about the client so as to be able to recommend products and services that are **suitable** to that client. Suitability for these purposes must be determined having regard to the client's knowledge and experience in the relevant investment field, his financial situation and investment objectives.

It remains to be seen whether this test can ever be met in a non-portfolio situation, particularly if a firm is merely providing advice and does not hold the client's assets - will they ever have the full picture in order to make the suitability assessment?

#### *Appropriateness*

For other retail investment services, other than execution-only business (see below), the firm will have to ensure that the service or product is **appropriate** for the client - a less wide-ranging assessment than the suitability test. This is a new concept for UK firms, and it seems likely this may require firms to ask for additional information on their clients in order to be able to reach a view as to whether the service or product is appropriate.

This information will have to relate to the client's knowledge and experience in the relevant investment field (that is, covering the same matters as for the first part of the suitability test described above). The firm will be obliged to warn the client if it concludes that the product is not appropriate, or (if sufficient information is not forthcoming) that the firm is unable to determine whether the service or product is appropriate, but it will still be able to provide the service in question.

#### *Execution-only business*

Firms which conduct execution-only business will not need to collect any information from their clients, or assess suitability or appropriateness, provided certain conditions are met, including telling its clients that no suitability test has been conducted. This scenario will be limited to *non-complex* products, including shares admitted to trading on an EEA regulated market (or an equivalent market outside the EEA) - thus excluding AIM listed securities - money-market instruments, bonds, or other forms of securitised debt (but not if they embed a derivative), UCITS, and other *non-complex financial instruments* (see below).

The execution-only service must be provided "at the initiative of the client". This means that it cannot be in response to a personalised communication to the client which invites or is intended to influence the client to engage in execution-only business. If this is not the case, or the investment service is in relation to a "complex" financial instrument, the firm will have to carry out the appropriateness test outlined above before the transaction can go ahead.

#### *Complex and non-complex financial instruments*

As indicated above, firms will not be able to provide investment services in relation to financial instruments other than "non-complex" financial instruments without assessing "appropriateness" (or "suitability", in the case of investment advice or portfolio management). The draft implementing directive clarifies the meaning of "non-complex" by setting out a list of types of instrument excluded from the "non-complex" category (including all derivative instruments), and criteria for making the determination in other cases.

In those countries, such as the UK, where there is an established execution-only retail market in some complex financial instruments (such as derivatives and covered warrants), transitional arrangements are anticipated enabling existing clients active in such instruments to be grandfathered through the appropriateness test.

#### *Room to gold-plate?*

The Commission hopes that regulators in member states will not gold-plate MiFID, since the draft directive now states that they should not add supplementary rules in those areas covered by MiFID, unless the Level 2 directive expressly allows this. Effectively, therefore, this is a "maximum harmonisation" directive.

The FSA will therefore need to go through its Handbook and strip out provisions even though they may be perceived as beneficial to the investing public (such as those relating to content of client agreements) in order to avoid gold-plating. We await the FSA's Consultation Papers to see the full extent of the proposed changes.

## Timetable

Date	Event
Feb 06	Commission publishes revised Level 2 proposals
Feb 06	ESC to debate Level 2 proposals
Jan – Apr 06	European parliamentary scrutiny of Level 2 texts, ending in formal Parliamentary Opinion
31 Mch 06	Feedback on Treasury consultation
Q2 06	FSA CP on systems and controls, to cover implementation of both MiFID and the Capital Requirements Directive
June 06	ESC vote on final Level 2 measures
July 06	Commission adopts Level 2 measures in final form
Q3 06	FSA CP on market transparency, transaction reporting, authorisation and permissions, and enforcement and co-operation
Q4 06	FSA CP on COB, covering MiFID provisions and impact on business outside the scope of MiFID
Q4 06	FSA CP on MiFID provisions on marketing communications, as part of wider FSA financial promotions review
31 Jan 07	Member states required to have implementing measures in place
1 Nov 2007	MiFID is implemented

## Conclusion

The drafting process is now drawing to an end, and firms should be well on the way to identifying how MiFID will affect their businesses. In many cases, the effects of MiFID will be profound, in terms of systems, training and the way in which business is done. Despite the delays in its implementation, firms should now be starting to identify and action the key areas where MiFID will have an impact, enabling budgets to be set and working groups established.

We can advise on all aspects of MiFID implementation. For further information, please contact either John Ahern, Partner, or Jacqui Brooks Longman, Senior Professional Support Lawyer, on 020 7796 6782 or 020 7796 6334 respectively.

# Enforcement round-up and priorities for 2006

Enforcement continues to be seen as one of the FSA's key tools and priorities, and formed one of the six broad focus categories of John Tiner's Overview in the FSA's Business Plan for 2006/07. Mr Tiner described enforcement as a "powerful way of changing behaviour and protecting consumers", and reaffirmed the FSA's commitment to the effective and proportionate use of enforcement to assist it in achieving its strategic aims and objectives.

But the process has not been without criticism, and of particular interest for the entire regulated community last year was the FSA's review of the enforcement process, and its recognition that steps needed to be taken, not only for the process to be fair but, more importantly, for it to be seen to be fair. The Strachan Review gained much publicity, and most of the recommended changes to the enforcement process have now been implemented, with a view to it being more transparent, to encourage speedy resolution of cases where possible, and to ensure that contested cases are pursued efficiently and robustly.

Below, we look at some of the key cases decided in the latter half of 2005 and look to the themes for the year ahead.

## Case update

### Market misconduct

On 2 March 2006, it was reported that the FSA notified GLG Partners, one of Europe's largest hedge funds, and its former star trader, Philippe Jabre, that it plans to fine them £750,000 each in connection with improper trading in the securities of Japan's Sumitomo Mitsui Financial Group. This is the most significant fine imposed by the FSA against a hedge fund in the UK and its largest fine imposed on an individual. This case is discussed in detail in our article "Hedge Funds: The New Frontier".

Last year saw some key milestones in the market misconduct area. August 2005 saw the FSA's first criminal prosecution under section 397 of the FSMA (misleading statements and practices).

Mr Carl Rigby, former Chief Executive and Chairman of software company AIT, and Mr Gareth Bailey, AIT's former Finance Director, were convicted of "recklessly" making a false statement to the London Stock Exchange plc, and each received prison sentences initially of three and a half and two years respectively. However, these sentences were reduced on appeal in late December 2005 to eighteen months and nine months respectively as the defendants had not been convicted of the more serious offence of "knowingly" misleading investors. The men were also ordered to pay compensation to investors (by way of confiscation of assets) totalling nearly £533,000.

The so-called "City Slickers" were also found guilty of market manipulation. On 7 December 2005, a jury at Southwark Crown Court found James Hipwell, a former *Daily Mirror* journalist, and Terry Shepherd, a private investor, guilty of conspiring to contravene section 47(2) of the Financial Services Act 1986 (the old market manipulation offence now found in section 397 of FSMA). Following a hearing on 10 February 2006, Hipwell was handed a six-month sentence, three months of it suspended, despite poor health. However, he has recently been granted the right to appeal against this sentence. Shepherd has appealed against his conviction. Anil Bhojru, a colleague of Hipwell's at the *Daily Mirror*, had pleaded guilty to the charge at an earlier hearing and has since been sentenced to 180 hours' community service.

During the seven-week trial, the court heard how Hipwell and Bhojru used their newspaper column to manipulate the market and generate thousands of pounds' worth of profits through share dealing. The

court heard that the pair bought shares, wrote positive articles on the companies involved and then sold them afterwards. Shepherd was in regular contact with the two columnists and benefited from the tips that they featured in the column. He encouraged and assisted their activities by publishing advance notice of their tips on internet bulletin boards.

In late December 2005, the FSA fined Jonathan Malins £25,000 for committing market abuse by misusing relevant information to buy shares in Cambrian Mining (Cambrian), an AIM company. Mr Malins, the finance director of Cambrian, bought 50,000 shares ahead of the announcement of a new share placing and 20,000 shares before the company's interim results in March 2005. Although this action was in respect of a listed company, and Mr Malins was not an approved person, the FSA reiterated the importance of senior management and its expectation that those who occupy positions of responsibility and trust in publicly traded companies should not abuse this by seeking to take advantage of the sensitive information in their possession.

It hasn't all been success for the FSA though. On 21 February, the Financial Services and Markets Tribunal cleared a City stockbroker over allegations of insider dealing, after a two-year investigation by the FSA.

Tim Baldwin, a former broker for Canaccord Capital, was accused of insider dealing in 2003, after he purchased shares in Minmet, the Ireland-based mining company, just days before its shares more than tripled on the back of a positive trading statement. He sold out of his position at a substantial profit a few days later.



"Margaret Cole, the FSA's Director of Enforcement, emphasised that one of the FSA's key priorities for 2006 and beyond is 'effective deterrence' - the use of enforcement action as a mechanism for behavioural change, both to ensure market integrity and to protect consumers."

The FSA alleged that Mr Baldwin had carried out the trades after receiving inside information in a phone conversation with Minmet's chief executive. However, after a three-day hearing - during which it emerged that the FSA was unable to prove that the telephone conversation took place - the three-man Tribunal panel found in favour of Mr Baldwin, dismissing the FSA's proposed £25,000 fines against him and his personal investment company, WRT.

#### *Action against approved persons*

One of the FSA's aims is to change individuals' behaviour through taking enforcement action against them and publicising this to provide a clear example of what is not acceptable. It believes that holding senior management to account is key to achieving the desired corporate culture, and its stated policy is to consider taking such action where a senior manager is personally culpable or where his behaviour falls beneath an acceptable standard. Two recent cases illustrate this: Idris Nagaty was sanctioned for his firm's compliance failings, while Ram Melwani was fined for his firm's failures over money laundering.

In September 2005, the FSA banned Idris Nagaty, formerly a director of Young Ridgway & Associates Limited ("Young Ridgway"), from undertaking any significant influence function in any authorised firm for two years. Mr Nagaty had been solely responsible for Young Ridgway's compliance function and jointly responsible for managing its business. Young Ridgway's principal activity was the sale of investment products, mostly to retired individuals with a low or low to medium risk profile. The FSA found that from 1999 there was a clear pattern of precipice bonds being sold by its advisers, many of which sales generated customer complaints.

The FSA determined that Mr Nagaty had breached the Statements of Principles for Approved Persons. He failed to ensure that there were appropriate systems and controls in place regarding suitability of sales and fair treatment of mis-selling complaints.

Mr Nagaty was found to have taken on too many responsibilities when it should have been obvious to him that he could not properly discharge all of his controlled functions.

In November 2005, the FSA imposed fines on both Ram Melwani and Investment Services UK Limited ("ISUK") for anti-money laundering failings. Ram Melwani is the managing director of ISUK, a small FSA-regulated bond broker with an offshore, corporate client base. Behind these corporate entities sit non-resident, high net worth individuals, whose identities firms must obtain and record for anti-money laundering purposes. ISUK arranged banking/trading facilities in the UK for its clients but subdivided the accounts of some, thereby effectively providing anonymous accounts without the bank's knowledge.

The FSA fined Melwani £30,000 for failing to act with due care, skill and diligence, failing to ensure the firm complied with anti-money laundering requirements and for knowingly being concerned in the actions taken by ISUK. Mr Melwani is the first approved person to be fined for anti-money laundering breaches. The FSA also fined ISUK £175,000 for conducting its business without due skill, care and diligence and for failing to control its business effectively in relation to anti-money laundering systems and controls.

#### *Individuals*

In November 2005, the FSA dropped its investigation into Sir Philip Watts, the former chairman of Shell. In August 2004, the FSA fined Shell £17m for market abuse and breaches of the Listing Rules after it discovered that the company had overstated its oil revenues. Shell was accused of engaging in "unprecedented misconduct". Some commentators have suggested that the FSA's climbdown over Sir Philip Watts demonstrates the difficulty which the regulator has in pursuing cases against individuals and non-approved persons.

It appears that the FSA would, to some extent, agree. At the beginning of February 2006, Tim Herrington, Chairman of the FSA's Regulatory Decisions Committee, was quoted in the press: "Getting big individuals

is difficult... They fight hard as you'd expect. When you're operating in a corporate environment, it's actually quite hard to pin things on an individual, as distinct from a corporate failing".<sup>2</sup>

#### *Listing Rules*

2005 also saw two additions to the FSA's growing list of disciplinary sanctions for Listing Rules breaches.

In January last year, the FSA fined Pace Micro Technology plc ("Pace") £450,000 for breaches of the Listing Rules occurring in January and February 2002. Pace had failed to ensure that its Interim Results Announcement on 8 January 2002 included all relevant information, when it did not reveal that its trade credit insurance, in respect of one of its largest customers, had been withdrawn. It also failed to update the market, without delay, of a change in its expectation as to its future revenue performance which had occurred on 4 February 2002. When Pace did alert the market as to its financial position on 5 March 2002, its share price fell 67% by close of trading.

Later, in July, the FSA fined MyTravel Group plc ("MyTravel") £240,000 for a breach of the Listing Rules. The company failed to announce, without delay, a change in its expectations as to performance. At the end of July 2002, MyTravel became aware of certain balance sheet exposures which were to be charged to profit for the financial year ending 30 September 2002. It therefore changed its expectations as to its performance, specifically as to the source, composition and timing of its profits for the 2002 year end. Such information was price-sensitive and an obligation arose to notify a Regulatory Information Service, without delay, of all relevant information which was not public knowledge concerning that change. MyTravel did not make an announcement until 28 November 2002, a delay of four months.

The cases reiterate the FSA's very clear message that listed companies must comply with their duties under the Listing Rules to keep the market informed without delay of any relevant developments in their businesses.



## The year ahead

During a speech in January 2006,<sup>3</sup> Margaret Cole, the FSA's Director of Enforcement, emphasised that one of the FSA's key priorities for 2006 and beyond is "effective deterrence" - the use of enforcement action as a mechanism for behavioural change, both to ensure market integrity and to protect consumers. Ms Cole made clear that the FSA will be looking at new ways to make sure "the punishment fits the crime".

### *Principles based approach*

The FSA continues to move towards a more Principles-based approach. The FSA is keen for firms to develop a culture of compliance. Rather than introducing more intrusive legislation, it has said it would prefer to rely on effective implementation by firms of high-level standards. The ultimate aim is less costly regulation but it does mean that firms need to start thinking more for themselves about what the Principles for Business should mean for them and about how to embed a culture of compliance from the top down.

### *Senior management responsibility*

The FSA expects senior management to take responsibility for ensuring that firms identify risks, develop appropriate systems and controls to manage those risks, and ensure that the systems and controls mitigate the risks in practice. In our contentious work, we are increasingly seeing the FSA asking for personal assurances of compliance from senior managers, as well as requiring key personnel (including directors on the boards of parent companies and in-house Counsel) to become Approved Persons. Senior managers need to ensure that they are taking appropriate action to identify and mitigate risks to protect their firms and, increasingly, themselves.

### *Penalty levels - on the increase?*

The FSA has again emphasised its commitment to making sure that the type and level of penalty imposed is sufficient to have a deterrent effect - and it cited market misconduct as an example of an area where penalties may well increase. Recent criticism that penalties in such cases have been too low appears to have struck a chord with the FSA and firms can now expect higher penalties. Regulatory fines should not simply be regarded as another cost of doing business.

### *So what should firms and individuals do?*

- Be proactive in identifying and assessing risks and developing systems and controls to mitigate them.
- Ensure that systems and controls are fit for purpose, work in practice and are kept under review.
- Ensure that staff are adequately trained and aware of their regulatory responsibilities and that policies and procedures are kept under review and up to date.
- Take appropriate advice and ensure that they have adequate information on which to base decisions, including by making appropriate challenges to those who provide the information.

And if a firm fails? It must take positive steps as soon as problems are identified or mistakes occur. Although Ms Cole emphasises that self-reporting of problems will not fully mitigate a disciplinary penalty, it will assist. The FSA will be looking for prompt remedial action, both in terms of addressing any systems and controls failures and compensating affected consumers. It will also be looking to firms to take decisive action against individuals who are responsible for the misconduct.

For further information please contact either Daren Allen or Eva Heffernan, Partners in the Financial Services Regulatory Group, on 020 7796 6824 and 020 7153 7157 respectively.

<sup>3</sup> At the Compliance Forum of the Securities and Investment Institute on 18 January 2006

# Hedge Funds: the new frontier

As the spotlight falls on hedge funds, the industry has been closely following the outcome of the FSA's investigation into GLG Partners ("GLG"), one of Europe's largest hedge funds, and Philippe Jabre, one of its fund managers. The case has been viewed as a watershed moment in the FSA's regulation of the hedge fund sector.

According to reports in the media, the FSA spent two years investigating allegations of insider trading against London-based GLG and Philippe Jabre. In the event, the FSA's decision, reported on 2 March 2006, was not as harsh as many had expected. GLG and Jabre are said to have been fined £750,000 each.

Although Jabre's fine is almost triple the level of the largest fine ever previously imposed on an individual, it would appear that he has escaped an industry ban with the FSA finding that he did not deliberately commit market abuse and did not breach FSA Principle 1, governing market integrity. GLG is said to have been found vicariously liable for failing to monitor Jabre more closely, although the details of the conduct for which Jabre and GLG were fined will not be known until the FSA publishes its Final Notice. The level of the fines imposed should be seen in the context of Jabre's purported personal fortune of £180 to £200 million and GLG's £6.35 billion assets under management. GLG and Jabre now have 28 days to appeal to the Financial Services and Markets Tribunal.

The case centres on a convertible bond issue by Sumitomo Mitsui Financial Group in early 2003. Hedge fund managers are routinely made "insiders" in the confidential marketing of such deals by investment banks, being told the specifics of bond issues in advance in order to gauge interest. If they are "taken over the wall" in this way, they should not trade in the securities of the company about to do the deal. Discussions between hedge fund managers and investment bankers which are sufficiently vague are said to be permissible and should not prevent a hedge fund manager from trading. If specific information is passed on, this is not in itself illegal but it cannot be acted on.

According to publicly reported information, the FSA alleges that Jabre was taken over the wall on the Sumitomo bond issue by an investment banker, and then traded on the information. It is said that Jabre already had a position in Sumitomo at the time he was provided with details of the upcoming Sumitomo bond issue and that he asked the investment banker if he could adjust his pre-existing position. The banker is alleged to have confirmed that he would get back to Jabre with Jabre being said to have understood this to mean that he was not in fact "over the wall". The matter of precisely what was said during their conversation will have been a central issue.

Hedge funds will continue to be a hot topic generally for the FSA in 2006. Hedge fund assets managed from London are estimated to have more than tripled in the past three years. The profile of typical hedge fund investors is also evolving. UK institutions and pension funds have already increased their exposure to hedge funds, while retail investors in the UK are becoming more interested in the sector as they look for new investment opportunities. As the hedge fund sector grows, so do the risks which it poses to the regulator's objectives. One of the FSA's key concerns regarding hedge funds is the potential for market abuse and its perception that some hedge funds are testing the boundaries with respect to insider trading and market manipulation. The regulator is, therefore, focusing on whether hedge fund managers act inappropriately and whether they create incentives for others to commit market abuse, given the high commissions paid and the close relationships with counterparties.

In our last edition, we reported that in June 2005 the FSA published two discussion papers focusing on hedge funds and retail investment products: "Hedge funds: A discussion of risk and regulatory engagement" and "Wider-range of retail Investment Products: Consumer protection in a rapidly changing world". The first paper set out the perceived risks posed by the hedge fund sector and the steps which the FSA has taken to date to mitigate these. The second paper looked at the regulatory regime applicable to sophisticated investment products which are increasingly using similar techniques to those used by unregulated collective investment schemes and hedge funds. The consultation period for the first paper ended in October 2005, and a feedback statement from the FSA is expected at the end of March 2006.

While the FSA is taking steps to increase regulation of the hedge funds sector, drastic changes are not expected as the regulator does not want to significantly increase the burden on firms. The FSA does not intend to supervise the funds themselves, but will instead focus its attention on the regulation of hedge fund managers. It is expected that the FSA will take steps to improve the collection of data from hedge fund managers and prime brokers. The availability of more data will enable the FSA to identify those fund managers which pose a higher risk to the FSA's statutory objectives and to target supervision more effectively.

In the US, the Securities and Exchange Commission ("SEC") has also decided that hedge funds merit closer attention. In the past, hedge funds were essentially unregulated investments.



Over recent years, however, there has been a broadening of the investor base and increased enforcement activity, with the SEC focusing on the activities of hedge funds under various anti-fraud provisions of the securities laws. New rules introduced in December 2004 mean that, from 1 February 2006, any hedge fund manager with more than fourteen US clients must register with the SEC unless an exemption from registration applies.

More than 100 hedge fund managers are subject to the dual requirements of both SEC and FSA rules. The FSA and SEC have said that they are working together to ensure a broadly consistent approach to the regulation of hedge fund managers. Hedge funds are seen as beneficial to the financial system, providing liquidity and choice to investors. Both regulators are no doubt equally keen to ensure that they do not drive hedge funds out of their jurisdiction into that of the other. Less than two weeks after the registration deadline, however, it has been reported that many hedge fund managers are trying to remove themselves from the clutches of the SEC by exploiting loopholes in the legislation. There is dissatisfaction surrounding the expense which will be incurred in hiring lawyers and compliance staff to avoid falling foul of the SEC.

In light of the heightened regulation of hedge funds in both the UK and the US, hedge funds, and the investment banks and counterparties that deal with them, will need to ensure they have adequate systems and procedures in place to prevent market abuse and insider trading.

For further information, please contact Eva Heffernan, Partner, or Elisabeth Bremner, Associate, on 020 7153 7157 and 020 7796 6230 respectively.

"One of the FSA's key concerns regarding hedge funds is the potential for market abuse and its perception that some hedge funds are testing the boundaries with respect to insider trading and market manipulation."

# Are you treating your commercial customers fairly?

Although there has been much commentary about how the Treating Customers Fairly ("TCF") principle applies to retail consumers, firms would be misguided if they failed to recognise its impact on business with non-retail customers. This article looks at three potential areas which may serve as examples of when regulatory challenge under the TCF principle may arise in the commercial community.

## Background

The TCF concept is firmly rooted in the FSA's sixth Principle for Business, namely that "A firm must pay due regard to the interests of its customers and treat them fairly". To date, the FSA has relied on the principle of caveat emptor to regulate the wholesale financial market, choosing to adopt a lighter touch approach to regulation. Firms are expected, however, to embrace the TCF principle across more than just the retail sector. While market counterparties are, by definition, excluded from being customers, intermediate customers are entitled to be treated fairly under Principle 6, and this universe of customers includes entities such as quoted companies, municipal authorities and other parties who are likely to be experienced in investment business and financially sophisticated.

## Conflicts of interest

The US Securities and Exchange Commission reached a settlement with several securities industry participants in December 2002 which addressed issues of conflicts of interest at broker/dealers following very public allegations about conflicts of interest between research analysts and investment banking divisions at a number of US firms.

The FSA followed this in March 2004 by publishing its Policy Statement: "Conflicts of interest in investment research", which articulated the FSA's position in relation to conflicts and suggested a road map aimed at ensuring firms manage them appropriately. There is a TCF context to the proper management of conflicts of interest, not just in relation to retail consumers, but also in so far as intermediate customers may be impacted by a weakness or failure in such conflict management.

While such failures or weaknesses would, in any event, result in a breach of other rules, they could also open an avenue of criticism and liability for the offending firm on a principle-based approach.

## Product development

The FSA has suggested that a useful starting point for senior management is to think of TCF in terms of the product life cycle, and this will include looking at the initial design and manufacture stages for TCF compliance. Many intermediate customers look to financial institutions for sophisticated and customised solutions, whether for hedging purposes or otherwise. Such products are typically manufactured on the institutional side of investment houses and are tailor-made to suit the particular needs of the customer - very often involving one or more embedded derivative. In these circumstances, firms should not overlook the importance of transparency in the structure of the particular product. An example of where TCF may become an issue is where the particular product is proprietary, and so the customer is forced to rely on valuations as determined by the manufacturer, even when the customer is looking to unwind the investment.

## Transparency

In the securities trading industry, it is sometimes the case that commission structures, trading commissions and mark-ups on financial instruments are not transparent to customers. In OTC transactions, in particular, the true costs of the instrument or transaction may be more opaque. That is not to say that opacity means that the transaction or charges connected with it are intrinsically in breach of the TCF principle.

However, TCF principles may offer an avenue of regulatory redress in certain circumstances where there may be little room for manoeuvre within the constraints of the contractual provisions relevant to the deal.

Transparency as to the manner in which a particular product is structured and any conflict between the manufacturer and the interests of the customer may be limited. In relation to conflicts, for example, a general disclosure may be made in terms of business with the relevant customer but not on a product by product basis. While there is nothing wrong with this per se, it will be interesting to see whether commercial customers will pursue firms where there is an intractable conflict on the basis of a breach of TCF obligations.

## Conclusion

Helping consumers achieve a fair deal is one of the FSA's statutory objectives and TCF is not a new concept. The FSA has sought to emphasise the importance of a culture change towards TCF. Clive Briault, Managing Director of Retail Markets at the FSA, has reiterated the need for senior management to take responsibility for this<sup>4</sup> saying that "Treating customers fairly needs to be embedded into the culture of a firm at all levels, so that over time it becomes business as usual. This is all very much a responsibility of senior management, not just a compliance issue." It is important that firms take this message to heart in their dealings with intermediate customers as well as with retail clients and that they do not lose sight of the application on Principle 6 outside of the retail environment.

For further information, please contact John Ahern, Partner, or Louise Bowen, Solicitor on 020 7796 6782 or 020 7796 6772 respectively

<sup>4</sup> In his speech at the FSA's Treating Customers Fairly Conference in October 2005



"Firms are expected... to embrace the TCF principle across more than just the retail sector... intermediate customers are entitled to be treated fairly under Principle 6..."

# Financial crime update

Speaking at the BBA Financial Crime Conference at the end of last year, Philip Robinson, the FSA's Financial Crime Sector leader, said that 2006 should be a key stage in the evolution of the UK's financial crime regime, as a number of developments come together: the establishment of the Serious Organised Crime Agency ("SOCA"), the results of Sir Stephen Lander's review of the Suspicious Activity Reports ("SARs") regime, and the implementation of the Joint Money Laundering Steering Group's ("JMLSG") new Guidance Notes.

This article gives a brief overview of these and other developments.

## Joint Money Laundering Steering Group Guidance Notes

The long-awaited revised Guidance Notes on the prevention of money laundering and the financing of terrorism for the financial services industry were published by the JMLSG on 31 January this year, and received HM Treasury approval on 13 February.

The intent is for the revised Guidance Notes, once fully implemented, to change the way that the risk of money laundering and terrorist financing is managed in the UK, with the financial services industry taking a more risk-based approach to the international fight against financial crime.

## The UK anti-money laundering regime

The UK anti-money laundering regime is contained in various Acts, regulations, rules and industry guidance, and the JMLSG Guidance Notes are just one piece of an ever increasingly complex jigsaw. The revised Guidance Notes, however, take a new approach, placing far greater emphasis on risk analysis than simply ticking boxes, and it is hoped that this will enable firms to adopt more appropriate, risk-based procedures to combat financial crime.

One of the key components of the revised Guidance Notes is to place responsibility for financial crime firmly on senior management's shoulders, with the aims of:

- allowing firms to focus their resources on the minority of customers who represent a higher risk;
- reducing the documentation needed to verify the identity of non-personal customers;

- simplifying the document requirements by which most individuals have to "prove" their identity;
- encouraging wider use of electronic means of verification of identity;
- reducing unnecessary duplication of identity checks; and
- providing additional guidance, tailored to particular business areas, to take account of special features in a number of sectors.

The Guidance Notes are in two parts: Part I gives generic guidance that applies across the UK financial sector, and Part II comprises extensive additional guidance aimed at particular sectors.

## Key changes in the revised guidance

*Senior management responsibility* - although this receives much more emphasis in the revised guidance, it is not a radically new concept: senior managers apply proportionate risk-based policies across all aspects of their firm's business, and have ultimate responsibility. However, their role will increase with the wider use of a risk-based approach, which will require firms to assess their vulnerability to money laundering and/or terrorist financing, and have systems and procedures to manage this, rather than the box-ticking approach previously adopted by many firms.

*Risk based approach* - although earlier JMLSG guidance had recommended a risk-based approach, until now it had not provided guidance on how it might be applied.

This demonstrates a key change in emphasis. The revised guidance encourages firms to assume that most customers are not money launderers, but to have systems in place to highlight those customers and situations which, on the basis of the firm's assessment, may indicate that they present a higher risk. The guidance does not prescribe in detail the approach that firms should adopt, but outlines the stages that such an approach should encompass and the questions that a firm should ask itself at each stage. This is supplemented by sector-specific advice.

*Simplification of customer identification* - there are some significant changes in this area. The guidance:

- distinguishes for the first time between the information about a customer that a firm should obtain, and the extent to which it should be required to verify it;
- recognises that the standard level of identification for individuals is capable of being met, at least in face-to-face situations, by a single document. This is a major departure from the current approach of a "Passport/driving licence and utility bill", which has been the cause of negative comment from customers and the media;
- contains new guidance on how to deal with those customers that cannot reasonably be expected to have standard identification;
- provides clearer, simpler identification procedures where more than one firm is involved in a single transaction, designed to avoid the customer being asked to produce ID documents more than once; and
- enables firms to rely on "confirmations" provided by other regulated firms that have already undertaken due diligence. This should assist in reducing the compliance burden.



Initial ID and ongoing checks - the guidance represents a better balance between initial identification procedures and ongoing monitoring activity of customers' accounts to identify unusual and potentially suspicious transactions, and to collect additional KYC information. The guidance recommends that firms consider this against the risks that they face and the nature of the products that they provide.

#### FSA position

The guidance takes account of the FSA's announcement last summer of its decision to delete the detailed rules in its Money Laundering Sourcebook entirely. They will be replaced with requirements for firms to have their own risk-based controls on money laundering. The changes to the FSA rulebook will come into force at the beginning of March, but there will be a transitional period until August to enable firms to become fully compliant. Existing government regulations will remain in place, supplemented by industry guidance, such as the JMLSG Guidance Notes.

The attitude of the FSA towards a risk-based approach, and in dispelling the "fear factor" of sanctions if a firm's decision in a particular situation turns out to be misjudged, will be crucial. It was reported<sup>5</sup> that Philip Robinson had indicated in a letter to the JMLSG that if a firm demonstrates that it has effective systems and controls to identify and mitigate its money laundering risk, enforcement action by the FSA is very unlikely, and that a risk-based approach cannot be a zero-failure regime, not least because a 100% standard will not be cost-effective. These assurances are welcomed.

#### Looking forward

There will be a six-month transitional phase from HM Treasury approval to implement the revised Guidance Notes. However, many firms are already applying a risk-based approach to their AML procedures, and thinking about the impact of the revised Guidance Notes.

Firms should start planning now for the introduction of the new Guidance Notes. At a minimum, they should be considering with senior management what their current and planned product range is and will be, what jurisdictions they are operating in, and the classes of client they deal with, and then assessing where the risks lie and implementing appropriate policies and procedures.

#### SOCA

SOCA will become operational from 1 April 2006 and will bring together the responsibilities which currently fall to the National Criminal Intelligence Service, the National Crime Squad, Home Office responsibilities for organised immigration crime and the investigation and intelligence responsibilities of HM Revenue & Customs in tackling serious drug trafficking and recovering related criminal assets.

#### Lander Review

Sir Stephen Lander, chairman of SOCA, has been asked by the Chancellor and the Home Secretary to undertake a review on how SOCA can make best use of SARs. The final report of the Lander Review is expected to be delivered in March 2006. It is believed that the review will deal with, amongst other things, issues of consent and the threshold amount specified under the Serious Organised Crime and Police Act 2005.

#### Third EU Money Laundering Directive

The Third EU Money Laundering Directive was formally adopted on 26 October 2005. The Directive entered into force on 15 December 2005, meaning that it will need to be implemented by 15 December 2007. The aim of this directive is to consolidate and revise the previous EU money laundering directives, to take account of the revised international standards in this area. The Directive updates and strengthens a wide range of standards over fighting money laundering, and provides a common EU framework for applying the revised 2003 Financial Action Task Force Recommendations on Money Laundering. Particular features of the Directive are that it requires firms to pay more attention to the risks of terrorist financing, and it increases their obligations as regards Customer Due Diligence. The Directive will, once implemented in the UK, have significant implications for FSA-regulated firms.

#### National Fraud Review

The fraud review was announced by the Attorney General, Lord Goldsmith QC, in October last year and is due to report this spring. This review is seen as a key step towards the development of a national fraud strategy, by helping to create a better understanding of the scale and nature of the problem.

For further information, please contact Daren Allen, Partner, or Karim Bouali, Solicitor, on 020 7796 6824 and 020 7796 6240 respectively.

<sup>5</sup> In the notes of a speech given by Ian Mullen at the FSA's Annual Financial Crime Conference held on 15 November 2005

# M&G - one year on

After N(M) and N(GI), the FSA's first priority was to check that affected firms had either applied for authorisation, sought appointed representative status or ceased regulated activities.

Findings in relation to both sectors were encouraging, suggesting that the publicity campaigns carried on by the FSA and trade associations in 2004 had largely hit home. It was also able to claim success in dealing with the authorisation process, with more than 600 firms either being refused permission or withdrawing their applications to conduct mortgage and/or general insurance business.

Details of some of the FSA's key reviews and findings during 2005 are set out below, together with a look at what it plans for 2006.

## General insurance

### Payment Protection Insurance ("PPI")

The FSA's investigations into PPI uncovered poor levels of compliance, particularly among firms selling into the sub-prime mortgage, revolving credit and unsecured loan sectors. Concerns included inappropriate sales, poor quality of advice and a lack of explanation of policy exclusions and limitations.

In response, the FSA produced a "Dear CEO" letter in November setting out ways for PPI firms to improve their compliance position, including conducting eligibility checks to ensure customers are sold only policies on which they can claim, and switching from selling policies on a non-advised to an advised basis where a firm feels that it cannot put in place adequate controls to prevent advice being given.

The FSA found that some firms reviewed had extremely high penetration rates for PPI, which it took as suggesting that unsuitable policies were being sold. The FSA will expect firms to have in place the systems and controls to detect such warning signs. Given the publicity which the mis-selling scandals of the last decade have received, firms which continue to sell unsuitable policies cannot expect leniency.

### Disclosure documentation

PPI figured again in the FSA's review of disclosure documentation. It found that many policies were unclear and overly complex. The same criticism applied to critical illness and income protection policies. More generally, the FSA identified quality issues around presentation and length of documents. The FSA wants documents to be as helpful to consumers as possible, and firms which continue to produce disclosure that is confusing can expect further action.

## Mortgages

### Sub-prime mortgages

The FSA's work in the sub-prime sector yielded mixed findings. On the negative side, many of the files reviewed showed that firms were not taking steps to obtain information from customers in key areas, without which they could not show they had recommended an appropriate product. Again, the key point is suitability - or rather the ability of firms to demonstrate it has been addressed!

On the upside, many firms were going beyond the requirements of the Mortgages: Conduct of Business Sourcebook ("MCOB") by, for example, reviewing a customer's product once their credit profile had improved, with a view to transferring them onto a prime mortgage. Again, follow-up work in the sub-prime sector is planned.

### Equity release

The FSA has long regarded equity release as a high-risk area, and its findings in 2005 were disappointing. In assessing standards of advice it found that more than 70% of advisers did not gather enough information about the customer to assess their suitability. The FSA will be scrutinising the sector intensively in 2006 and firms should ensure that they are getting adequate information from their customers, assessing suitability properly and documenting their advice clearly.

### Disclosure documentation

Finally, as with general insurance, the FSA undertook a review of disclosure documentation. While acknowledging the efforts firms had made to produce the documents, the FSA identified excessive length, failure to use prescribed formats and use of jargon as problems to be addressed.

## The year ahead

Perhaps the most significant planned change is the extension of the regime to cover home reversion schemes and Ijara Home Purchase Plans. The FSA will start consultation on the rules governing these activities in April 2006. Firms active in these markets should be beginning to turn their minds to making the necessary applications for authorisation or variation of permission, as the case may be.

PPI will continue to figure largely. The FSA will conduct a second round of work this year, and it is likely to want to see firms explaining policies properly to customers, and that the risk of sales of unsuitable policies is minimised. Firms in this sector will need to give serious consideration to applying the practical measures outlined in last year's "Dear CEO" letter, if they have not done so already.

Having reviewed compliance with client money rules in the wholesale insurance sector in 2005, the FSA will move on to the retail sector in 2006. A report is expected in April.

Equity release will also remain under the microscope, as the FSA revisits the work it undertook in 2005. It explicitly stated, when releasing the results of that work, that it was not ruling out the use of its enforcement powers. It seems highly likely that firms which have not taken steps to improve their information-gathering and the quality of their advice can expect strong action from the FSA.

Finally, mention must be made of the TCF initiative. TCF underpins much of the sector-specific work pursued by the FSA in 2005, including PPI and equity release. Indeed, in its first enforcement cancellation case against a general insurance firm on conduct of business grounds,<sup>6</sup> the FSA cited breach of Principle 6 - the heart of TCF - as one of the grounds for cancelling the firm's permission. Xsavi Limited had misrepresented the position in relation to the availability of travel insurance to consumers, which could have left them without cover, and had thus treated them unfairly.

TCF is certain to remain at the top of the agenda, and the holistic approach which the FSA takes to it - encompassing everything from product design to scrutiny of management information - means that firms should continue to examine their businesses this year every bit as carefully as they did in 2005.

For further information, please contact John Ahern, Partner, or Joanne Wardale, Barrister, on 020 7796 6782 and 0113 369 2676 respectively.



"TCF underpins much of the sector-specific work pursued by the FSA in 2005, including PPI and equity release... TCF is certain to remain at the top of the agenda."

<sup>6</sup> See FSA Press Notice dated 21 February 2006 (FSA/PN/013/2006) in relation to Xsavi Limited

# The Consumer Credit Bill

The Consumer Credit Bill is due to have its third reading in the House of Lords within the next few weeks and could come into force some time during 2006. The Bill marks the next stage in the Government's agenda for reform of the UK's Consumer Credit laws which was set down in the White Paper of December 2003.

It will present a fresh set of challenges to lenders who are still coming to terms with the recent raft of changes to consumer credit laws covering, amongst other things, advertising, the layout of credit agreements and new early settlement calculations.

## Changes ahead

The Bill contains a number of significant measures:

- It will remove the current financial limit of £25,000, with some exceptions for business lending and high net worth individuals.
- It will replace the existing rules on extortionate credit bargains with a new test based on the concept of the "unfair credit relationship".
- It will introduce new requirements for lenders to give debtors more detailed information about the state of their agreements throughout the life of those agreements.
- It will make significant changes to the licensing regime and will also grant the Office of Fair Trading ("OFT") considerably increased powers to intervene when they identify behaviours of which they do not approve.
- It will introduce a new alternative dispute resolution system by extending the jurisdiction of the Financial Ombudsman Service ("FOS") to consumer credit agreements.
- It will remove those provisions under section 127 of the Consumer Credit Act 1974 ("Act") which can make regulated agreements wholly unenforceable so that in future the court will have a discretion as to whether to enforce them or not.

Each of these measures is discussed further below.

## Financial limits

The Bill proposes to remove the current financial ceiling of £25,000 for all "consumer lending". However, the definition of "individual" will be changed so that the current ceiling will be retained for business lending to partnerships with three partners or fewer.

It will clearly be important for a lender to understand when he is lending for business purposes, and new regulations will be introduced which will allow debtors to declare that the credit has been advanced for "wholly or predominantly" business purposes.

The Bill will also provide a mechanism through which individuals who are deemed to be of "high net worth" may elect to waive the statutory protections provided by the Act. It seems probable that a high net worth individual will be defined as a person having an income of at least £100,000 in the preceding financial year, or assets of not less than £250,000 in that year. Where agreements are entered into by two or more individuals, then each of them will need to provide the requisite statement.

Final details of the declarations which will need to be made to confirm that lending is for business purposes, and how the high net worth arrangements will work in practice, are to be provided in secondary legislation.

## Unfair credit relationships

The Government believes that the extortionate credit bargain provisions in the Act have not been effective in providing a remedy to debtors where the behaviour of the lender has been unfair and detrimental to the debtors' interests. Accordingly, the Bill will introduce a new concept of "unfair credit relationship" which will allow the court to examine not only the terms of the credit agreement, but also the conduct of the

parties, both before and after the agreement was made.

It seems apparent that the new test will represent a lower threshold for debtors to cross, but what remains unclear is what is meant by "unfair" behaviour. During parliamentary debates there has been no discussion on the meaning of unfairness. The OFT will be required to provide some guidance but, ultimately, it seems likely that we will have to wait for the courts to determine the meaning.

In addition, the application of the concept of unfairness appears to be very wide. It is concerned with the relationship between the lender and debtor and not just the terms of the agreement between them. A relationship may be deemed to be unfair as a result of the terms of the credit agreement, how the lender has exercised or enforced his rights during the lifetime of the agreement and any other thing done (or not done) by or on behalf of the lender either before or after the making of the agreement. In each case the concept will extend to any related agreement entered into by the debtor. If a relationship is found to be unfair, then the courts will have wide-ranging powers, including to require lenders to repay sums already received, reduce or set aside sums due from the lender and alter the terms of the credit agreement.

The proposals do give rise to some concerns. They are clearly wide ranging but there is, as yet, little clarity on the meaning of unfairness. The Bill appears to shift the burden of proof so that, if a debtor alleges unfairness, it is up to the lender to prove the contrary. The provisions will also have some retrospective effect on longer-term agreements which could have been entered into before lenders were aware of the new provisions, which could cause problems if the agreements have been assigned or securitised.



### Provision of information

In line with the Government's stated objective of making credit agreements more transparent, the Bill imposes more obligations on lenders to keep debtors informed about the state of their account. Broadly, these amended requirements will apply to both new and existing agreements.

The new requirements include the following:

- Lenders will be required to issue annual statements on all fixed-sum credit agreements that have a term of more than 12 months. There will be sanctions for failure to provide such statements, including precluding lenders from charging default interest and fees or enforcing agreements during the period when they are in breach.
- Lenders will be required to issue an arrears notice 14 days after an account goes into arrears. The notice will need to include information about the arrears, any fees and charges which may be payable, and the options available to the lender. Again, there will be sanctions for failure to comply, including releasing the debtor from having to pay interest or penalties relating to the period of non-compliance.
- New information will also have to be included in default notices. This will include information about whether interest will be charged on the outstanding debt after a judgment has been obtained and, on hire purchase and conditional sale agreements, a notification of the customer's right to voluntarily terminate upon payment of half of the total purchase price.

### Licensing

The Bill will make a series of changes to the current licensing regime with the intention of allowing the OFT to control licensing more

effectively. It aims to reduce the regulatory burden on consumer credit businesses that are fit to hold licences, allowing the OFT to focus on those which may not be.

The Bill will introduce a stricter requirement to establish whether an applicant for a licence is a fit and proper person. The OFT will produce guidance on the types of conduct it expects from licence holders. The range of factors which the OFT may take into account is very wide including, for example, any breaches of the Act, acts of discrimination or unfair or improper business practices and the actions of the applicants, its employees and its agents.

The OFT will be given powers to require the provision of information by licence holders if they are concerned about the licence holder's fitness. They may also require access to business premises to inspect any documents and review how the licence holder is carrying on its business. The OFT will be able to apply a wide range of sanctions where it identifies conduct of which it disapproves, including the levying of fines of up to £50,000. It will also have powers to vary a licence if it feels it appropriate to do so.

Following comments made in the Hampton Report, there has been some debate about whether the OFT is the appropriate body to regulate consumer credit, or whether this role should be fulfilled by the Financial Services Authority. However, Sir Callum McCarthy, the FSA's chairman, has suggested that the FSA is not the right regulatory body for this role.

### Alternative dispute resolution

The Bill will establish a new dispute resolution service to deal with consumer credit disputes which will be administered through the FOS. The intention is to introduce a new system which will allow for

the cheap, efficient and quick resolution of consumer disputes at considerably less cost than court action. The Government also feels that many debtors find taking court action far too daunting, so the new service will provide an easy means of seeking redress for a much wider range of debtors.

It is intended that the scheme will be free for debtors but businesses will be required to pay a case fee when a complaint is handled by the FOS. The fee is expected to be around £360, although the first two complaints each year will be free to lenders.

### Enforceability of regulated agreements

Under section 127(3)-(5) of the Act, the court has no discretion to enforce credit or hire agreements which do not contain certain prescribed terms. The Bill proposes to repeal these provisions so that it will no longer be the case that relatively minor technical breaches of the complex rules regarding the form and contents of agreements can result in agreements becoming wholly unenforceable. Given the proposed removal of the financial limit for most consumer credit business, this is a helpful change.

### Conclusion

We do not yet have a firm date for when the Bill will come into force, but the changes it will bring about will present further risks and challenges to consumer credit businesses.

Our team of lawyers specialising in consumer finance issues can advise on all aspects of the Bill, and consumer credit law in general.

For further information, please contact Jeff Vernon, Associate, on 0151 237 4766.

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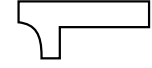
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