

# Key issues for fund managers

## Market rumours

In conjunction with FSA's continued focus on tackling market abuse which we commented on in our last update of November 2008, FSA has also conducted a thematic review project to look at firms' systems and controls to deal with market rumours. Hedge fund managers, amongst others, have been involved with this work. FSA has reviewed firms' procedures and policies to handle market rumours and published its findings in Market Watch 30 in November 2008. This paper gave examples of good and bad practice and also gave an example case study of how market rumours should be dealt with. Hedge fund managers should be aware of the need for suitable guidelines and formal policies for handling rumours, the need for adequate training for employees and finally the need for appropriate monitoring of communications and trading including retrospective investigation of communications surrounding suspicious price movements.

The full text of the market watch can be found at [http://www.fsa.gov.uk/pubs/newsletters/mw\\_newsletter30.pdf](http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter30.pdf).

## Short selling

As expected, FSA lifted the short selling ban on 16 January 2009. In FSA's view, the market conditions that initially made the ban necessary no longer persist and it emphasised again that short selling is a "legitimate technique" in normal market conditions.

The disclosure requirement, which was introduced by the FSA at the same time as the ban, however, remains in force (in an amended form) until 30 June 2009 and will continue to act as a deterrent to abusive market behaviour.

This time around, FSA did give the market a short consultation period (5 days) to respond to its proposals (CP09/1 "Temporary short selling measures"). FSA received an impressive 33 responses, the majority of which were in favour of FSA's proposal to:

1. allow the ban to expire
2. retain the disclosure obligation but in an amended form until 30 June 2009.

Our summary of the new measures applicable in the UK following FSA's consultation and an update on the status of the EEA short selling measures can be found at <http://www.law-now.com/shortselljan09.htm>.

There is a clear shift away from the urgency with which these measures were brought into force last September. The focus is no longer on 'fire-fighting' but on consulting with the market and other regulators on long-term solutions.

FSA will consult shortly on its long-term proposals, focusing on the wider market, and we will update you on this once this consultation commences.

## Changes to the approved persons regime

FSA has decided, post Northern Rock, to increase the rigour of its day-to-day supervision, especially where the competence of firms' management is in issue, and has therefore reviewed its approach to the significant influence controlled functions. These proposals are contained in the FSA Consultation paper CP08/25 The Approved Persons Regime - significant influence function review which can be found in full at [http://www.fsa.gov.uk/pubs/cp/cp08\\_25.pdf](http://www.fsa.gov.uk/pubs/cp/cp08_25.pdf)

The key proposals include:

- Extending the definition of the existing CF1 (director) and CF2 (non-executive director) controlled functions to include individuals exercising significant influence on a regulated firm from a parent undertaking or holding company unregulated by FSA or an EU financial services regulator;
- Clarifying the role of non-executive directors;
- Extending the definition of the CF29 controlled function to include all proprietary traders. Recent events suggest that the risks of proprietary trading in firms and the current market situation now warrant review of the position of all proprietary traders in relation to the approved persons regime. FSA considers the ability to take enforcement action may assist in deterring both senior and junior proprietary traders from undertaking activity for short term advantage that is either unauthorised,

exposes the firm to risk of financial failure or jeopardises confidence in UK markets.

For further detailed information and commentary please go to <http://www.law-now.com/law-now/2009/approvedpersonsjan09.htm>.

## European developments

The European Parliament has carried out a review to assess whether action is needed at European level in relation to hedge fund investment. In the UK, FSA has stated that it is satisfied with industry-led initiatives and regulation of hedge fund managers alone, but it has made clear that the position should be monitored.

The European Parliament's Committee on Economic and Monetary Affairs (ECON) published the 'Rasmussen' Report in April 2008 which was adopted by European Parliament in September 2008. This report makes proposals to the Commission to take various measures in relation to the hedge fund industry (and private equity). The proposals include:

- frequent reporting and disclosure to increase transparency;
- common global standards for portfolio valuation and internal governances;
- better risk management;
- enhanced counterparty risk regulation;
- more effective overall supervision; and
- enhanced cooperation between supervisory authorities across the EU.

The European Parliament has also asked the Commission to consider more generally reviewing existing financial services regulation to identify any legislative gaps regarding hedge funds.

The European Parliament's Committee on Legal Affairs (JURI) also published a report in August 2008, the 'Lehne' Report (A6-0296-2008), on transparency of institutional investors. This report also makes proposals for the Commission to consider. In particular the Lehne Report proposes that a directive be implemented to guarantee a common standard of transparency to tackle issues in relation to hedge funds. Both these reports call for a European overlay to regulation of hedge funds (and private equity).

In response to the above reports, on 18 December the European Commission launched a consultation on hedge funds. Responses to the Consultation must be submitted by 31 January 2009. It is anticipated that initial

recommendations will be published in February 2009 and discussed at a high-level conference in late February.

The consultation paper is available at: [http://ec.europa.eu/internal\\_market/consultations/docs/hedgefunds/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/hedgefunds/consultation_paper_en.pdf).

The consultation paper sets out five areas on which further information and evidence is sought from interested parties:

- The first area considered by the paper is how hedge funds should be defined. The paper notes some common characteristics of hedge funds such as the investor base (mainly institutional investors), the investment strategies and the focus on delivery of absolute returns. The paper notes that the organisation of hedge funds and the principal actors (hedge fund managers, the fund itself, the administrator and the prime broker) may differ across member states and as a result the policy response must take into account these differences.
- The second area considered by the paper is the systemic risks posed by hedge funds. The paper notes that hedge funds may pose risks to the stability of the financial system due to their volume and frequency of trading. This has not traditionally been the view, and the paper asks respondents whether there should be a reassessment of the systemic relevance of hedge funds.
- Thirdly, the paper considers market efficiency and integrity. Short selling is mentioned as a main concern although the extent of this practice is unclear. Respondents are asked to indicate to what extent they consider short selling threatens market stability. Market rumours and other abusive practices such as manipulative actions are also key concerns. The paper asks respondents whether they think controls need to be 'tightened up' in this regard.
- The fourth area covered is risk management. Hedge funds are not immune from liquidity risks. The Financial Stability Forum has called for hedge funds to improve their risk management processes. Currently industry codes have been implemented, and the paper asks whether a regulatory initiative should be introduced as well.
- Finally the paper asks respondents their views on transparency towards investors and investor protection. The paper concludes generally that there are 'frailties in hedge fund operating models' that might 'warrant closer prudential oversight'.

It is anticipated that the responses to the Consultation and the Commission's recommendations will be used as the basis of a European regulatory initiative for the hedge fund industry, and this should be announced in

June 2009. The Commission's recommendations will also form the basis for EU input into the parallel reflections on hedge funds at international level by the G20 and IOSCO.

Although the European Parliament and Commission have been taking steps to review the risks posed by hedge funds in light of recent market turmoil, Mr McCreevy the European Commissioner for Internal Markets, has made it clear in a speech in September 2008, that hedge funds' role in economic contraction should not be overstated.

## International developments

The G20 summit on financial markets in November 2008 had the objective 'to ensure that all financial market product and participants are regulated or subject to oversight as appropriate to their circumstance'. Following this summit, IOSCO decided to establish a task force, the Technical Committee Task Force, which will take action to address the main concerns in global economies. Of particular interest to hedge fund managers is that the Task Force will be examining unregulated financial entities, such as hedge funds. It will look at the issues surrounding these entities and consider if any regulatory approach should be developed to mitigate the risks posed by their trading and 'traditional opacity'. It is anticipated that the Task Force will present their reports in meetings in February 2009 and this will be inputted to the G20 summit in the Spring 2009.

## Industry standards of best practice gaining pace

FSA is focussing on systems and controls across the spectrum of firms, including hedge fund managers. In particular FSA has stated the importance of transparency, scenario planning and stress testing. FSA supports industry-led initiatives in this area which include the Hedge Fund Standards Board ('HFSB') standards of best practice and has said that it will take these into account

when making supervisory judgements. These standards were published in January 2008. Firms sign up on a comply or explain basis.

After a slow start, a number of fund managers have signed up to these standards, with 33 having signed up as at 15 December 2008 and we expect to see more signing up this year.

## Telephone taping

Finally, hedge fund managers should be aware of, and prepare for, FSA's new rules on telephone taping that will come into force on 6 March 2009. Firms that receive client orders, negotiate, agree or arrange transactions across the equity, bond and financial commodity and derivative markets, are required to take reasonable steps to record all conversations and electronic communications which conclude, or are carried on with a view to concluding, an agreement. The rules do exclude discretionary fund managers in respect of their communications with other firms who are subject to the taping rules and also with those who are not provided such communications are infrequent and a small proportion of the total relevant communications made. Firms are required to retain these recordings for a minimum of six months.

The full text of the rules can be found at:  
[http://www.fsa.gov.uk/pubs/policy/ps08\\_01.pdf](http://www.fsa.gov.uk/pubs/policy/ps08_01.pdf)

## Contact our team at CMS Cameron McKenna



### **Simon Morris**

Partner, Financial Services

T +44 (0)20 7367 2702

E [simon.morris@cms-cmck.com](mailto:simon.morris@cms-cmck.com)



### **Alison McHaffie**

Senior Counsel, Financial Services (Disputes)

T +44 (0)20 7367 2785

E [alison.mchaffie@cms-cmck.com](mailto:alison.mchaffie@cms-cmck.com)

## **Law-Now™**

CMS Cameron McKenna's free on-line information service

Receive expert commentary and analysis on key legal issues affecting your business. Register for free email alerts and access the full Law-Now archive at [www.law-now.com](http://www.law-now.com)

CMS Cameron McKenna LLP  
Mitre House  
160 Aldersgate Street  
London EC1A 4DD  
T+44 (0)20 7367 3000  
F+44 (0)20 7367 2000

CMS Cameron McKenna LLP is a limited liability partnership registered in England and Wales. It is able to provide international legal services to clients utilising, where appropriate, the services of its associated international offices and/or member firms of the CMS alliance. The associated international offices of CMS Cameron McKenna LLP are separate and distinct from it.

CMS Cameron McKenna LLP and its associated offices are members of CMS, the alliance of independent European law firms. Alliance firms are legal entities which are separate and distinct from CMS Cameron McKenna LLP and its associated international offices. CMS offices and associated offices worldwide:

Amsterdam, Berlin, Brussels, London, Madrid, Paris, Rome, Vienna, Zurich, Aberdeen, Algiers, Antwerp, Arnhem, Beijing, Belgrade, Bratislava, Bristol, Bucharest, Budapest, Buenos Aires, Casablanca, Cologne, Dresden, Dusseldorf, Edinburgh, Frankfurt, Hamburg, Kyiv, Leipzig, Ljubljana, Lyon, Marbella, Milan, Montevideo, Moscow, Munich, New York, Prague, Sao Paulo, Sarajevo, Seville, Shanghai, Sofia, Strasbourg, Stuttgart, Utrecht, Warsaw and Zagreb.

[www.cmslegal.com](http://www.cmslegal.com)

The members of CMS are in association with The Levant Lawyers with offices in Beirut, Abu Dhabi, Dubai and Kuwait.