



## DIPLOMA SUMMER 2009 EXAMINATION

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### REGULATION AND COMPLIANCE

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<b>DATE OF EXAM</b>	Tuesday 23 June 2009
<b>3 Hrs 15 mins</b>	10.00 am – 1.15 pm
<b>RUBRIC</b>	SECTION A - <i>ALL</i> questions in this section are to be answered SECTION B – Answer <i>QUESTION 11</i> and <i>ONE</i> other in this section SECTION C – <i>TWO</i> questions in this section are to be answered

**Candidates are reminded that no marks will be awarded for illegible work**

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#### NOTES TO CANDIDATES

1. Please insert your Candidate Number on the cover of your Answer Book. *Do not insert your name.*
2. Show *all* workings in your Answer Book.
3. Candidates may attempt the sections in any order. Please indicate clearly in your Answer Book which questions you are answering.
4. Please insert in the box provided on the cover of your Answer Book the numbers of the questions you have attempted in the order in which they appear in the Answer Book.
5. You may use the calculator provided or one approved by the Securities & Investment Institute.
6. You must hand your Answer Book to an invigilator before you leave the Examination Hall. *Failure to do so will result in disqualification.*
7. Once submitted, the examination scripts become the property of the Securities & Investment Institute and will not be returned to candidates.

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**PLEASE TURN OVER WHEN INSTRUCTED**

**USE ANSWER BOOK A FOR THIS SECTION****Answer ALL questions in this section**

- 1 Identify the main threshold conditions set out in Schedule 6 of the Financial Services and Markets Act 2000 (FSMA). *(3 marks)*
- 2 Explain the difference between authorisation, permission and approval under ss 19, 20 and 59 of the FSMA. *(4 marks)*
- 3 Identify six of the regulated activities covered by the FSMA. *(2 marks)*
- 4 What information must a firm obtain in order to assess appropriateness and suitability under the Handbook of Rules and Guidance issued by the Financial Services Authority (FSA)? *(4 marks)*
- 5 Explain the two different types of professional client covered by the revised Conduct of Business Rules (COBS) contained in the FSA's Handbook of Rules and Guidance. *(2 marks)*
- 6 List any three general principles set out in the City Takeover Code. *(3 marks)*
- 7 Explain the general purpose of the CASS sourcebook within the FSA's Handbook of Rules and Guidance. *(2 marks)*
- 8 List the main compensation amounts payable under COMP in the event of the collapse of a bank, a securities firm and an insurance undertaking. *(3 marks)*
- 9 Explain the role and function of the Financial Services and Markets Tribunal as set out under Part IX of the FSMA. *(3 marks)*
- 10 List four of the principles set out in the Securities and Investment Institute's Code of Conduct. *(4 marks)*

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## USE ANSWER BOOK B FOR THIS SECTION

## Answer QUESTION 11 and ONE other question in this section

- 11 You work in the Far East for PB Private Bank which is a part of a large multinational financial services group (MSG) with your firm's client profile being principally ultra high net worth individuals and families.

Among this group of clients is the Chang family whose wealth derives from a highly successful manufacturing business. Five years ago, the founder of the business died leaving his 3 sons to run the business and with a financial interest each but with his wife holding a controlling financial interest although taking no part in the management.

Under the direction of the sons, the business has continued to prosper to the point at which they wish to expand significantly although this has produced tensions with regard to the way in which this could be achieved. Due to the close nature of their relationship with the Private Bank, the Changs have maintained their commercial banking interests within your group at MSG and have only taken advice on their financing discussions from MSG until now.

PB's relationship manager responsible for the Changs' non-commercial interests is JM who has been based in the Far East for many years. Since JM's wife is a family friend of the Changs, you believe that the relationship with the Changs is secure. Consequently you have every expectation that, whatever form of financing is deemed appropriate, the investment banking arm of MSG (MSGIB) will win the mandate for the new instructions.

In due course, you learn that the Changs have discussed the various options available with MSGIB who have suggested that they should consider raising the funds through a 'bought deal' with 60% of the shares being issued to outside professional investors. This would reduce the Chang family's holding to 40% of the capital of the company, with Mrs Chang's interest being diluted to 20% overall. She is not happy with this proposal as she sees herself as the guardian of her late husband's legacy, over which she will then have little influence.

As Mrs Chang's agreement is essential to the new financing proceeding in the manner envisaged, MSGIB have asked that PB try to convince her to accept the proposal, explaining, among other things, that she will receive a large amount of money from the sale and will still own a substantial piece of the business. MSGIB analysts believe the business is likely to become even more successful following the external capital injection.

JM accordingly arranges a meeting with Mrs Chang to try to resolve the issue and afterwards advises you that Mrs Chang considers that the deal is designed solely to enrich her sons and the bank at the expense of the business. She has nevertheless suggested to JM that in light of the Changs' long friendship with JM's wife, the only

way in which she would agree is if JM is made a non-executive director of the business to manage Mrs Chang's interests. JM informs you that he considers that this is a good idea, as he would then be able to look after Mrs Chang's interests at the same time as those of all of PB's other clients.

JM further believes from conversations with MSGIB, that they will expect PB's client managers to recommend investment in the issue to their clients or, where they are discretionary managers, to buy on their clients' behalf. JM also believes that the issue will be substantially sold to MSG Fund Management's Far East Fund.

You are concerned about the potential conflicts of interest that may arise. While some of them may be resolved, you are not clear whether the full implications of these potential conflicts have been fully considered and the potential damage that this may cause to the bank's reputation especially in the private client area.

- a) Explain the various conflicts of interest that may arise with regard to Mrs Chang, JM, MSGIB, PB or elsewhere. *(16 marks)*
- b) How should Private Bank and MSG deal with the proposal? *(4 marks)*

- 12 During the course of a successful diplomatic career, CD established close contacts with British mining companies operating in South American countries. Following retirement from HM Diplomatic Service, he was invited to sit on the Board of an oil and gas exploration company, OAGE plc (OAGE), operating in Peru. The company is AIM listed and CD accepted the appointment in a non-executive capacity. At the same time, CD was a Director and major shareholder in an Isle of Man incorporated holding company, SDH Ltd (SDH), set up with colleagues as an investment vehicle in promising AIM listed companies operating in South and Central American countries.

Shortly after CD joined the Board of OAGE, the company discussed tendering for oil exploration opportunities in Peru, for which certain awards and approvals were required from the government. Additionally, OAGE was looking for a partner to engage in the project as the Board's view was that the project may significantly overstretch the company's resources. CD was not present at all of the discussions that took place in relation to these matters, although he had received paperwork in advance of Board Meetings where these matters were discussed and was therefore fully aware of the company's plans.

At the time CD joined OAGE, he had personally purchased a modest number of shares in the company. SDH Ltd had also invested in the company on a long term investment basis although the holding company's investment had been made before CD's appointment to OAGE. As OAGE's discussions with various parties progressed and entering into a partnership agreement with another oil and gas exploration company appeared to be imminent, SDH invested heavily further in OAGE at CD's suggestion. The minutes of the relevant meetings recorded that the decisions to buy further shares were made based on a steady rise in the share price over time. SDH purchased shares in OAGE on four occasions during the period of negotiations with the partnership company and the Peruvian government. At the

same time, CD made substantial purchases for his own account through his usual broker. At no time did CD discuss any of the developments at OAGE with his fellow Directors of SDH nor did he advise OAGE of his purchases of shares in OAGE or of the purchases by SDH in OAGE.

OAGE subsequently announced its proposed partnership agreement with the other oil and gas exploration company, although this was still subject to winning the tender and obtaining the relevant awards and approvals from the Peruvian government. The reception of the news caused a substantial rise in the company's shares. The second announcement made by the company, confirming the partnership agreement and the required awards and approvals from the Peruvian government, again resulted in a further rise in the share price.

Shortly after the public announcement of the successful tender for the Peruvian project, SDH invested in a further substantial number of shares. CD meanwhile sold the shares that he had bought during the period of negotiation, reducing his personal investment to the level it had been when he first joined OAGE and effectively doubling his money on the investments made over that period.

- a) Discuss at which point, or points, CD might be considered to be committing market abuse and the type of market abuse. *(4 marks)*
  - b) Discuss whether SDH has committed market abuse at any time. *(4 marks)*
  - c) Is there anything inappropriate in the final purchase of shares by SDH after the announcement of the tender? *(4 marks)*
  - d) Discuss any potential exchange requirements that may have been breached as a result of CD's behaviour. *(4 marks)*
  - e) If subject to enforcement action by the FSA, what penalties might be imposed by the FSA on CD and/or SDH? *(4 marks)*
- 13 You are the Compliance Officer and Money Laundering Reporting Officer (MLRO) of an FSA regulated asset management firm based in the West End of London. You receive a visit to your office from Gemma, a senior investment manager, who asks you to look up a news item on the internet about one of her recently acquired clients.

You read that the client has been arrested on suspicion of tax evasion in the UK. You further note that the client is a Member of Parliament (MP) in the Eastern European country where he has been arrested. Linked to the news items is a press statement prepared by a City of London based public relations firm (PR firm), instructed by Gemma's client. The press release indicates that the arrest is an attempt by the government of his country to 'gag' your client from speaking out against the government's human rights policies. Gemma is clearly surprised to hear of her client's arrest and explains that she considered him to be a 'very nice chap' and a champion of international human rights although she had never met him in person.

Gemma then shows you a signed letter received from her client, the day before his arrest, giving written permission for his PR firm and his wife to instruct your firm about the management and distribution of his investments which included the realisation of part of the fund up to the sum of £250,000 with the total current value of the fund being £1.25M.

Gemma also produces two e-mails, one from the PR firm and one from the client's wife which were received late last night and this morning respectively. Both request that certain named cash investments are realised and part of the monies transferred to the PR firm's bank account held at a UK retail bank and the balance to the client's wife's private bank account in Jersey. Other e-mails from the client's wife request that the funds are transferred immediately to allow her to her husband's legal fees, pay a sum of money into court to secure her husband's release on bail and pay other outstanding medical bills. The wife is due to call Gemma in the next hour to discuss the transfer of funds.

On reviewing the file you note that there is very little client identification material on record. You ask Gemma about this and she replies that as her client had been referred to her former employer, the private wealth management division of a large accountancy firm, and as he was an MP, she had not sought client identification when she had opened the client's account.

Gemma further comments that when she joined the firm in January 2008, she was told by her team leader that the anti-money laundering training she received at her previous firm was sufficient but that she should review a high level note prepared by you (only intended for the heads of department as an outline note on what the revised Money Laundering Regulations would cover at that time) to bring her up to date with the new Regulations. The team leader had also told Gemma that, given her seniority, she would be solely responsible for opening and approving her own client accounts. You are asked to consider the following.

- a) What are your immediate concerns regarding Gemma's client? *(3 marks)*
- b) What steps would you take regarding the request for the release of funds from the portfolio and what specific advice can you give Gemma? *(4 marks)*
- c) Identify the main money laundering offences that may arise in this situation and outline the possible defences to each. *(3 marks)*
- d) The Chief Executive Officer has asked to know what action the FSA may adopt and what mitigation steps the firm could take at this stage. *(3 marks)*
- e) On the way home you consider your own position as the MLRO. Outline your key functions, responsibilities and liabilities of an MLRO. *(3 marks)*
- f) You are concerned about Gemma's comments as to the anti-money laundering training that she has received. Prepare a short briefing note on the training that should be provided and any amendments required to the firm's anti-money laundering systems and controls. *(4 marks)*

- 14 A Paris-based private equity fund management company wishes to raise monies in the London markets for a number of new specialist funds that it is setting up to invest in Eastern European government supply companies. It has identified a number of potential private companies and public corporations that it will take private following restructuring. The target investor group is made up of wealthy UK 'non-doms' or other high wealth individuals or other small investment funds based in the UK. You are asked to advise on the following.
- a) Explain the extent to which the company may or may not be required to be authorised or hold any relevant permission under the FSMA in the UK. *(4 marks)*
  - b) Explain the main restrictions that would apply with regard to the making of financial promotions in the UK. *(4 marks)*
  - c) To what extent could the company cold call potential UK clients? *(4 marks)*
  - d) What rights would the company have to move to other major European financial centres to conduct business? *(4 marks)*
  - e) One of the high net worth individuals has asked you to provide him with specific investment advice. What initial action must be taken before any advice can be provided? *(4 marks)*

## **SECTION C**

**TOTAL 30 MARKS**

### **USE ANSWER BOOK C FOR THIS SECTION**

#### **Answer TWO questions in this section**

- 15 Discuss the extent to which remuneration and bonus packages raise ethical issues that have to be dealt with by regulated firms and their non-executive boards of directors. *(15 marks)*
- 16 Explain the purpose and content of the FSA's Treating Customer's Fairly (TCF) initiative and comment on its value and effectiveness. *(15 marks)*
- 17 Comment on the extent to which Sovereign Wealth Funds (SWFs) should be made subject to more direct regulatory control. *(15 marks)*
- 18 Assess the extent to which the system of financial supervision and regulation set up under the FSMA has to be fundamentally overhauled in light of the crises that have unfolded in national and international financial markets over the last eighteen months. *(15 marks)*