

DIPLOMA WINTER 2008 EXAMINATION

REGULATION AND COMPLIANCE

DATE OF EXAM	Tuesday 2 December 2008
3 Hrs 15 mins	10.00 am – 1.15 pm
RUBRIC	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

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. The decision of the Securities & Investment Institute is final and no correspondence will be entered into concerning the grade awarded.
8. 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 Explain briefly the general purpose and structure of the High Level Standards contained in the Financial Services Authority's (FSA) Handbook of Rules and Guidance. *(4 marks)*
- 2 Identify four of the ways in which conflicts of interest can be dealt with under the revised Conduct of Business Rules (COBS) contained in the FSA's Handbook. *(4 marks)*
- 3 List the four categories of exempt person under the FSMA. *(2 marks)*
- 4 Identify six of the supervisory principles set out in section 2(3) of the Financial Services and Markets Act (FSMA). *(3 marks)*
- 5 Explain the principal role and function of the Money Laundering Reporting Officer (MLRO) within a regulated institution. *(2 marks)*
- 6 Specify four conditions contained in COBS with regard to the issuance of unsolicited real time financial promotions. *(4 marks)*
- 7 List four of the Specialist Sourcebooks contained in the FSA's Handbook of Rules and Guidance *(2 marks)*
- 8 Explain the general purpose of the FSA's Treating Customers Fairly initiative and its relationship to the FSA's statutory objectives. *(4 marks)*
- 9 Specify the consequences of breach of the restriction on financial promotion imposed under section 21 of the FSMA. *(2 marks)*
- 10 Briefly explain the nature of the relationship between the FSA, HM Treasury and the Bank of England under the regulatory regime set up under the FSMA. *(3 marks)*

USE ANSWER BOOK B FOR THIS SECTION**Answer QUESTION 11 and ONE other question in this section**

- 11 A new divisional director (Herbert) has been hired from overseas to head up your Equities division. He will be required to be registered with the FSA as an Approved Person to allow him to direct the division and advise clients.

When he joins, as the firm's Compliance Officer you state that, despite his considerable experience, he will need to pass the regulatory module of an appropriate UK qualification before he can start taking investment decisions or providing investment advice. It is not considered feasible for him to be supervised given his seniority and experience.

Both the Divisional Managing Director and Herbert indicate that this should not be a problem and that, while studying for the examination, Herbert will restrict himself to strategy and other non-trading activities.

Herbert begins to study for the examination and, over the following period, the performance of the Equities division improves substantially. You learn from an unattributable, but reliable source that, Herbert has, in fact, been providing detailed direction to his department including taking investment decisions and offering investment advice for which he is not currently approved.

On raising these concerns with both Herbert and his Managing Director, they reassure you that he is not taking investment decisions or providing any investment recommendations or advice. However, your source remains adamant that, despite the reassurances that you have received, Herbert is conducting regulated activities while performance within the Equities division continues to strengthen.

Herbert is scheduled to take the regulatory examination in the near future and is expected to pass, which will allow him to be judged to be competent and therefore registered for the appropriate controlled functions.

- a) Outline the nature and operation of the regime for approved persons under the FSMA. *(8 marks)*
- b) Given the above facts, what action would you take from a compliance perspective, if any, and what factors would you take into account? *(10 marks)*
- c) Would your answer differ if you were aware that the FSA were due to visit and have indicated that they will look at your firm's internal compliance procedures and T & C arrangements? *(2 marks)*

- 12 A new Asian Sovereign Wealth Fund decides to open a representative office in Mayfair in London and approaches your asset management firm for advice on suitable investments. The fund is particularly interested in possible lucrative but safe investment opportunities in Africa and Latin America but is concerned to avoid any criminal involvement. A senior member of the fund's investment's committee asks to meet with you to discuss UK money laundering requirements and their possible effect on the fund's investment strategy. You are asked to respond to the following questions.
- a) Explain the extent to which the UK money laundering requirements would apply with regard to the services to be provided by the management firm. *(4 marks)*
 - b) Identify the main money laundering offences that might arise and defences that would apply. *(4 marks)*
 - c) Outline the main customer identification, documentation and record requirements that would apply. *(4 marks)*
 - d) Comment on the extent to which the members of the investment committee of the fund may be held liable for any breaches of relevant money laundering requirements. *(4 marks)*
 - e) Explain the extent to which the senior management of the investment firm may be responsible and liable for any breaches of the money laundering requirements applicable. *(4 marks)*
- 13 You are the Compliance Officer for the M&A division of an FSA regulated bank that has a private equity (PE) division. The PE division manages a single fund with a UK focus, which is established as a limited partnership in the Cayman Islands. The Compliance Officer for the PE division has recently left the firm and you are asked to take over his responsibilities, being told that this will not affect your existing duties as private equity is subject to a very light touch regulatory regime.
- a) What are the principal parts of the FSMA and FSA Handbook or other FSA guidance that private equity businesses in the UK should be familiar with? Identify the specific sources and explain their relevance. *(3 marks)*
 - b) What other sources of non-FSA best practice guidelines should UK private equity firms be aware of? *(1 mark)*
 - c) What is the potential for conflicts of interest to arise between the M&A division and the PE division? Suggest ways in which these conflicts could be managed. *(6 marks)*
 - d) You learn that one of the directors of the PE division has a material personal holding in the shares of a listed company that the division is hoping to take private. What advice would you give the PE division concerning the management of this situation? *(5 marks)*

- e) The company allows co-investment rights in other entities in the same group. How would you ensure that this arrangement is managed with maximum transparency and minimum potential for conflicts arising with the interests of the investors in the fund? *(5 marks)*

- 14 You are the compliance officer of a medium sized hedge fund. On Friday morning you are heading back to your desk and are approached in the corridor by the fund's top performing portfolio manager who asks for a "quick chat". During your conversation you discover that on Monday the fund manager had been contacted by an investment bank about the refinancing plans of ABC Company, an international company with its headquarters in Germany. ABC Company has issued corporate securities in the form of bonds which are to be listed on the Luxembourg Stock Exchange.

The investment bank had contacted the portfolio manager for his views on the refinancing which included the tender for certain of ABC Company's bonds ("the ABC bonds"). During the course of this conversation, the portfolio manager was informed about the size of the refinancing deal (EUR 0.7 billion), the date of the announcement (the following Thursday), and that the ABC bonds would form part of the tender offer.

Later on Monday afternoon the portfolio manager gave instructions to a junior broker in the firm to purchase 1.4 million of the ABC bonds. On Thursday ABC Company made a regulatory announcement that it had commenced a cash tender offer for certain bonds including the ABC bonds. The ABC bonds rose sharply in value and shortly after the portfolio manager gave instructions to sell which realised a healthy profit for the fund.

On Thursday evening while toasting the profit for the fund, one of the portfolio manager's friends from another hedge fund, who had recently attended a course on market abuse, commented that the portfolio manager may have committed market abuse. After a sleepless night, the portfolio manager decides to speak with you in the morning.

You immediately request the telephone recordings of the telephone conversation between the portfolio manager and the investment bank. To your horror, you discover that the conversation was not recorded. You further discover that the portfolio manager's notes on the refinancing deal had been left open on his desk before the announcement was made.

- a) You immediately contact the fund's Chief Executive Officer (CEO) and inform her about the situation. She requests an analysis from you on whether any market abuse has been committed including details of the relevant possible offences that may have been involved. How would you respond? *(6 marks)*
- b) Having given your analysis to the CEO, she further asks what corrective action the fund should take and what are the likely steps that the FSA may take, should the fund notify the regulator? *(4 marks)*

- c) The CEO then requests an immediate review of the fund's anti-market abuse systems and controls. In order to undertake this review, you prepare an outline of the potential risks to the firm and applicable internal policies and procedures that may be adopted to mitigate these. Explain the general content of the outline. *(6 marks)*
- d) On the Saturday morning, the worried portfolio manager calls you on your mobile. He asks you what the regulatory penalties are for his conduct and the consequences for him and the firm. What would you advise? *(4 marks)*

SECTION C

TOTAL 30 MARKS

USE ANSWER BOOK C FOR THIS SECTION

Answer TWO questions in this section

- 15 Comment on the extent to which the amount, content or structure of executive pay packages may raise significant ethical issues for regulators and whether the FSA should be able to limit or control such entitlements. *(15 marks)*
- 16 Explain how the Markets in Financial Instruments Directive (MiFID) has been implemented in the UK and comment on its potential value and relevance. *(15 marks)*
- 17 Discuss the value and effectiveness of the FSA's policy of adopting a More Principles Based approach to Financial Regulation (MPBR) and its possible limitations or deficiencies. *(15 marks)*
- 18 Assess the extent to which the system of financial regulation set up under the FSMA has been able to respond capably and effectively to the recent crises in UK and global financial markets or requires further amendment or revision following these events. *(15 marks)*