SECURITIES & INVESTMENT INSTITUTE DIPLOMA

SUMMER 2009

CHIEF EXAMINER'S REPORT - REGULATION AND COMPLIANCE

General Comments

The summer 2009 paper was answered well although not spectacularly well. Answers were solid but in many cases not substantial. A few candidates had also failed to read the questions properly and either missed or combined subsection answers. Candidates should note the number of specific sub-questions asked in each question and answer the specific question sought to obtain full marks.

All of the Section A questions were relatively straightforward and answered well. The most commonly answered questions in Section B were on conflicts of interest (ethics) and either money laundering (13) or market abuse (12). The most commonly answered questions in Section C were 16 (TCF) and 18 (financial crisis) and then remuneration. Many of the TCF and financial crisis answers were of a high standard.

One of the key issues in many of the problem questions was to note which parties were subject to UK FSA and FSMA regulation and which were not having regard to the geographic situation of the facts described. This applied specifically with regard to the French authorised private equity fund management company in question 14 and the conflicts of interest issues raised in question 11. Candidates should also be aware that even where specific FSA conflicts of interest obligations do not apply, firms still have to consider wider ethical and reputational issues and in so doing be able to summarise the FSA's approach to promoting ethical conduct within the financial services industry. Question 11 is now a mandatory question in all papers.

As in every other year, candidates should allocate their time carefully and provide as substantial answers as possible within the time available. This approximates to six minutes per question in Section A and 30 minutes per questions in Sections B and C.

SECTION A

(1) Threshold Conditions

The threshold conditions set out in Schedule 6 consist of:

(a) legal status (body corporate or partnership);
(b) location (head and registered office must be in the UK);

(c) no close links that prevent effective supervision;
(d) maintenance of adequate resources;
(e) fit and proper (suitability).

EEA and Treaty firms must also comply with (a), (c), (d) and (e) in connection with an application for Part IV permission or additional permission. A non-EEA firm must also comply with any other additional conditions specified.

One mark for each correct response up to **three marks**.

(2) Authorisation, Permission and Approval Regime

Any person carrying on a regulated activity in the UK must be authorised (or exempt) under s 19(1) FSMA. Authorised persons are listed in s 30(1) – anyone holding a Part IV permission, EEA passport firms (Schedule 3), Treaty firms (Schedule 4) and a person otherwise authorised under the FSMA. Authorisation constitutes a form of **status** or **condition** for the carrying on of any regulated activity in the UK.

Authorised persons must also hold the relevant permission to carry on the specific regulated activity or activities conducted in the UK (s 21(1) FSMA). Breach is not an offence as such although it is subject to FSA disciplinary action. Applications for permission are made under s 40 and Part IV generally. Permission is accordingly concerned with the specific **legal right**, **authority or entitlement** to carry on the particular financial activity or activities concerned.

Authorised persons must take reasonable care to ensure that all persons that carry one or more of the 27 controlled functions (listed under SUP in the FSA Handbook) are properly approved by the FSA to do so (s 59(1) FSMA). Approval accordingly applies to **individuals** within firms rather than authorised firms as such. The objective is principally to confirm the **suitability** of the individual to carry out the particular functions covered.

One mark for each general correct explanation up to three marks although detailed responses are not required. **One extra market** is available for any additional correct relevant information.

(3) Regulated Actitvities

The regulated activities listed in Schedule 2 FSMA and the RAO include:

(a) Dealing in investments;
(b) Arranging deals in investments;
(c) Deposit-taking;
(d) Safe-keeping and administration of assets;
(e) Managing investments;
(f) Investment advice;
(g) Establishing collective investment schemes;
(h) Using computer-based systems for providing investment instructions.

One mark for each **three correct sets** of reference up to **two marks**.

(4) Appropriateness and Suitability

Appropriateness
In order to determine whether the client has the necessary experience and knowledge to understand the risks involved in relation to the product or service offered or demanded, a firm must obtain information on:

- The types of service, transaction and designated investment with which the client is familiar
- The nature, volume and frequency of the client's transactions and the period over which they have been carried out; and
- The client's level of education, profession or relevant former profession.

One mark for each correct response up to **two marks**.

Suitability
A firm must obtain necessary information regarding the client's:

- Knowledge and experience relevant to the specific type of investment or service;
- Financial situation; and
- Investment objectives;

for it to make a recommendation or decision that is suitable.

One mark for each correct response up to **two marks**.

(5) Professsional Clients

Per Se Professional Client
A client may either a **per se professional client** or an **elective professional client** (under COBS 3.5.1 R).

A **per se professional client** includes any of the following (unless it is an eligible counterparty or is given a different categorisation under the chapter):

(1) an entity required to be authorised or regulated to operate in the financial markets;

(2) in relation to MiFID or equivalent third country business a large undertaking meeting two of the following size requirements on a company basis: (a) balance sheet total of EUR 20,000,000; (b) net turnover of EUR 40,000,000; and (c) own funds of EUR 2,000,000;

(3) in relation to business that is not MiFID or equivalent third country business a large undertaking meeting certain conditions;

(4) a national or regional government, a public body that manages public debt, a central bank, an international or supranational institution (such as the World Bank, the IMF, the ECP, the EIB) or another similar international organisation; or

(5) another institutional investor whose main activity is to invest in financial instruments (in relation to the firm's MiFID or equivalent third country business) or designated nvestments (in relation to the firm's other business) including securitisation of assets or other financing transactions entities.

One mark for any correct reference

Elective Professional Client
A firm may treat a client as an **elective professional client** if it falls under with (1) and (3) or where applicable (2):

(1) the firm undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved **(the 'qualitative test')**;

(2) in relation to MiFID or equivalent third country business in the course of that assessment, at least two of the following criteria are satisfied: (a) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters; (b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000; or (c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged **(the 'quantitative test')**; or

(3) the following procedure is complied with: (a) the client must state in writing to the firm that it wishes to be treated as a professional client either generally or in respect of a particular service or transaction or type of transaction or product; (b) the firm must give the client a clear written warning of the protections and investor compensation rights the client may lose; and (c) the client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing such protections.

One mark for any correct reference. Up to **two marks** in total.

(6) Takeover Code

The 6 (previously 10) General principles produced by the Takeover Panel are:

(a) all holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of a company, the other holders of securities must be protected;

(b) the holders of the securities of an offeree company must have sufficient time and information to enable them to reach a properly informed decision on the bid; where it advises the holders of securities, the board of the offeree company must give its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business;

- **(c)** the offeree company board must act in the interests of the company as a whole and must not deny the securities holders the opportunity to decide on the merits of the bid;
- **(d)** false markets must not be created in the securities of the offeree company, of the offeror company or any other company concerned by the bid in such a way that the rise or fall of the prices of the securities becomes artificial and the normal functioning of the markets is distorted;
- **(e)** an offeror must announce a bid only after ensuring that he/she can fulfil in full any cash consideration, if such is offered, and after taking all reasonable measures to secure the implementation of any other type of consideration; and
- **(f)** an offeree company must not be hindered in the conduct of its affairs for longer than is reasonable by a bid for its securities

Half mark for each correct statement up to **three marks** although a full and exact reproduction of each principle is not required.

(7) Purpose of CASS

CASS is the Client Assets sourcebook. It contains the requirements concerning the holding of client assets and money in the FSA Handbook of Rules and Guidance.

This includes specific provision with regard to Collateral (CASS 3), Client money: insurance mediation activity (CASS 5), Custody rules (CASS 6), Client money rules (CASS 7), Client money distribution (CASS 7A) and Mandates (CASS 8).

One mark for each correct reference up to **two marks**.

(8) Compensation Limits

The compensation levels available under COMP are:

- **(a)** Investments £48,000 (100% of £30,000 and 90% of next £20,000);
- **(b)** Deposits £31,700 (100% of £2,000 and 90% of next £33,000)
  BUT subsequently raised to £50,000 following Northern Rock;
- **(c)** Long-term insurance, 90% of value attributed to policy;
- **(d)** General insurance, 100% of valid claim if compulsory and 100% of £2,000 and 90% of remainder if non-compulsory.

One mark for each correct response up to **three marks**.

(9) Role and Function of the FSMT

The Tribunal is set up under s 132(1) FSMA. The Tribunal is **assigned the functions conferred on it by or under the Act** (s 132(2)). This will generally include references or appeals against decisions of the FSA or the Regulatory Decisions Committee (RDC) as provided for under the FSMA or the FSA Handbook. This will, for example, include the issuance of decision and final notices (ss 388 and 390) and supervisory notices under SUP.

This is distinct from an appeal on a point of law to the courts under s 137 which is available from any decision of the Tribunal disposing of a reference to the Tribunal.
One mark from each general correct reference up to **three marks**.

(10) SII Code of Conduct

One mark for each correct reference to any the following up to **four marks**.

The Principles	Stakeholder
1. To act **honestly and fairly** at all times when dealing with clients, customers and counterparties and to be a good steward of their interests, taking into account the nature of the business relationship with each of them, the nature of the service to be provided to them and the individual mandates given by them	Client
2. To **act with integrity** in fulfilling the responsibilities of your appointment and seek to avoid any acts, omissions or business practices which damage the reputation of your organisation or which are deceitful, oppressive or improper and to promote high standards of conduct throughout your organisation.	Firm
To **observe applicable law, regulations and professional conduct standards**when carrying out financial service activities and to interpret and apply them to the best of your ability according to principles rooted in trust honesty and integrity	Regulator
When executing transactions or engaging in any form of market dealings, to **observe the standards of market integrity**, good practice and conduct required by, or expected of participants in that market.	Market Participant
To **manage fairly and effectively** and to the best of your ability any relevant **conflict of interest**, including making any disclosure of its existence where disclosure is required by law or regulation or by your employing organisation.*	Conflict of Interest
To **attain and actively maintain a level of professional competence** appropriate to your responsibilities and commit to continued learning and the development of others.	Self
To strive to **uphold the highest personal standards** including rejecting short-term profits which may jeopardize your reputation and that of your employer, the Institute and the industry.	Self

SECTION B

(11) Conflicts of Interest

The fact pattern raised difficult issues of conflicts of interest and ethical and reputational risk. As PB is based in the Far East, it is unclear whether the FSA rules will strictly apply. MSG and MSGIB may nevertheless be based in London with PB either being a branch or subsidiary operation of a London regulated institution. PB, MSG and MSGIB may also adhere to the SII Code of Conduct or equivalent provisions in the Far East. The question can accordingly be answered by applying equivalent relevant principles with or without specific reference to the FSA or SII provisions.

(a) The questions asks for the relevant conflicts of interest in connection with each party to be considered separately. The most comprehensive answers would have dealt with each set of relations individually although this was not strictly necessary.

Mrs Chang

As Mrs Chang is not a regulated person, conflicts of interest and ethical standards do not strictly apply. JM, PB, MSGIB and MSG more generally must nevertheless consider relevant conflicts and ethical issues in their relations with Mrs Chang. Mrs Chang's relations with her three sons again do not raise any regulatory conflicts issue although their differences of opinion mean that they should at minimum be advised separately to take independent legal advice concerning their own interests in the company and proposed restructuring.

The other relevant issue to Mrs Chang personally is her status as a client and the degree of protection required. Mrs Chang would be classified as a retail client with an appropriate full client agreement having been entered into and with all other relevant provisions within COBS applying.

In terms of JM's relationship with Mrs Chang. As the client agreement only covers advice on non-commercial matters, JM cannot act in connection with the proposed restructuring without amendment which will, in turn, depend upon JM's relevant experience and expertise. JM should have considered referring this to a separate department or relationship manager at an early stage. JM's wife's close relation with Mrs Chang is not strictly relevant from a regulatory perspective although JM should have referred this to compliance and ensured that this does not interfere with his professional ability or judgement. JM must, of course, also be careful not to use his wife's relationship with Mrs Chang directly or to pass information back to Mrs Chang through his wife. In light of the close nature of these relations and size of the transaction, JM may again have elected to disqualify himself from acting at an early stage either on grounds of conflict or ethics and have the matter referred to a separate relationship manager.

MSG Group

Strict Chinese walls must be maintained between each of the divisions and separate entities within the MSG group. The restructuring more generally and Mrs Chang's interest in the restructuring may be passed on to a separate division within PB and/or MSGIB provided that full separation is respected. Necessary security arrangements must be put in place to ensure that any sensitive information remains confidential. Appropriate security arrangements must also be maintained between PB and MSGIB. This may include documenting any contact between employees and information transfers. The compliance departments within each operation should be notified appropriately.

MSGIB

The introduction by PB of Mrs Chang (and possibly her sons) to MSGIB should also have been properly documented with written consent taken to pass on names, identities and other file information.

MSGIB must properly identify and document its relationship with its client which will be the company in this case. The sons should already have been advised to take separate advice on their personal interests to the extent relevant. MSGIB must properly identify its client as a professional party and carry out all necessary pre-service actions including agreeing appropriate terms of business and disclosing all relevant costs, charges and other payments.

The recommendation of the 'bought deal' does not raise any direct regulatory issues provided that the MSGIB staff consider that this is the most appropriate recommendation in the particular circumstances. This advice would, of course, normally include other options with comment on their relevant merits and demerits. MSGIB will be required to act in the interests of the company as a whole as its client with each of the other parties concerned taking their own independent legal and financial advice on the merits of the transaction.

MSGIB must not attempt to place any pressure in any way on PB or JM to 'convince' Mrs Chang or any other party to support the restructuring proposed. This would be contrary to PRIN, SYSC, APER, FIT and SII. The severity of the breach would require immediate notification to the FSA to the extent relevant or other local authority (below).

Investment Analysts

Investment analysts working within MSGIB corporate finance will provide documentation in support of their recommendation. Any other analyst within MSGIB or MSG issuing independent advice must be separated by appropriate Chinese walls and comply with relevant regulatory provisions including, in particular, COBS 12 or the local equivalent standards.

Client Managers

Chinese walls must also be maintained between MSGIB and PB client managers and discretionary portfolio managers. MSGIB must not attempt to influence their decisions with investment decisions being taken on an independent and client basis. This also applies with regard to MSG Fund Management.

Mrs Chang has requested that JM act as a non-executive director on the restructured company board to represent her interests. This would be wholly inappropriate. It would also be inappropriate for JM to attempt to act on behalf of other PB clients as suggested. As a non-executive director, JM would be required to act solely in the interests of the company under relevant company law provisions.

Information must not be passed between MSG companies or divisions in connection with the proposed restructuring and share offer which may otherwise constitute insider trading, market abuse or be contrary to s397 FSMA.

Insider lists may also be considered under the Disclosure Rules and Transparency Rules (DTR 2.8.

(b) PB and MSG would have to deal with both the significant breaches that have already occurred as well as avoid any further infraction. No further action should be taken on the restructuring until all relevant matters have been dealt with. These would include the following:

(i) The issue must be referred to compliance within PB, MSGIB and MSG to the extent relevant;

(ii) JM should consider withdrawing immediately and passing responsibility on to dealing with Mrs Chang to another relationship manager within PB;

(iii) The terms of service for Mrs Chang should be confirmed and extended if necessary;

(iv) A separate relationship manager may be appointed to Mrs Chang to advise on commercial matters either within PB or independently;

(v) Mrs Chang's sons should be advised to take separate advice on their own positions;

(vi) JM must not be allowed to be appointed a non-executive director to the board of the restructured company;

(vii) Any independent research advice must comply with all relevant provisions;

(viii) PB client managers and discretionary managers must act independently;

(ix) MSG Fund Management must also act independently;

(x) As MSGIB is already conflicted, it may consider withdrawing its initial tender for the restructuring mandate;

(xi) Following discussion with the company and full disclosure, MSGIB may be given permission to re-tender and resubmit;

(xii) Strict Chinese walls must be maintained between all parties;

(xiii) Any transfers of information between the various divisions must be strictly controlled;

(xiv) In light of the inappropriateness of the action already taken by MSGIB staff (in trying to convince PB to persuade Mrs Chang and in expecting PB client managers and discretionary managers to purchase the new company stock), compliance may consider referring the matter to the FSA, SII or any other appropriate regulatory authority with full details of the remedial action and proposed arrangements set up to ensure that no future breach of the conflict provisions arise;

(xv) To the extent that any pressure may be placed on you not to disclose any matters, relevant 'whistle-blowing' provisions may apply;

(xvi) Senior management within PB and MSG may consider writing to Mrs Chang and her sons explaining the regulatory issues concerned and the action taken in the interests of good client relations and to avoid any reputational damage;

(xvii) The board of PB, MSGIB and MSG may also consider withdrawing from the tender to avoid any reputational damage and to be seen to promote high ethical standards;

(xviii) Internal disciplinary action may be considered against the MSGIB staff involved with approaching PB;

(xix) Separate issues may arise with regard to the disclosure of short positions during a rights issue under the FSA Code of Market Conduct.

(12) Market Abuse

The question raises issues with regard to insider trading under the Criminal Justice Act 1993, market abuse under s118 FSMA and market manipulation under s397 FSMA. Candidates should have provided as much relevant information as possible on each of the offences under the relevant sub-headings.

(a) CD may have committed market abuse at the two stages of 'suggesting' that SDH purchase shares in OAGE and separately increasing his own holdings in OAGE through his broker. This may clearly have constituted market abuse under s118(2) (insider dealing) and s118(4) (information misuse) as well possibly of s118(8) (market distortion). Candidates should have explained all relevant conditions and possible defences under FSMA or the Code of Market Conduct for the full four marks. Reference may also have been made to possible insider dealing under CJA 1993 and the difference between the civil and criminal offences concerned. As AIM may not be a regulated market, CD may not have been listed on the Disclosure Rules and Transparency Rules (DTR) under the Market Abuse Directive (Disclosure Rules) Instrument 2005 although it would appear that AIM is covered by the DTR rules generally.

(b) Whether SDH had committed market abuse would depend on relevant knowledge. Insider dealing under the CJA would have required direct notice while market abuse under s118 is assessed on an objective (regular user) test basis. As CD had not disclosed any inside information to SDH or its board, SDH would have a defence under s123 FSMA that it did not believe on reasonable grounds that the behaviour amounted to market abuse. This was confirmed by the minutes kept of the meetings which record that the decision was taken on the

basis of the rise in the share price over time. Other arguments may nevertheless be raised that the SDH board knew of CD's involvement with OAGE and that CD's 'suggestion' may have been on the basis of inside information. It may have been safest for the SDH board to record separately that CD was asked to confirm that there was no insider trading or market abuse involved. This may have constituted the second defence of having taken reasonable precautions under s123 FSMA. This may nevertheless still have been insufficient in all of the circumstances in light of the close relationships between CD and both SDH and OAGE. Whether a decision was taken to prosecute or not may depend on the size of the SDH board and CD's influence on the board and its decisions.

(c) The further purchase was made after the public announcement of the award of the tender offer. This would not then constitute inside information with a defence again being available under s123 FSMA of no reasonable belief if necessary. Again, however, even if a strict offence was not committed under CJA or s118(2) FSMA, the repetitive nature of the behaviour following the earlier purchases may still be considered suspicious and, at minimum, an attempt to increase further the share price before disposal either by SDH or CD. CD's involvement in the decision to make the final share purchase and any relevant minutes or other surrounding circumstances would again have to be confirmed. Candidates may also have raised the issue of CD's failure to make any relevant disclosure to the board of the SDH which may be considered to constitute dishonest concealing under s397 FSMA.

(d) Major shareholdings have to be notified under the DTR 5 rules. This specifically applied where shareholdings reach or fall below 3% of voting rights or any increase or reduction in 1% above 3%. Notifications must be made to the company within two business days or four trading days for non-UK issuers. Some uncertainty arises in the materials as to whether AIM is included although candidates are entitled to assume that AIM is included for these purposes (above). Reference may also be made to beneficial interests being disclosed to the company under ss89(a)-89(n) FSMA as well as to the trigger ratios in connection with takeover offers under the City Code or notices under s793 Companies Act 2006. Reference may also be made to the Model Code for Directors' Dealings under Listing Rules 9 Annex 1.

(e) All relevant offences under s118 FSMA with relevant defences should have been referred to. Candidates may also have noted all of the relevant offences and defences under s397 FSMA and CJA. Candidates may also have referred to the general enforcement powers of the FSA for breach either of the Listing Rules as opposed to regulatory breaches under FSMA which would strictly not apply in the particular case as neither CD nor any of the companies involved were regulated persons.

(13) Money Laundering

The circumstances raise significant concerns with regard to the effectiveness of the money laundering systems maintained within the firm and the potential liabilities of the client, the PR firm, the wife and Gemma as well as the firm and the MLRO.

(a) Full customer due diligence (CDD) should have been carried out. Immediate concerns arose with regard to the failure to have carried out proper client identification with regard to the MP and his possible involvement in money laundering. The client is a 'politically exposed person' (PEP) with enhanced due diligence (EDD) being expected. The size of the fund being held by an MP, the undisclosed source, the attempt to move the funds to the Jersey bank account of the wife and the arrest on suspicion of tax evasion all raise suspicions of money laundering.

(b) The funds should be frozen until appropriate money laundering checks have been carried out and permission if given to proceed. The MLRO should consider submitting a Suspicious Activity Report (SAR) with SOCA and await a reply or expiration of the reply period. Gemma and the firm must take care not to 'tip off' the MP, PR firm or the wife.

(c) All relevant money laundering offences and defences should have been outlined under POCA and MLR and JMLSG.

(d) The FSA must be informed immediately with a report of the action taken and action to correct firm future failings in money laundering proceedings including specifically client identification and training. Available FSA review, inspection, documentation and enforcement powers should have been referred to.

(e) The role and function of the MLRO should have been outlined with penalties for breach.

(f) FSA training requirements should have been reviewed and explained.

(14) Authorisation and Perimeter

The facts raised issues with regard to the need for authorisation and permission under FSMA in connection with the cross-border provision of financial and other services and the regulatory perimeter and perimeter offences.

(a) The fact pattern clearly suggests that the private equity fund management company only wished to approach potential investors and raise funds with candidates being expected to comment on whether or not this constituted a regulated activity for the purposes of the FSMA. The firm has four options of not carrying on any regulated activity within the UK, providing cross-border regulated services, establishing a branch or establishing a subsidiary in the UK. The implications of each option could have been reviewed briefly. Candidates may also have referred to the possibility of only setting up a representative office.

(b) Candidates should have reviewed the restrictions imposed under s21 FSMA with possible reference to relevant exemptions and other requirements under the FPO and COBS 4. Candidates could specifically have noted the offer or invitation requirements in COBS 4.7 and overseas element in 4.9. They should also have referred to the fact that the fund may have constituted a collective investment scheme subject to ss238 and 241 FSMA and the promotion under Collective Investment Scheme (Exemptions) Order 2001. Reference may also have been made to the EU Distance Marketing Directive and Distance Marketing Regulations 2004.

(c) Candidates should have reviewed relevant cold calling obligations under COBS 4.8 subject to the separate restrictions on the promotion of unregulated collective investment schemes (above).

(d) Candidates should have explained the operation of the EU single market rights in the financial area. The fact pattern clearly suggests that the company was initially established and regulated in France. The effect of the European passport rights with regard to financial directives and Treaty rights contained in Schedules 3 and 4 FSMA should have been referred to to the extent that the company became separately regulated in the UK.

(e) The candidate rather than the fund management company is asked to provide the advice on the assumption that the candidate is based in the UK and therefore constitutes a regulated activity under FSMA. Clients would initially have to be classified as either retail or possibly per se professional clients or elective professional clients under the relevant rules. All other relevant pre-service activities should have been outlined including client agreements or terms of business, disclosure of relevant costs, payment arrangements and compensation, stability and appropriateness where relevant, key features document (KFD) where relevant and relevant money laundering procedures.

SECTION C

(15) Executive Pay and Ethics

This was similar to the question set in winter 2008 but remains of importance and relevance especially with the Walker Review on Corporate Governance issued in July 2009. Regulatory concerns arise with regard to the possible risk distorting effects that unbalanced incentive packages can have on risk management with consequent effects on firm and market instability.

The question could have been dealt with in a number of ways. Reference could, for example, have been made to the FSA's statutory objectives and supervisory principles in ss2(2) and (3) FSMA as well as to the high level standards contained in PRIN, SYSC and APER, COND, FIT and the SII Code of Conduct.

Specific provisions include PRIN 1 (integrity), 3 (management and control), 6 (customers' interest), 8 (conflicts of interest) and 11 (relations with regulators); SYSC 2 (senior management arrangements), 3 (systems and controls including remuneration policies), 7 (risk controls) and 10 (conflicts of interest); APER 1 (integrity), 2 (skill, care and diligence), 6 (skill, care and diligence in management) and 4 (regulatory relations); FIT 1 (honesty, integrity and reputation) and 2 (competence and capability); and SII 1 (honesty and fairness), 2 (integrity), 5 (conflicts of interest) and 7 (high personal standards). Reference may also have been made to COBS 9 (suitability), 10 (appropriateness), 12 (conflicts of interest), 2.3 (inducements), 11.6 (dealing commissions), 11.2 (best execution) and possibly 11.7 (personal account dealing).

Reference should have been made to the FSA CEO letter concerning remuneration packages in banks and the draft Code issued in March 2009 and possibly to the recent additional issues that have arisen with the partial nationalisation of major UK financial institutions following the recapitalisation announced by the Government on 8 October 2008. The FSA policy would generally appear to be to leave this to be dealt with within specific financial institutions including, in particular, at board level or through existing management arrangements for other senior staff. Firms must nevertheless avoid increasing or aggravating firm risks and exposures which fall within their risk management capability.

Candidates should also have including discussion on relevant ethical rather than purely legal or regulatory aspects of the problem. Reference could have been made to the FSA's general discussion paper 18 on Ethics of October 2002 and to the FSA's general approach in this area. Reference may also have been to the CEO letter of 10 November 2005 on conflicts of interest or cross-reference to the earlier discussion on high-level standards.

(16) Treating Customers Fairly

The FSA has issued a number of statements confirming the importance of the Treating Customers Fairly (TCF) initiative in recent years. This is based on PRIN 1 and 6 (and SII 1). The FSA approach was developed in the July 2004 paper on TCF, DP06/4 and more recent update and progress statements. The FSA's six consumer outcomes should have been referred to. The importance of management information (MI) and use of the ARROW II operating framework could also have been noted. Relevant deadlines could have been outlined.

Reference could also have been made to other level standards or other specific consumer protection obligations such as in COBS. Reference could also have been made to the FSA's statutory objectives and to MPBR and Financial Capability.

(17) Sovereign Wealth Funds

Attention has been attracted to the role and function of sovereign wealth funds (SWFs) during the recent crisis. While SWFs have confirmed that they can act as important sources of investment

especially in times of crisis which supports financial stability, concerns remain with regard to their transparency and accountability as well as the political sensitiveness of overseas government controlled agencies assuming control of major utility or service areas including banking and financial services. These issues have been referred to in various documents including the FSA Financial Outlook 2008.

The meaning and function of SWFs should have been explained. Reference may also have been made to objectives and market size. Specific funds may also have been noted.

As the question specifically referred to the possible need to make SWFs subject to direct regulatory control, the extent to which overseas SWFs fall within the scope of the regulatory system set up under the FSMA could have been noted and the issues that would arise in terms of the FSA's statutory objectives (s2(2) FSMA) as well as larger financial stability objectives to be conferred later this year following the Turner Report and Treasury White Paper on *Reforming Financial Markets*.

Reference may also have been made to the current work undertaken in this area by various organisations and committees including the Committee of European Securities Regulators (CESR) and the International Organisation of Securities Commissions (IOSCO) as well as the Basel Committee and the European Commission. The issue has also been discussed within the US Congress.

The specific regulatory issues that arise include the following:

(1) Disclosure and transparency;
(2) Corporate governance;
(3) Management autonomy within target firms;

(4) National security (although specific definitional issues arise in defining relevant interests with this possibly extending to include energy companies, transport and freight (such as the New York Port Authority) in addition to military and armaments interests);
(5) Money laundering;
(6) Possible market distortion or disruption;
(7) Moral hazard (with the implied sovereign support or guarantee provided); and
(8) Potential corruption and political interference in certain countries.

(18) Financial Crisis

The question on financial crisis could have been dealt with in a number of ways. Reference may initially have been made to relevant UK or more general US and global developments in terms of financial crisis and instability. Relevant UK factors included the forced support for Northern Rock by the Bank of England and then its subsequent nationalisation following the failure to find a private sector solution and then with the subsequent nationalisation of the Bradford & Bingley.

Reference could have made to the House of Commons Treasury Committee report in January 2008 and then to as many of the Tripartite (FSA, Treasury and Bank of England) reports as possible (including the initial *Banking Reform* discussion paper in October 2007 and subsequent *Financial Stability and Depositor Protection* consultation document in January 2008 and then additional papers in July 2008 on *Financial Stability* and *Special Resolution Regime* and then on *Cross-Border Challenges* in September 2008). The FSA also issued its own internal review into the supervision of Northern Rock in March 2008 which created the 'supervisory enhancement programme' (SEP). The Treasury brought the new Banking Bill before the House of Commons in October 2008 following the earlier Banking (Special Provisions) Bill in February 2008.

Reference may also have been made to relevant US, EU and other international developments including the Financial Stability Forum (FSF) report on *Enhancing Market and Institutional Resilience*

in October 2008 as well as the G20 ‘Bretton Woods II’ Summit in Washington in November 2008 and in London in April 2009.

Reference may also have been made to the Turner Review on the *Global Banking Crisis* in March 2009 and to the anticipated Treasury White Paper on *Reforming Financial Markets* and Walker Review on *Corporate Governance in Banks* both subsequent published in July 2009.