

Client Memorandum

UK Regulatory Regime

July 2009

The Requirement for Authorisation

The carrying on of an investment management business in the United Kingdom constitutes a regulated activity for the purposes of the UK Financial Services and Markets Act 2000 and related legislation and, accordingly, any firm providing such services would need to apply for authorisation to do so from the UK Financial Services Authority (FSA). It should be noted that there are no "de minimis" or "sophisticated investor" exemptions. The carrying on of a regulated activity for or on behalf of a single client requires authorisation. Whilst investment managers established in other Member States of the European Economic Area¹ may be able to take advantage of the "single passport" under the Markets in Financial Instruments Directive, there are not currently any reciprocal arrangements for managers regulated in the United States.

Timescale

Significantly, it usually takes about 3 months after submission of the application pack for the FSA to approve an application and 3-4 weeks to prepare the application for submission. It is, therefore, important to factor into the timetable that the UK investment manager will not be authorised to conduct investment management activities until such time as the FSA has authorised it to do so. There is no "interim" or "conditional authorisation". Undertaking unauthorised investment business is a criminal offence.

The Application Process

The FSA authorisation process is an "up front" process. In order to obtain authorisation, a firm must satisfy certain "threshold conditions" established by statute relating to the form of the firm, location, resources, whether close links to other firms and individuals are likely to prevent effective supervision and, in particular, that it is a "fit and proper person" to carry on regulated activities. To assess whether the applicant is a "fit and proper person", the FSA will have regard to all relevant matters of significance including, without limitation, the competence and prudence of its management and whether it will conduct its business with integrity, with due skill, care and diligence and in compliance with proper standards. This will include demonstrating, among other things, that it has been open and co-operative in all its dealings with the FSA and any other regulatory body, that it has appropriate systems and controls in place for compliance with the regulatory system and that employees are aware of, and compliant with, the regulatory requirements. Further, the firm will have to demonstrate that senior management have the appropriate skill and experience to understand and operate a regulated business and have put in place appropriate controls to ensure compliance.

¹ The Member States of the European Economic Area currently comprise the Member States of the European Union and, in addition, Norway, Iceland and Liechtenstein.

The application pack, which is designed to elicit information on these and other areas, is split into a number of sections as outlined below:

1. Checklist and declaration: this is to ensure that applicants have completed the appropriate sections. Various representations must be made;
2. Core details: this form sets out to identify core information about the applicant (i.e. about its legal status, structure, personnel and the systems and controls the applicant will use in its business);
3. Supplement for investment managers: this form includes the following subsections:
 - a) regulatory business plan: this sets out details of the types of business that will be carried on, the rationale for doing so and how the applicant will actually carry on its business;
 - b) scope of permission required: this identifies the proposed regulated activities including the investments in relation to which investment business will be carried on and the types of client for whom the applicant will carry on investment business;
 - c) financial resources: this will set out budgeted income and expenditure and is used by the FSA to determine if the applicant has sufficient financial resources necessary to carry on the proposed regulated activities;
 - d) personnel: this identifies individuals performing "controlled functions";
 - e) compliance arrangements: the applicant must confirm that it has documented compliance procedures in place and provide a copy of its compliance monitoring programme; and
 - f) fees and levies: this is used to calculate the annual FSA fees and related levies that are payable.
4. Owners and influencers appendix: this identifies the applicant's controllers and close links and whether the applicant is part of a group or an overseas firm. Additional forms must be submitted for each controller.
5. Disclosure of significant events appendix: if the applicant has previously traded, it will be required to provide information about its business history.

The application pack also includes individual forms for those who will carry out "controlled functions" (such as the chief executive, compliance officer, money laundering reporting officer, directors, partners, certain senior managers, traders exerting a significant influence on the applicant as well as any director or senior manager of the applicant's parent or holding company who has a significant influence on the applicant) each of whom will need to be individually registered as an "approved person". Such individuals will need to satisfy a "fit and proper" person test, the key criteria of which are honesty, integrity and reputation, competence and capability and financial soundness. These items can delay submission of the application if not dealt with at an early stage due to the detailed information required.

As part of the FSA application, the firm will need to have office premises and individuals who are able to carry on the investment business. The FSA application is designed to provide a snapshot of the firm at the date of authorisation. Accordingly, it is not necessary to have all of these in place at the time the application is submitted, but authorisation may not be granted until the FSA has physically visited the office premises and determined that they are suitable for the business to be carried on (this could include a systems test) and that there are people who are able to carry on the business and who have been approved by the FSA accordingly.

Together with the completed application pack, the FSA will, on submission, also wish to see the fund offering documentation and the investment management agreement under which the firm will provide its investment management services. These documents need only be in draft on submission of the application which, from a practical perspective, leaves time for their completion while the FSA processes the firm's application for authorisation.

It should also be noted that an authorised firm will be subject to a financial resources requirement so as to ensure that it has sufficient minimum capital. This figure will depend on the risks posed by the applicant's

activities and its prudential category, and is typically comprised of a base capital requirement (usually €50,000) and a variable capital requirement. The rules are complex and applicants usually work with their auditors to determine the appropriate requirement. The applicant will be required to develop, maintain and document an internal capital adequacy assessment process.

In order to avoid delays in the application process, it is vital to ensure that the application is complete prior to submission.

Principles for Business

The "Principles for Business" apply, in whole or in part, to every FSA regulated firm. They are a general statement of fundamental obligations and are the basis for conduct of business and other rules. The FSA views them as linked to the "fit and proper" test and breach of the Principles, even if there is no specific rule which may have been breached, may call into question the fitness and propriety of a regulated firm. In disciplinary actions, breach of a specific Principle is often cited alongside breach of a rule. Actions based solely on breaches of the Principles may also be brought.

There are eleven Principles:

1. Integrity: a firm must conduct its business with integrity.
2. Skill, Care and Diligence: a firm must conduct its business with due skill, care and diligence.
3. Management and Control: a firm must take reasonable care to organise its affairs responsibly and effectively, with adequate risk management systems.
4. Financial Prudence: a firm must maintain adequate financial resources.
5. Market Conduct: a firm must observe proper standards of market conduct.
6. Customers' Interest: a firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with Clients: a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of Interest: a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers: Relationships of Trust: a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. Clients' Assets: A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with Regulators: A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Senior Management Arrangements, Systems and Controls

The applicant must ensure that it has robust governance arrangements proportionate to the nature, scale and complexity of its activities, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems. It must monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements and take appropriate measures to address any deficiencies.

Under the "four eyes" requirement, the applicant must also ensure that its management is undertaken by at least two senior personnel of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the firm. Further, the applicant must ensure that it employs personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them taking into account the nature, scale and complexity of its activities.

The applicant must also ensure that the performance of multiple functions by any person does not and is not likely to prevent such person from discharging any particular functions soundly, honestly and professionally. Arrangements must be in place concerning the segregation of duties within the firm and the prevention of conflicts of interest. Outsourcing of critical operational functions is permitted but the applicant must take reasonable steps to avoid undue additional operational risk. Such outsourcing must not impair materially the quality of the applicant's internal control or the ability of the FSA to monitor its compliance with its regulatory obligations and must be notified to the FSA.

The applicant must implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, and have appropriate systems and controls for the management of liquidity risk. In addition, it must maintain an effective conflicts of interest policy and arrange for orderly records to be kept of its business and internal organisation, including all services and transactions undertaken by it, that are sufficient for monitoring purposes.

A regulated firm must also implement and maintain adequate policies and procedures sufficient to ensure compliance of the firm, including its managers and employees, with its regulatory obligations. A compliance officer must be appointed to be responsible for compliance. Those involved in compliance must have (or be given) the necessary authority, resources, expertise and access to all relevant information. Unless it would not be proportionate and the firm continues to meet its compliance obligations effectively, such persons must not be involved in the performance of services or activities that they monitor and the method of their remuneration must not compromise their objectivity nor be likely to do so.

The firm should have a written compliance manual tailored to its business and also maintain a compliance monitoring programme to check that it is following its own compliance procedures. The firm should have assessed its business to determine areas where there might be regulatory concern and address them appropriately. The compliance manual is designed to illustrate and document the way in which the firm intends to comply with its regulatory obligations and its compliance procedures should be subject to regular review and reassessment. It should be noted that the compliance manual sets out the firm's particular procedures. A firm might still be in compliance with the FSA Rules even if it deviates from its own procedures but that deviation might itself be deemed to be non-compliance. The compliance manual will establish procedures in relation to a number of conduct of business issues, some of which are touched on below. In addition, it will deal with internal reporting lines, anti-money laundering procedures, client acceptance, employment and personnel issues, policies for countering financial crime and also business continuity plans. In this last regard, regulated firms are required to have in place appropriate arrangements, having regard to the nature, scale and complexity of its business, to ensure that it can continue to function and meet its regulatory obligations in the event of an unforeseen interruption. These arrangements should be regularly updated and tested to ensure their effectiveness.

Conduct of Business Issues

Classification of Clients

Regulated firms must classify their clients as retail clients, professional clients or eligible counterparties. The purpose of the classification is to ensure that regulatory protections are properly focused on those clients that need them most (i.e. retail clients), rather than interfering in business relationships that need minimal regulatory protections (i.e. inter-professional business). In the context of a hedge fund, it is the fund itself rather than the individual investors which needs to be classified for these purposes and whilst hedge funds can in certain circumstances be classified as an eligible counterparty, they are typically classified as professional clients.

Inducements and Use of Dealing Commissions

These rules relate to Principles 1 and 6 (above). Regulated firms must not pay or accept any fee or commission, or provide or receive any non-monetary benefit, in relation to business carried on for a client unless it is designed to enhance the quality of the service to the client. Such fee, commission or benefit must be paid or provided to or by (i) the client or a person on behalf of the client or (ii) a third party so long as it does not impair compliance with the firm's duty to act in the best interests of the client and there is proper prior disclosure of the existence, nature and amount of the fee, commission or benefit.

The range of goods and services which an investment manager can receive from a third party where such party's charges are passed onto clients is limited to execution services and investment research. The investment manager must be reasonably satisfied that such goods and services will reasonably assist the investment manager in its services to the clients on whose behalf the orders are being executed and are not likely to impair its compliance with the duty to act in such clients' best interests. In addition, adequate prior and periodic disclosure must be given to clients, including details of the goods or services that relate to the execution of trades and, wherever appropriate, separately identifying those that are attributable to the provision of research.

Best Execution

This relates to Principles 2 and 6 (above). Generally, regulated firms must provide best execution when executing a client order. In order to provide best execution, a regulated firm must take all reasonable steps to obtain, when executing orders, the best possible result for its clients taking into account such factors as price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order. Price need not necessarily be the most important factor and the relative importance of these factors must be determined by reference to the characteristics of the client, the client order, the financial instruments that are the subject of that order and the execution venues to which the order can be directed.

A regulated firm must also establish and implement an order execution policy to enable it to comply with the above obligation. The firm must provide appropriate information to its clients regarding (as well as obtain their consent to) such policy, monitor its effectiveness on a regular basis and review it annually.

Client Order Handling; Aggregation and Allocation

These rules relate to Principles 1, 6 and 8 (above). The rules provide that a firm must implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other orders or the trading interests of the firm and must allow for the execution of otherwise comparable orders in accordance with the time of their reception by the firm. The firm must ensure that orders executed on behalf of clients are promptly and accurately recorded and allocated. It must also carry out otherwise comparable orders sequentially and promptly unless the characteristics of the order or prevailing market conditions make this impracticable or the interests of the client require otherwise.

The rules provide that firms may not aggregate client orders with an own account order or with another client order unless it is likely that the aggregation will not work to the disadvantage of each of the clients concerned and it has disclosed that the effect of aggregation may, on some occasions, work to the disadvantage of a client. An order allocation policy must also be established and effectively implemented, providing in sufficiently precise terms for the fair allocation of aggregated orders and transactions, including how the volume and price of orders determines allocations and the treatment of partial executions. Where a firm has aggregated a client order with an own account order it must not allocate the related trades in a way which is detrimental to a client.

Personal Account Dealing

This relates to Principles 3 and 8 (above). There is no absolute prohibition on personal account dealing. However, a regulated firm must put in place arrangements aimed at preventing activities in relation to personal account dealing which involves the misuse or improper disclosure of confidential information (including inside information) or which conflict or more likely to conflict with the firm's obligations to its customers. These arrangements must be designed to ensure that employees are aware of the restrictions on personal transactions and the related measures established by the firm and to ensure that the firm receives prompt notification of, or be otherwise able to identify, any such transaction. A record of such transaction, including any related authorisation or prohibition, must also be kept. Firms must institute a personal account dealing policy which will form part of the compliance manual and also, typically, any employment contract. These may require pre-approval of certain types of transaction (typically those investments in which the firm may itself deal) and/or impose limitations on the frequency and amount of trading.

Supervision

The FSA pursues a risk-based approach to supervision to ensure that it focuses its regulatory resources on those areas likely to give rise to more issues. Part of this approach is assessing not only the probability of certain matters occurring but also their impact were they to do so. The approach to risk assessment of firms is based on the extent to which they pose risks to the FSA meeting its regulatory objectives, namely, market confidence, public awareness, the protection of consumers and the reduction of financial crime. Risks can arise not just from the nature of the firm's business but also the types of customer to which it provides services, its financial soundness, market risks, organisation and internal controls.

Following an internal review of its supervisory practices in the wake of the recent financial crisis, the FSA has emphasised that it will now also pursue a more intensive and invasive "outcomes-focused" approach to supervision, while working in a proportionate and risk-based way. Accordingly, the FSA will give greater focus to outcomes testing (including through mystery shopping and on-site visits) and judging the results of regulated firms' actions and their impact on clients rather than just ensuring that appropriate systems and controls are in place under a competent management. These changes to the FSA's supervisory practice are primarily aimed at enhancing the FSA's supervision of high-impact firms (and banks in particular) but are nevertheless generally applicable.

The FSA has a variety of supervisory tools available to it which it categorises as (1) diagnostic, (2) monitoring, (3) preventative or (4) remedial. The FSA uses a variety of tools to monitor whether a firm, once authorised, remains in compliance with regulatory requirements.

These tools include:

1. desk-based reviews
2. liaison with other agencies or regulators
3. meetings with senior management
4. on-site inspections
5. reviews and analysis of periodic returns and notifications
6. reviews of past business
7. transaction monitoring
8. use of auditors
9. use of other experts

The FSA gives more intensive regulatory attention to the largest hedge fund managers and those regarded as particularly "high-impact". Such managers are overseen by a specialist supervisory team. Other hedge fund managers are supervised in the same way as other small "wholesale" firms, through thematic projects, firm visits, telephone assessments and reviews of their regulatory returns and other data.

It should be remembered that authorised firms have a duty to keep the regulator informed and there is also a requirement to notify the FSA of serious rule breaches and certain other matters of which the FSA ought to be informed. In some cases, prior approval must be sought (e.g. a change of control or a change in the nature of the business). In the event that the FSA does find cause for concern, then it may give guidance or recommendations for preventative or remedial action or it could impose specific requirements or even limit or alter a firm's authorisation.

Enforcement

Following its risk-based and proportionate approach to regulation, the FSA focuses on bringing enforcement action which it believes will enable it to make a real difference to markets and clients rather than taking such action for every breach that it identifies. It emphasises what it calls a "credible enforcement" strategy aimed as

detering wrongdoing and demonstrating that firms will face meaningful consequences if they fall below the prescribed standards of behaviour.

The FSA has the power to issue public censures or statements, impose financial penalties, place restrictions on individuals and firms (and prevent them carrying on financial business if it so determines), intervene in businesses and obtain restitution orders. Depending on the nature or degree of an offence, other remedial measures may be employed including private warnings.

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The entire FSA Handbook of Rules and Guidance can be found online at <http://fsahandbook.info/FSA/html/handbook/>

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