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Robust Regulation and Effective Supervision

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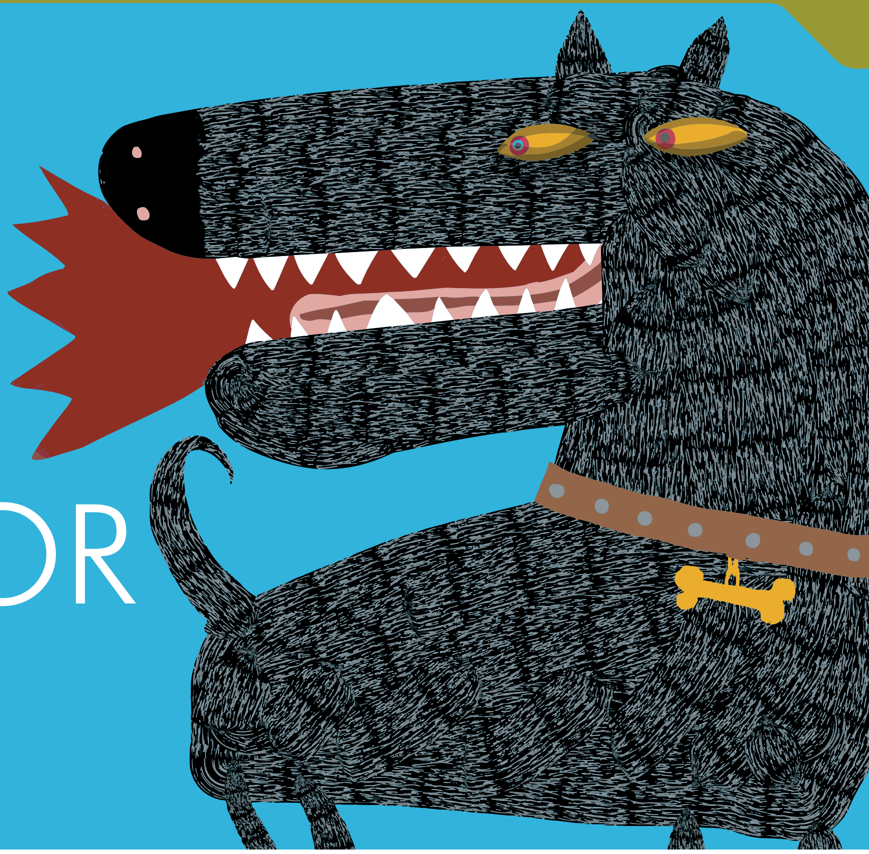

THE REGULATOR COMETH

Most will have been glad to see the back of 2009, for many in the financial services sector the toughest year in living memory. The start of 2010 has been lively in regulatory terms to say the least. Governments and politicians have been releasing policy ideas and plans for regulatory reform of the financial services sector on an almost daily basis. These plans do not appear to have been methodically thought out, and it would be a push to describe them as consistent in their application and their goals, especially if viewed globally. The drivers in many cases of this rash of regulatory reform appear to be very political; change is needed but will the right change be the result? Almost certainly not — a lot of what has been suggested of late plays to a populist agenda and looks designed to win votes rather than future-proof the next crisis most effectively.

The impact for compliance and regulatory practitioners is a period of even more uncertainty; the climate requires us all to watch, interpret and attempt to anticipate what might evolve. Most of this reform is not going to materialize overnight and we should all have time to prepare for, and adapt to, whatever develops.

One predictable constant for this year is the attitude of regulators (those that survive that is), or perhaps watchdogs is a better description. Their declarations (barking) this year have built on those made post-crisis last year, and no one should doubt their determination to be viewed as fierce and with sharp teeth. This theme pervades the entire gamut of their interaction with the regulated — supervision, examination and enforcement. They have repeated their insistence that they will not tolerate behavior from firms that impedes their ability to meet their objectives as regulators, and lack of resource is not a valid excuse.

The changes and increased regulatory pressure have led to more demands from our clients to help with the added complexity of the environment, and to deliver compliance more efficiently. We are working with many more of our clients to improve their use of technology in the ways that they supervise, control and educate the business lines, and demonstrate this to the regulators. Clients require information and data that is better organized and categorized so that it propagates their systems and automates a number of compliance and regulatory processes where the regulators require total transparency. We have noted a discernible change in attitude from some firms, a flight to quality, where they have approached us with clear intent of their need to resist cutting corners and to not risk a brush with an intolerant regulator.

With the regulatory heat rising, the compliance officer faces a busy year as the new demands around risk management, compensation practice, regulatory relations and consumer protection provide daily challenges, with the spectre of much larger changes looming not much further behind.

Chris Pilling CEO

The Office of Foreign Assets Control is the primary US agency responsible for the administration of US economic sanctions against designated non-US countries and persons. In addition to country specific sanctions, OFAC maintains a list of specially designated nationals and blocked persons (SDN List) with whom transactions are specifically prohibited or restricted.

US SANCTIONS - OFAC, BLOCKED VESSELS AND THE 'STRIP CLUB BANKS'

By Nigel Kushner

Blocked vessels

OFAC has designated the Islamic Republic of Iran Shipping Lines and other affiliated entities as proliferators of weapons of mass destruction. It names well over one hundred vessels owned by IRISL and other designated entities, which are collectively labelled "blocked vessels". Its primary effect is to freeze all assets of these blocked vessels that are now, or in the future, under US jurisdiction or are under the control of a "US person". Blocked vessels must be physically blocked should they enter US jurisdiction. Freight forwarders and shippers may not charter, book cargo on, or otherwise deal with blocked vessels. Property related to a blocked vessel which may be subject to blocking may include goods, deposits, fund transfers, loans, letters of credit, drafts and negotiable shipping documents.

What is a 'US person'?

A "US person" is defined as any US citizen or lawful permanent US resident wherever located; any person in the United States; or any US company, including its foreign branches. Notably, affiliates of US companies that are not formed under US law are excluded.

OFAC fines

Criminal penalties can include fines that range from $50,000 to $10m and imprisonment that ranges from 10 to 30 years. Civil penalties range from $250,000 or twice the amount of each underlying transaction to $1,075,000 for each violation. If you think you are immune — think again. OFAC is becoming tough. In 2008, the aggregate of OFAC's civil penalties and settlements was reportedly $3.5m. In 2009 that reportedly rose to $772.4m.

The 'strip club banks'

OFAC has, however, recently asserted jurisdiction over financial institutions which are not US persons. They are colloquially known as the "strip club banks," after having allegedly stripped out identifying information from payment messages so as to prevent US correspondent banks identifying the origins. Had the origins

not been stripped out, the payments would have been routinely blocked or rejected. These cases exhibit OFAC's interest in penalizing non-US entities for "causing" a US entity to violate sanctions. A number of banks are said to be currently under investigation.

In December 2009, a Swiss bank settled certain allegations with a payment of $536m. That may sound a lot but, arguably, the Swiss bank got off lightly — it faced a base penalty under OFAC's guidelines of $1.7bn.

US banks and blocked vessels

Banks that fall into the definition of a "US person" are required to reject any fund transfers that reference a blocked vessel and must notify OFAC with a copy of the payment instructions that funds have been returned to the remitter. Banks must contact OFAC should the name of a blocked vessel appear in shipping documents presented under a letter of credit or if noticed in a documentary collection, or under an electronic funds transfer. Whether a bank is acting as the advising, issuing, confirming, paying or reimbursing bank under an L/C, it ought to apply a rigorous compliance regime.

We are not a company formed under US laws — why are we affected?

Any transfer of US dollars via the banking system by a non-US person in connection with a transaction that involves a blocked vessel is at risk of being rejected or blocked. You and your counterpart may not be subject to US jurisdiction but your transaction may be incapable of being completed in the manner agreed. (Perhaps unsurprisingly, some non-US organizations shipping goods on blocked vessels are beginning to trade in euros rather than US dollars since this reduces the exposure of having funds blocked or rejected — the funds will not automatically pass through the US banking system).

Further, non-US organizations must ensure that no US person is involved with any business which would be in breach of sanctions. For example, an English company that nominates a blocked vessel may not be in breach of OFAC sanctions. If the shipping manager for that English company is a US citizen, however, and they were involved in the nomination, then the shipping manager may well be in breach of OFAC sanctions.

Sanctions clauses

Those involved in the international sale of goods must amend contracts where necessary to provide adequate protection. Otherwise, they risk not being paid. The sanctions clause must be robust — it is not unknown for less scrupulous traders to use a badly drafted sanctions clause to "walk" from a contract if the market moves against them.

If you require any further information please contact Nigel Kushner at nigel.kushner@whalerocklegal.com

Nigel Kushner is the managing director of Whale Rock Legal Limited, a niche legal practice in the City of London, providing traditional legal services together with in-house legal support. Regulated by the Solicitors Regulation Authority.
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There is now a global consensus that insurers, like other financial institutions, are a source of systemic risk. Insurers say their own systemic risk is of a different kind than for banks. Supervisors recognise that insurers have distinct business models, but they do not all understand these models.

SYSTEMIC RISK: DIFFERENT FOR INSURERS THAN FOR BANKS

By Alex Davidson

The debate on what systemic risk means, including in relation to different financial services sectors, is ongoing. At a recent conference of the Committee of European Insurance and Occupational Pensions Supervisors in Frankfurt, Jean-Claude Trichet, president of the European Central Bank, said that insurers and pension funds were systemically important for three reasons: size, interconnectedness and economic functions.

Trichet said that he would expect the planned European Systemic Risk Board to make a substantial contribution in helping the public sector to detect systemic risk and in translating risk warnings into actions. The ESRB is one of several bodies that will be set up to deal with systemic risk, and there is fear of public confusion about distinctions in roles. Secrecy does not help to dispel this fear.

The Financial Stability Board has a current remit of ensuring financial stability; it does not publish its list of 30 systemically important firms. Officials say that the FSB list is not of companies deemed too big to fail and that the list remains unpublished because of the risk that the public might use it as a proxy for this. It is no secret, however, that the FSB's list contains some insurers. The view is that American International Group's collapse illustrated how real the threat of systemic risk for insurers can be.

IAIS paper

The International Association of Insurance Supervisors and the Basel Committee on Banking Supervision have provided full input into the work that the FSB has coordinated on supervisory colleges. The IAIS has gone so far as to define systemic risk in a recent paper, "Systemic Risk and the Insurance Sector".

According to the paper, systemic risk could be caused, for example, by the failure of one or more insurers or by the withdrawal of insurance or reinsurance cover, as has occurred, for example, with terrorism cover. Insurers are subject to direct counterparty risk that could cause the failure of related financial institutions by way of immediate contagion effects.

The paper said that because the insurance sector was typically among the largest investors, a sudden decrease in the value of investments or movements of interest rates might adversely affect the portfolio of an insurance company and its liquidity. In addition, withdrawal from purchasing financial instruments issued by banks might further lead to a contraction of credit products available in the real economy. In the area of investment activity, the insurance industry could act as an amplifier of systemic risk.

According to the paper, these potential sources of risk could emerge individually but could also be combined and, therefore, compound a systemic problem. An important source of an insurance failure or malfunction is related to core insurance functions of underwriting and provisioning, and a further source could be via reinsurance.

The paper said that in conjunction with a lack of substitutability in a non-competitive market, the potential failure of a significant insurance company could create significant disruption to households and businesses through a shortage of insurance capacity. This could occur if crucial insurance cover became unavailable; however, on the other hand, an extremely competitive insurance market with low premiums or weak underwriting could weaken the market's resilience should there be financial or economic shocks.

The paper observed that systemic problems in insurance tended to emerge over a longer time horizon than for banking. Banking failures could arise in hours or days; however, insurance failures usually took months or years, although loss of insurance capacity could emerge in weeks, if insurers or reinsurers changed offering cover after serious problems were discovered.

Insurance: 'less systemically relevant than banking'

At UK level, Adair Turner, chairman of the Financial Services Authority, said at the recent conference, *The Turner Review: progress towards global regulatory reform*, that financial institutions other than banks faced systemic risk. He noted that a proliferation of contracts hugely increased the interconnectedness of the system and lay behind the judgment that AIG was both too big and too interconnected to fail.

CMS Cameron McKenna, the law firm, said in a regularly updated report, "Regulatory Reform: Underlying the Impact", that the "FSA does, however, recognise that insurance is less systemically relevant than banking. It is looking at the read-across from the banking sector and the possibility of an insurance-specific regime".

In its report, CMS Cameron McKenna noted that the FSA intended to carry out a cost-benefit analysis of any changes or read-across from the banking sector (as in FSA feedback statement 09/5). The firm said that the larger life offices and insurers would need to watch development of macro-prudential regulation, the policy on too big to fail/systemically important institutions and related areas such as reverse stress-testing, "living wills" and the Financial Services Compensation Scheme reform.

CMS Cameron McKenna said that some of the emphasis on more realistic regulation of groups and cross-border business might have an impact on insurance, but this depended on further policy development in the banking sector. The law firm noted that reforms in the banking and funds sectors would bring "impacts and opportunities" for insurers and life offices, both in insurance and as investors, and opportunities existed for insurance-based solutions and new capital instruments.

Pandora's box

The debate continues. Stewart Hodges, professor of finance at Cass Business School, has suggested that regulators opened a "Pandora's box" by focusing on systemic risk because it is something which nobody can measure. His view is that systemic risk could ultimately apply to insurers as well as banks and that modelling issues are basically the same, although with some distinctions — in life insurance, the long-term nature of assets and liability matches means that companies may focus on forecasts with a one-year horizon for many risks, as opposed to the shorter models often applicable in banking

Ultimately, systemic risk is only one of the areas on which the insurance industry is focused in efforts to make its distinct business model understood. Insurers are striving generally against the risk of regulatory backlash from the crisis, which was caused by banking, and how far they are categorised as systemically relevant is manifestly part of this.

Andrew Baker, chief executive of the Alternative Investment Management Association, says the global hedge fund industry supports transparency and desires stability.

STRIVING FOR FINANCIAL STABILITY

by Andrew Baker

The global economic crisis that began in 2007 and reached its height in 2008 posed the greatest challenges that the hedge fund industry has ever faced. It is, therefore, only natural that we, as the global hedge fund industry association, would support greater stability in financial markets.

Policymakers have said that they need a better sense of concentrations of risk in global financial markets to prevent future instability. That is why we are determined to do everything we can to assist international policymakers in preventing systemic instability. It is also why we would always support good regulation that has been crafted sensibly and has been subject to a proper process of consultation and evaluation.

The European Commission's Alternative Investment Fund Managers Directive is one of the key responses to the crisis. Many of its goals are laudable. It is desirable, for example, for there to be appropriate European structures in place for the registration and authorisation of hedge fund managers. The reporting by those managers of systemically-relevant information would enable supervisors and macro-prudential authorities to better tackle systemic risk. Establishing a "passport" for managers to market funds to specified investors within the European Union would be a welcome and positive step, creating what would be in theory a European single market for funds.

The procedure involved in agreeing on the directive is proving complex, however. A measure of this is the existence of three different versions of the draft directive — the original, which the EC published in April 2009, and those that the European Parliament's "rapporteur" and the then Swedish Presidency of the EU subsequently proposed. If you include the hundreds of possible amendments to each version, which MEPs and other policymakers proposed in January, there are an almost limitless number of potential outcomes.

Readers will be familiar with the industry's assessment of the original draft directive, which the EC published in April 2009. During the intervening period, a broad consensus has built up among European policymakers and other influential commentators that the original form of the directive needs substantial revision. Even some erstwhile critics of our industry, including the Church of England, have found fault with the directive. Meanwhile, a number of independent studies — including one that the European Parliament itself commissioned — have conveyed concerns with the EC's original draft of the directive and the rationale for it.

Against such a backdrop, it was no surprise when the newer versions of the draft directive deviated from the EC's initial outline. The Swedes' draft seemed eminently sensible and raised hopes that it might form the basis for the way forward. The inclusion of a new section on remuneration may have raised some eyebrows; however, the Swedes' subsequent decision to revise this (and other) sections in a further redraft was characteristic of their pragmatic and constructive approach. Sweden's sterling work passed to Spain, which took over the rolling EU presidency in January.

Meanwhile, the European Parliament's rapporteur, Jean-Paul Gauzès, produced his own list of recommended amendments in November. Gauzès' text contained some welcome steps forward, not least his recognition of the importance of alternative investment funds in financing the European economy and his declared intention to strike a balance between the vitality and creativity of the industry and proportionate regulation and supervision. There were a number of helpful specific proposals, including the alignment of the directive with existing EU financial laws and regulations and the recognition that national private placement regimes should still apply.

There were some areas, however, where we and many others agreed that further revisions to Gauzès' directive could yield better regulation. For instance, we would argue that short-selling is a market-wide issue and measures relating to it do not belong in this directive. Revising the apparent restriction on funds of hedge funds intended for retail investors that invest more than 30 per cent in third-country AIFs would be beneficial. Greater clarity would also improve the provisions relating to leverage and depositaries.

As I write this, efforts to reconcile the different versions of the directive continue. For the directive to become law, it needs to be approved by the European Parliament, which is made up of MEPs representing the citizens of Europe, and the European Council of Ministers, which comprises government representatives of all 27 member states.

It is in everyone's interests, whether they are policymakers who regulate or the market participants who are regulated, that this process produces European regulation of our industry that is transparent, proportionate and workable.

"Further revisions to the AIFM Directive could yield better regulation."

About the author

Andrew Baker became the chief executive of the Alternative Investment Management Association, the global hedge fund trade association with more than 1,100 corporate members in over 40 countries worldwide, in January 2009. Prior to joining AIMA, he spent six years at Schroders in London where he was COO - Alternative Investments.

Previously, Andrew held senior business management positions at Gartmore and UBS Asset Management after a 15-year spell of managing institutional assets at HD International and NM Rothschild. In the early 1980s he spent two years on secondment at the Bank of Papua New Guinea in Port Moresby. He has a degree in Mathematics from Imperial College, London and is married with three children.

About AIMA

As the only truly representative global hedge fund association, AIMA, the Alternative Investment Management Association, has more than 1,100 corporate members worldwide, based in over 40 countries.

Members include leading hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms and fund administrators. They all benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals and its excellent reputation with regulators worldwide.

AIMA is a dynamic organisation that reflects its members' interests and provides them with a vibrant global network. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation — the industry's first and only specialised educational standard for alternative investment specialists.

For further information, visit AIMA's web site, www.aima.org, or call +44 (20) 7822 8380.

As one of the leading financial centers in Asia — or, indeed, the world — Singapore saw its share of turmoil in the wake of the global financial crisis.

INVESTOR AND GOVERNANCE ISSUES HIGH ON SINGAPORE'S REGULATORY AGENDA FOR 2010

By Trond Vagen

In the last year, the country has had to deal with issues such as public uproar over the mis-selling of structured products to retail investors, calls for improved corporate governance at its listed companies, as well as a growing stream of regulatory changes from abroad influencing the local approach to regulation. We spoke to Shane Tregillis, deputy managing director at the Monetary Authority of Singapore, on the lessons learned from the crisis and what the regulator sees as its main challenges in 2010.

Through most of 2009, the MAS was kept busy resolving disputes related to the mis-selling of structured investment products to the retail sector. These products, of which the most commonly sold type was the infamous Lehman Brothers minibond, were sold to thousands of investors by bank staff with poor or non-existent product knowledge. When Lehman collapsed in 2008, these products were rendered worthless overnight. A review by the MAS subsequently found that 10 of the financial institutions that had been distributing these products had not been compliant with existing rules on the sale and marketing of investment products.

"MAS conducted detailed investigations into the financial institutions and the sale and marketing of the notes," said Tregillis. "Our investigations found that the financial institutions that distributed the notes had policies, procedures and controls in place for the approval, sales and marketing of the notes. However, the extent of the due diligence and level of internal controls differed among them. As a result, there were various forms of non-compliance with MAS' notices and guidelines on the sale and marketing of investment products."

As a result of the MAS' review, the 10 financial institutions involved were banned from distributing similar products for up to two years and told by the regulator to rectify "all weaknesses identified by the investigations and to review and strengthen all internal processes and procedures for the provision of financial advisory services across all investment products," Tregillis said. "The institutions were also required to appoint an external person approved by the MAS to review their action plan and report on its implementation. They will not be able to distribute structured notes until we are satisfied with the measures they have put in place."

The MAS also reviewed the regulatory regime that governs the sale and marketing of investment products, issuing a consultation paper in March 2009 on proposals to enhance the regulation of investment products. The proposals aim to promote more effective disclosure by improving the quality of information available to investors, and strengthen fair dealing in the sale and advisory process, according to Tregillis.

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#7 islamic finance

Islamic finance is stepping into the mainstream of financial services around the world. The financial crisis has shone a harsh light on a number of activities undertaken as a matter of course in conventional finance, many of which are simply not present in Islamic financial practices. Investors and consumers alike are beginning to turn to the more transparent, ethical and potentially more stable activities of Islamic financial institutions to meet their financial services needs. Islamic finance is at a nascent stage of its development and has a number of challenges to face in order to meet the growing demand for its services while also maintaining its distinct identity.

Why it survived the crisis better than conventional finance

There are a number of features inherent in Islamic finance which have meant it has, by and large, proved to be more resilient than conventional finance services in the recent crisis. By its structure and design Islamic financial activities have remained firmly coupled to the underlying economic activity. It is the decoupling of economic activity from conventional financial services which eminent Islamic adviser Professor Mahmood Faruqui has dubbed a weapon of mass economic destruction. The close link between financial and productive flows in Islamic finance has reduced the potential for over-exposure to risks associated with excessive leverage and imprudent risk-taking. As part of the overarching concept of profit and loss sharing there is an explicit requirement for appropriate due diligence to ensure that the profit is commensurate with the risks. This emphasis on the economic viability of the underlying assets and on good governance, ethics and transparency are the foundation stones which provide Islamic finance with an in-built mechanism to enhance the prospects for soundness and stability. By and large a Sharia'h-compliant approach has insulated IFIs from the over-zealous innovation and resulting toxic assets which have bedevilled so many conventional firms.

Another element which has assisted Islamic finance is the active interest taken by investors or depositors in the activities of their banks. As investors take on some part of the risk they have more incentive to exercise more active oversight, and this has helped IFIs avoid unduly risky investments. Even where potentially high-risk investments have been made, IFIs tend to hold a relatively large share of their assets in reserve accounts which act as liquidity buffers should there be a negative external shock.

To find out more on Islamic finance and the implications for compliance departments, get your copy of the full iBriefing on Islamic finance at:

www.complinet.com/ibriefing/islamicfinance

Raising the Issue

Researched and written by Complinet's in-house team of former regulators, attorneys and industry practitioners, this iBriefing series will provide insight into current key regulatory topics that educate compliance staff, inform business lines and escalate dialogue with senior managers.

Some of these proposals, such as a cooling-off period and a separation of deposit-taking staff and investment advisory staff at banks, have already been implemented.

The crisis identified several investor protection weaknesses in Singapore, and Tregillis said financial institutions would have to work hard to regain the confidence and trust of their customers. Banks, however, could not be blamed solely for the lack of investor education, Tregillis noted. "The recent crisis reinforces the importance of customers investing only in products that they understand and taking steps to better safeguard their interests when making investment decisions. The basic tenet remains: if you do not sufficiently understand the nature and risks of a product, you should not buy it. MAS and our partner agencies are stepping up our financial literacy education efforts."

Governance issues

The MAS also recently announced the formation of a Corporate Governance Council, which has been tasked with reviewing the country's Code of Corporate Governance. The timing of the announcement was impeccable, with a growing number of disgruntled investors in Singapore having voiced their concerns over the lack of appropriate governance measures at the so-called S-Chips — or Singapore-listed mainland Chinese companies — following years of scant attention to the rules by the companies' directors.

"Aside from the review, the council will also focus on identifying opportunities for continuing professional development of directors and the development of practical guidance for board committees," Tregillis said, noting the MAS was also conducting a review of its corporate governance regulations for locally-incorporated banks and significant life insurers. "This review is separate from the council's review of the Code of Corporate Governance for listed companies. As part of the MAS' review, we will focus on the effectiveness of risk management at the board level, including the board's role in safeguarding the safety and soundness of their institutions, and in setting remuneration policies to manage risks effectively."

The Singapore Exchange also recently announced a series of measures to strengthen corporate governance practices and foster greater disclosure. These include requirements for the appointment of a governance adviser to help newly-listed companies put in place good corporate governance frameworks and practices, as well as an audit committee to assess and comment on the adequacy of a company's internal controls and risk management systems. In addition, listed companies will in the future have to have at least one independent director, who is resident in Singapore, to sit on the board of its offshore principal subsidiaries.

"The SGX has also proposed to have the right to publicly censure directors or key executive officers and object to their appointments, if they have refused to cooperate with the regulators or caused a breach of rules, laws or regulations," Tregillis noted. "Taken as a whole, these measures would help listed companies better comprehend and meet their obligations."

Regulators can formulate good corporate governance rules and best practices; however, the conformance with rules and the quality of companies' corporate governance practices depended on people and values, he added. "Directors, in particular, play a critical role in establishing a framework of controls, setting appropriate risk management and remuneration policies, fostering good compliance culture and ensuring that obligations to shareholders are met."

Hedge fund concerns

Singapore has been very successful in attracting hedge funds and other wealth management outfits over the past few years, partly due to its exempt regime for hedge funds, but this may also be about to change. While the political wrestling in Europe continues over the Alternative Investment Fund Managers Directive — which could have a profound impact on Singapore's hedge fund industry — market players in Singapore still await a consultation on the hedge fund licensing regime by the MAS. Many expected it to arrive at their desks some time in November 2009, although most now believe the MAS will wait until it has a clearer picture of how the AIFM Directive develops.

"The events of the past eighteen months have clearly led to some shifts in the expectations of investors, counterparties and regulators, in the oversight of hedge funds," Tregillis explained. "We are reviewing our regime to ensure that it remains sound and responsive to the changing needs of the various stakeholders. This includes re-examining the way in which hedge fund managers are regulated, and the way in which they relate to their investors and other stakeholders."

He said that the MAS would maintain its consultative approach with the industry. "As is our usual practice, we will consult the industry on any proposed changes to the regulatory regime for fund managers. In making any changes, we will be mindful of the need to provide sufficient time for industry to adapt. In the meantime, we will continue to deal with hedge funds based on the current approach."

Love funding and champerty

FULL STEAM AHEAD FOR LITIGATION FUNDING AND SECURITISATION?

By Helen Parry

The litigation funding and insurance markets

As the effects of the credit crisis have hit home, fund managers have been casting around for fresh fields to cultivate - areas that can offer healthy returns derived from asset classes which are not connected to the vicious vagaries and volatilities of classic securities markets — so-called non-correlated assets. There are always opportunities to be found in the nooks and crannies of any market downturn for those who care to look, and as market players get deeper into the game of pass the losses parcel, the ever growing mountain of post-crash commercial litigation is now being viewed by some hedge funds and others as a potentially lucrative new investment opportunity. Litigation funding is beginning to be viewed as a potential target market for securitisation. For those engaged in investing in law suits, securitisation could be the final link in the chain of the litigation finance market of which conditional fee agreements, legal expenses insurance and third-party litigation funding form the rest.

Conditional fee agreements

These are defined in Lord Justice Jackson's recently published "Review of Civil Litigation Costs" as an agreement pursuant to which a lawyer agrees with their client to be paid a success fee in the event of the client's claim succeeding, where the success fee is not calculated as a proportion of the amount recovered by the client. A typical example of a CFA is where a law firm is retained on a "no win, no fee" basis.

"The bankers haven't historically understood the legal market, and the lawyers haven't historically figured out how to access external capital. So what you're seeing now is really the beginnings of the convergence of law and finance,"

Richard W. Fields, chief executive, Juridica Capital Management Ltd.

Legal expenses insurance

LEI is defined as insurance (either after (ATE) or before (BTE) the event) that covers a person against their own legal costs and/or the legal costs of an opponent in litigation. It may also pay interim cost orders which could arise during the course of proceedings. The cost of the premia may also be recoverable. Lord Jackson recommends that such premia should be no longer recoverable as such arrangements can be unfair to defendants. An insurance premium is not a true item of strictly legal costs and only legal costs are recoverable in law. It could also cause a significant ratcheting up of costs in commercial cases which could produce a potentially serious effect on the attraction of London as a forum for international dispute resolution. Some law firms are now offering clients a package that comprises CFA, insurance and TPF. This package enables the client to hedge much of the risk of commercial litigation and to pursue its claim at a relatively modest cost.

Conversely, however, the other side will face a potentially crushing costs burden, namely:

- Its own costs
- The insurance premium
- A success fee

The advantage for the plaintiff is that this hedge on risk is available at no upfront cost; no cost if the case fails and, if the case succeeds, the cost of the insurance policy should be recoverable from the opponent. This is true whether the cost of the litigation is modest or significant. If a client has sufficient cash flow to pay some of the interim costs involved in pursuing litigation, safe in the knowledge those costs are ultimately insured in the event of a loss, it is, potentially, possible to transfer up to 100 per cent of the financial risk at no cost whatsoever.

Third-party funding

TPF is defined as the funding of litigation by a party who has no pre-existing interest in the litigation, usually on the basis that:

The funder will be paid out of the proceeds of any amount recovered as a consequence of the litigation, often as a percentage of the recovery sum.

The funder is not entitled to payment should the claim fail.

Typically, funding will be offered in return for a 30-40 per cent return on the funder's investment. Funders may also put in place ATE insurance to cover their own losses, when they get it wrong.

Factors driving the choice of risk transfer vehicle

For litigants with limited or no assets, the prospect of being indemnified by means of insurance for a failed suit will not suffice as they will not be able to fund the initial expenses and ongoing costs of litigation. For such litigants, TPF is undoubtedly a major ingredient in their risk transfer mix. For others, the insurance option may be more advantageous in that they may be able to recover the premium and they will not have to share their damages with their funder. For most clients, a combination of both types of funding will usually be the most appropriate option.

Above average returns for hedge fund investors

In current market conditions, many corporations are facing huge financial stresses and have limited funds to bring litigation. Hedge funds and other alternative asset managers are stepping into the breach with the provision of such funding and are finding that it can bring above average returns for their investors.

How does this work in practice?

A company that may have a claim worth £500m may be facing potential litigation costs of £50m. They could opt for TPF and agree to pay out 30 per cent of the amount recovered (if any) rather than put the £50m up front with the hope of eventually making a full recovery.

'...securitisation could be the final link in the chain of the litigation finance market...'

Maintenance, champerty and barratry — relics of an earlier age?

Such financing techniques do, however, run the risk of falling foul of the ancient common law "offences" of barratry, maintenance and champerty, and in recent years champerty-based objections have been raised in securitisation chain-related disputes. Such a dispute involving a mortgage originator, Love Funding Corporation, has, however, recently been resolved in the New York Court of Appeals, with a finding against champerty. This decision has been welcomed as potentially clearing the way for the further development of these markets.

Medieval concepts

To understand the legal issues involved in these cases, it is necessary to consider three medieval legal concepts:

- Barratry: The practice of exciting and encouraging lawsuits and quarrels.
- Maintenance: An officious or unlawful intermeddling in a cause depending between others, by assisting either party with money or means to carry it on.

Champerty (an aggravated form of maintenance): The prosecution or defence of a suit, whether by furnishing money or personal services, by one who has no legitimate concern therein, in consideration of an agreement that they shall receive, in the event of success, a share of the matter in suit; maintenance with the addition of an agreement to divide the thing in suit.

The historical origins of the law

The law in this area is believed to have emerged and developed in response to perceived abuse of the judicial process in medieval England, whereby interference in litigation by powerful nobles and officials was a tactic used to harass and oppress private individuals. Champerty was especially feared because the champertor's financial stake in the court action provided a strong temptation to suborn justices and witnesses, and to pursue worthless claims which a defendant may have lacked resources to withstand. In the US, barratry has resurfaced as a result of the aggressive style of "ambulance chasing" practiced by some lawyers.

Champerty and the law of contract

These rules made it illegal to financially assist a party to litigation without lawful justification. In 1982 the position began to change in England when the House of Lords decided that a bank that had financed a sale of cement by one of its customers could validly take the assignment from the customer of their claim for damages for wrongful failure to pay for the cement. The essential condition required for the validity of the assignment, however, was that the assignee had a "genuine commercial interest" in accepting the assignment and enforcing it for its own benefit. The House of Lord's main concern was to prevent trafficking in litigation by parties whose primary interest was speculation as opposed to seeing justice done.

The Jackson Review and champerty

Lord Jackson notes that there has been a sea change in the approach of the courts, both in the UK and elsewhere, as many clients cannot afford to litigate without some form of third-party funding and that it is better for such claimants to forfeit a percentage of their damages than to recover nothing at all. This means that TPF definitely has a part to play in promoting access to justice. What is required, according to Lord Jackson, is a modern regime of regulation to replace the old and out-of-date case law.

The voluntary Code of Conduct

The Third-Party Litigation Funders Association, in conjunction with the Civil Justice Council (an advisory body established under the Civil Procedure Act 1997 with responsibility for overseeing and coordinating the modernisation of the civil justice system), has published a voluntary Code of Conduct for third-party funders. The contents include:

- Introduction
- Criteria for case selection
- Contents of the funding agreements
- Funder's commitments of fair dealing
- Capital adequacy requirements
- Client's obligation to support the litigation
- Funder's obligation to pay out adverse costs
- Funder's entitlement to costs and a share of the proceeds in the event of success
- Role of the client's solicitor
- Protection of confidential information.
- Disclosure of terms
- Complaints
- Enforcement
- Appendix with key terms to be included

Compliance with such a regime, according to Lord Jackson, should be sufficient to prevent any agreements being overturned on the basis of maintenance and champerty.

Regulation by the Financial Services Authority

Lord Jackson has also addressed the proposition that TPF providers should be subject to statutory regulation by the Financial Services Authority, particularly with regard to issues such as capital adequacy. The FSA, he notes, has been holding a general watching brief in relation to this area. It is, however, not currently aware of a significant risk to consumers and Lord Jackson is not recommending formal statutory regulation at this time. The door has been left open for this proposition to be revisited in the future if it is deemed appropriate in the light of further market developments.

Litigation financing through assignment of claims

Another possible technique for the financing of litigation could be achieved by means of the device of the assignment of a liability claim to a funder/investor. Under such an arrangement, the original claim holder would receive an upfront payment in exchange or the assignment of the claim before there has been any ruling with regard to the actual liability of the defendant. The spread between the anticipated level of damages and the cost of the assignment must, of course, incorporate payment for the risk of failure plus interest.

An interesting spread

The value of the claim may change between the moment it was first transferred and the date of a final ruling on the issue. Such price changes may be of interest to investors and this could facilitate the raising of capital for financing civil litigation, and allows the transfer of the risk related to liability claims at lower transaction costs.

Assignment and securitisation

One of the further advantages of such a technique lies in its susceptibility to securitisation. This process can, in turn, facilitate the raising of capital for financing civil litigation by helping to transfer the risk related to liability claims at even lower transaction costs.

Champerty, tort and securitisation

It is impossible for an injured party to sell his right to sue a tortfeasor, with the exception of the right to subrogation in insurance law. It is, however, possible to enter an agreement with an investor to

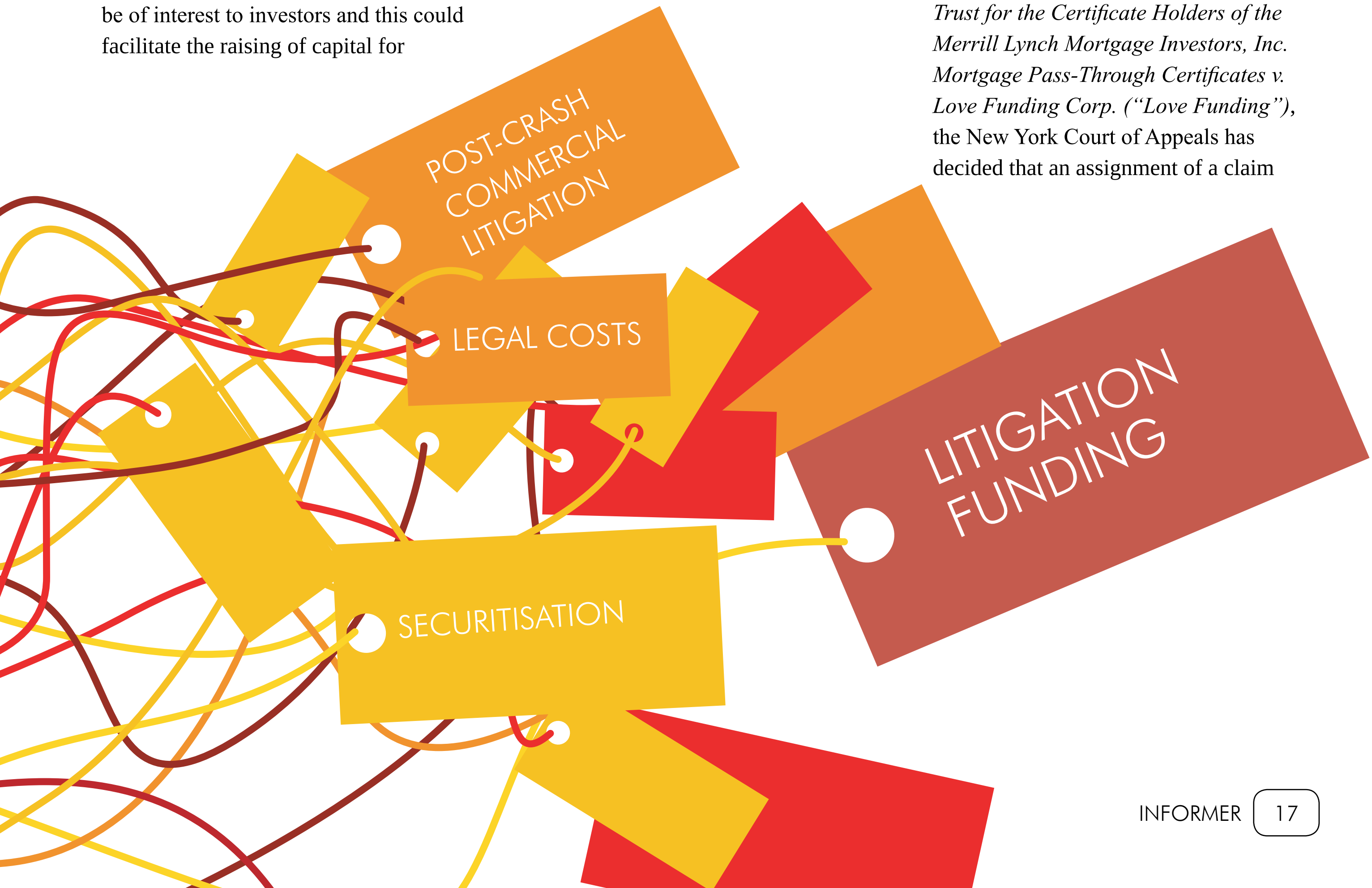
assign the proceeds of the action that could be recovered in exchange for the financing of the lawsuit. There is, therefore, a clear distinction between the assignment of a liability claim and the assignment of part of the proceeds of the liability claim. In the case of tort claims, there already is a market in the securitisation of tort settlements.

Champerty and assignment in the US

In both of these markets, the securitisation of these assets is a developing area of potential alternative investment through assignment or through the setting up of a securitisation vehicle, to which the claim is assigned and whose asset is the eventual future credit against the defendant. The transfer or partial transfer of the rights in the claim can then subsequently be realised by share purchase agreements. This allows for the syndication of a claim where more than one investor takes part. The shares can then be traded on a stock market. There may, however, be legal impediments such as possible champerty claims to be addressed in connection with such techniques. A recent ruling in the US has, however, clarified the law in this area in connection with a dispute which arose in the context of a securitisation chain of mortgages which had been created through a series of assignments.

Champerty and mortgage securitisation in the US: The Love Funding judgment

New York's champerty statute specifically forbids trading in litigation claims; however, in the groundbreaking judgment *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates v. Love Funding Corp. ("Love Funding")*, the New York Court of Appeals has decided that an assignment of a claim



does not violate the statute if the purpose of the assignment is to collect damages by means of a lawsuit for losses on a debt instrument in which the assignee holds a pre-existing proprietary interest.

The Loan Syndications and Trading Association steps in

The Loan Syndications and Trading Association, acting on behalf of the multi-billion dollar secondary loan trading market by means of an *amicus curiae* brief (a legal opinion presented by someone who is not a party to the case who volunteers to offer information on a point of law, or some other aspect of the case to assist the court in deciding a matter before it), had expressed concern that a ruling to the effect that New York's

> 'The purpose of New York's champerty statute was to prevent attorneys and solicitors from purchasing debts for the purpose of obtaining costs from a prosecution.'

champerty laws prohibited the assignment of litigation rights would severely disrupt this important market and threaten future liquidity.

Transferring the right to assert a claim

Loan trading in the secondary market is based on the premise that the "entire bundle" of rights that a lender holds is transferable, including all mechanisms for enforcing rights and protecting the holder's interests. Accordingly, an essential component of the value of the traded instrument is the ability to assert a claim to protect the buyer's investment and recover, to the greatest extent possible, for any losses.

In *Love Funding,* the appellant, a trust, held a pool of commercial mortgage-backed securities, some of which were fraudulent. They initially sued UBS AG, the next in line in the chain which had securitised the loans. The appellant and UBS eventually settled all but one of the appellant's claims, for which UBS assigned to the trust litigation rights against Love Funding, the loan originator, the respondent. The respondent argued that the assignment of litigation rights to the trust was void for champerty. The trust appealed and the US Court of Appeals for the Second Circuit requested the New York Court of Appeals to clarify the proper interpretation of New York's champerty laws.

Scope of champerty laws

The court found that the prohibition on champerty historically has been limited in scope and largely directed towards preventing attorneys from filing suit merely as a vehicle for obtaining costs. The purpose of New York's champerty statute was to prevent attorneys and solicitors from purchasing debts for the purpose of obtaining costs from a prosecution. It was really put in place to protect the integrity and standing of the legal profession. It was never intended to prevent the purchase for the honest purpose of protecting some other important right of the assignee. The court noted that: "If a party acquires a debt instrument for the purpose of enforcing it, that is not champerty simply because the party intends to do so by litigation."

The court held that the champerty statute did not apply when the purpose of the assignment was the collection of a legitimate claim, such as when the purpose was to collect damages by means of litigation for losses on a debt interest in which it holds a pre-exisiting proprietary interest.

The standard terms and conditions of the purchase and sale agreement for distressed trades

The LSTA standard terms include a provision that the seller is selling the loans and any transferred rights, including legal rights of action.

This decision clarifies the position for those engaged in these markets provided that they include New York choice of law and jurisdiction clauses in the contract.

The background to the dispute

The case involved a dispute over mortgage-backed securities and the origination, pooling and securitisation of such securities. Love Funding Corporation was a commercial mortgage banking corporation — a mortgage originator — which had entered into an arrangement with Paine Webber Real Estate Securities Inc. (which later became part of UBS), whereby Love Funding would originate mortgage loans and evaluate the buyers, while Paine Webber would provide financing and ultimately assigned the loans for securitisation.

The mortgage loan purchase agreement

Under this agreement, Love Funding represented that the underlying mortgage loans were not in default and promised that if this was not the case they would buy back the loan and otherwise indemnify Paine Webber against any claims. One of the loans covered was a \$6.4m loan to Cyrus II Partnership, secured by a mortgage on an apartment complex. The borrowers have since become embroiled in an unsuccessful but high-profile case of defamation prompted by their perception that certain abusive processes, which were of economic benefit to parties engaged in the lucrative business of the special servicing of defaulted loans, had taken place prior to the finding of default.

The second MPLA

The mortgage, along with 32 others, was assigned and sold by Paine Webber to Merrill Lynch pursuant to a second mortgage loan purchase agreement which contained similar terms. Merrill Lynch then placed the mortgages into a trust which then sold certificates to investors.

Declaration of default

The trust declared the mortgage to be in default in March 2002 and started foreclosure action in Louisiana state court with respect to all of the loans. It was then discovered that mortgagors' principals had committed fraud in obtaining the mortgage. The trust then commenced an action against UBS, Paine Webber's successor-in-interest, claiming breach of the representation regarding no loans having been in default and claiming that the fraud had put the mortgage in default from the outset, which meant that the representation made by UBS in the Merrill MLPA was not true when it was made.

Agreement to settle

On September 13, 2004, UBS and the trust agreed to settle the case. With respect to the other 32 loans, UBS agreed to settle with the trust for $19.37m. With respect to the Cyrus II loan, the trust received an assignment of UBS' rights against Love Funding under the Love MLPA. The trust then sued Love Funding on the representation regarding the mortgage made by Love Funding under the Love MLPA.

Champerty claimed

Love Funding asserted a defense of champerty. The US District Court for the Southern District of New York found in favour of Love Funding, noting that the assignment was the only consideration the trust took in exchange for releasing UBS from the trust's claims with respect to the mortgage, concluding that the primary purpose of the assignment was for the trust to purchase a lawsuit against Love Funding, which the District Court viewed to be prohibited by the champerty statute. The court dismissed the action and the trust appealed and, as has been noted, won the case on appeal.

Recent developments in terms of the Jackson Review and the Love Funding judgment are pointing towards the clarification and liberalisation of possible legal restrictions on the market for funding, trading and securitising litigation rights. Such arrangements may soon be added to the long list of non-correlated asset classes that have been already securitised, from personal injury claim structured settlements (where the plaintiff is paid in instalments rather than in a lump sum), annuities, life settlements and viaticals, "Bowie bonds" and even lottery winnings (in those US state lotteries in which they pay the winner in instalments). Even disgruntled but impecunious spouses facing costly but potentially lucrative divorces can now look to the hedge funds sector as a means of funding their divorces. Wherever there is juicy lump sum or an income stream in the offing, somewhere there will be a hedge fund seeking to buy it and a banker and his clever lawyer eager to securitise it. The way is being cleared for such developments which may well, in the words of Richard Fields cited above, lead to the convergence of law and finance now that the legal establishment on both sides of the Atlantic is seeing fit to restrict the legal risk posed by those tiresome medieval anachronisms of barratry, maintenance and champerty severely.

THE ENFORCEMENT AGENDA FOR 2010

By Ian Mason

Some Financial Services Authority purists might deny that there is such a thing as an "enforcement agenda" in its own right, stating only that there is an "FSA agenda" which the Enforcement Division implements. A review of FSA enforcement cases in 2009 shows a number of clear themes, however, including systems and controls cases, market abuse, financial crime, treating customers fairly and mortgage fraud. The FSA's enforcement recipe for 2010 is likely to be "more of the same".

The last significant enforcement case of 2009 (Toronto Dominion Bank) was in fact a systems and controls case on the theme of mismarking, a subject which was also highlighted in a number of earlier enforcement cases (see, for example, the UBS and Nomura cases). The FSA fined Toronto Dominion £7m for serious failings in its systems and controls, concerning trading book pricing and marking which resulted in a negative valuation adjustment of CAD$96m in July 2008. The FSA found that these failings amounted to breaches of both principles two and three of its Principles for Businesses. This is not the first time that Toronto Dominion has been on the receiving end of enforcement action by the FSA for failures in its systems and controls. In November 2007, the bank was fined £490,000 when it failed to identify the activities of a fixed income trader who had been misreporting trades over a two-year period. This latest fine is the fourth largest that the FSA has ever levied and reflects the seriousness with which the FSA views repeat offences.

There are certain to be more cases concerning systems and controls in 2010. Few firms have flawless systems and controls, and sometimes auditors (internal and external) and compliance consultants have a nasty habit of writing reports identifying flaws and deficiencies which are not promptly acted upon by senior managers. These are a fertile source of enforcement action for the FSA.

Financial crime

Systems and controls are also relevant to another FSA priority, financial crime. The fine of £5.25m imposed on Aon early in 2009 for having inadequate controls against bribery and corruption was a bombshell. Combined with new offences created by the Bribery Bill, this case has resulted in many firms reviewing their systems in this area. In September 2009, the FSA reported that its review of anti-bribery and corruption systems and controls in commercial insurance broker firms had revealed low standards in relation to due diligence and third-party payments. Firms were not adopting a risk-based approach in relation to high-risk jurisdictions, and there were also issues over staff vetting and training. There were also several cases in 2009 concerned with internal fraud, for example, the Seymour Pierce and UBS cases.

Information security is another strand of financial crime: in July 2009 the FSA fined HSBC £3m for not having adequate systems and controls in place to protect its customers' confidential details from being lost or stolen. This is another area where firms will always have some weaknesses, laptops will go missing, sometimes data is not encrypted, and there is scope for human error. Expect to see more financial crime cases in 2010.

Market abuse

Market abuse was a strong theme in 2009. The FSA won two key insider dealing cases, the McQuoid and Uberoi cases. These cases both resulted in custodial sentences, and when one of the defendants appealed against his sentence (R v McQuoid), the Court of Appeal strongly upheld the sentence, establishing a valuable precedent for the FSA. The move towards the increasing use of criminal powers was also reflected in more raids. Working with the police, the FSA arrested 16 suspects in four different investigations; some of these are believed to have been working at City firms. It is now quite possible that the FSA may arrive unannounced on the doorsteps of a regulated firm, accompanied by the police, wanting to arrest staff. Firms need to have a contingency plan in place to deal with that kind of situation.

The FSA is still using its civil powers as well in market abuse cases. There is a particular focus on individuals working at City firms, for example, the case against two bond traders, Darren Morton and Christopher Parry, showed that the FSA also expects appropriate standards of market conduct to apply in the debt markets. The FSA also fined a former stockbroker, Alexei Krilov-Harrison, £24,000 for using inside information about an AIM company to encourage his clients to buy its shares.

The FSA has started 2010 in similar vein. In January it announced that it is prosecuting four former directors of iSOFT Group plc for conspiracy to make misleading statements. Market manipulation cases are more difficult to detect and prosecute than insider dealing cases, and the iSOFT case is the first criminal case based on allegations of misleading statements since the successful AIT case in 2005. Also in January, the FSA announced civil action for market abuse against a former research analyst, Robin Chhabra, and his friend, Sameer Patel. The tribunal held that they had committed market abuse by using inside information to carry out a series of profitable spread bets. The tribunal will determine the sanction at a separate hearing; the FSA had been seeking fines and bans against them. Further criminal insider dealing trials are also scheduled to take place in 2010. The FSA will have a new power to offer statutory immunity from prosecution to those willing to give evidence against others, so it will be interesting to see how the FSA uses this power.

The FSA's market abuse focus includes not just substantive cases of market abuse but also failures in systems and controls or to report suspicious transactions. In 2009 the FSA fined a broker, Mark Lockwood, £20,000 for failing to report a suspicious market abuse transaction. Although many firms will have reviewed their procedures following that case, there are still some grey areas: for example, when does market gossip or rumour become information on which firms should not deal? Are firms that have made a low number of suspicious transaction reports more at risk or does this indicate a good compliance culture? Expect more action in this area in 2010.

Retail focus

There is still plenty for the FSA to do on the retail side. The FSA announced in 2009 that it had referred three firms to Enforcement in relation to potential mis-selling of Lehman-backed structured products. There is probably more action to come on payment protection insurance sales and the sale of mortgage products. Complaints handling remains a vulnerable area for firms. The FSA stepped up action against unfair contract terms last year, and this will continue.

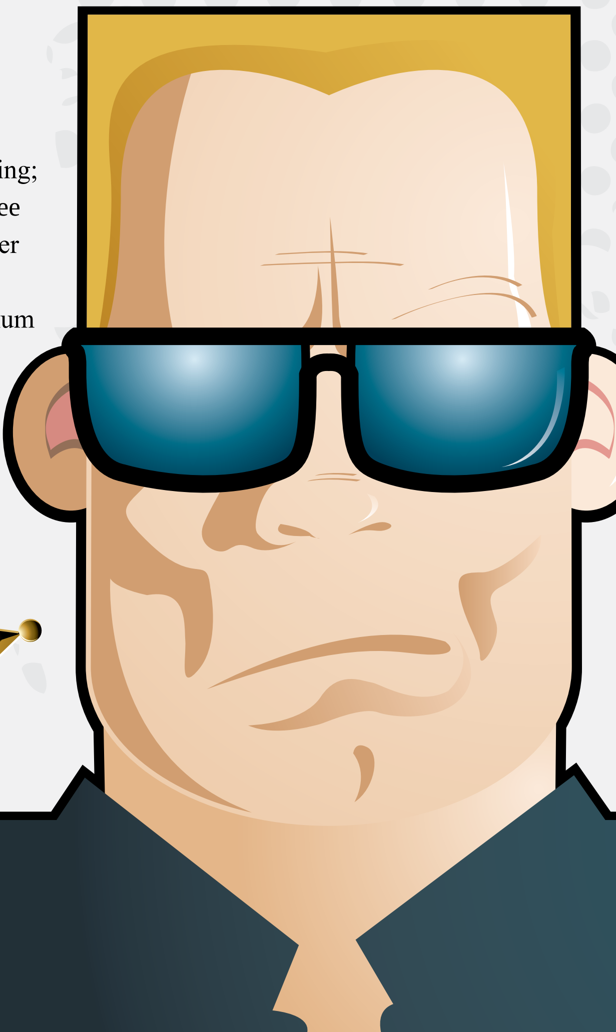
Fines and elections

Early in 2010, the FSA will be confirming its proposals on raising fines. The earlier proposals clearly signalled that these would be increasing; in some cases they will be two or three times the current level. Expect tougher sanctions, in particular, on market abuse (the FSA wants to see a minimum £100,000 fine) and a harsher regime on fines for individuals.

There are a couple of other "dark horses" to watch out for in 2010. It has been reported that the FSA, with the assistance of certain of the large accounting firms, is investigating some of the "credit crunch" banks. It will be interesting to see whether these result in any enforcement action, particularly any against the then senior managers of those banks. Secondly, what impact will the general election have on the FSA? Some disruption may be expected as a result of organisational and structural changes in the event of a Conservative victory; however, the substantive work of enforcement will continue. There is no particular reason to think that the FSA or its successor will be less tough under a new regime — indeed, the Conservatives have been quite critical of the FSA's role in protecting consumers.

Stand by for an interesting year.

Ian Mason is a partner and head of the Financial Services and Regulatory team at Barlow Lyde & Gilbert LLP



HOW TO PREPARE FOR A REGULATORY EXAM

By Daniel Bender and John Schneider

You have read the speeches and heard the industry buzz about the new Securities and Exchange Commission exam process, including enhanced coordination among various regulators, more in-depth exams and the addition of examiners with specialized training in trading, portfolio management, risk management and fraud assessments.

These changes, coupled with the far-reaching and ongoing impact from the Madoff ponzi scheme and accompanying reports issued by the SEC's Office of Compliance Inspections and Examinations, are fundamentally changing not only the duration and depth of exams, but how the SEC assesses risk (at the firm and industry levels with more fact-finding "sweep" exams, for example) and determines exam schedules and their examination procedures. In time (some of you may have already experienced the change), the new exam process will appear more adversarial and, in fact, be more adversarial, since document production will be expected in days or a day, not weeks.

All of these changes have resulted in longer deficiency letters and commitments of additional time and resource from firms when responding to questions during an exam and drafting responses to identified deficiencies.

There are several steps that firms can take to plan and prepare for an SEC exam. Although each firm's experience with examiners can be different, the following advice has proven useful to CCOs at firms expecting an exam:

1. **Know and prepare your firm:** An obvious red flag to any examiner is when a CCO or senior executive does not know what is in the firm's compliance manual or other material aspects of the firm's business activities, such as service or business arrangements with affiliates.

   Mock interviews: Meet with each professional who is likely to be interviewed by the examination team and conduct mock interviews. Follow up with each professional to ensure you have addressed any gaps — and do not forget the rest of your staff.

   Staff communication: The entire firm should be aware of the dates that the examination team will be onsite and where they will be located. Additionally, all employees should ensure they are sensitive to the commitment required to assist the SEC in completing its fieldwork and the importance of the exam process.

2. **Develop a firm overview:** A firm overview is a good tool for providing examiners a view into where the firm has identified potential conflicts, how those conflicts have been mitigated and where to focus their efforts. This is true particularly for complex organizational structures where affiliates provide services, and when professionals may be wearing two hats and products may compete with each other (i.e., side-by-side management).

3. **Responsible party and exam oversight function:** Assign a party to be responsible for managing the effort. This person should be sufficiently oriented to the exam process, firm policy regarding communication with examiners and the document production procedures. A group of individuals that comprises the staff from each business unit should coordinate the overall effort, meet periodically to monitor the process, identify any requests that appear unreasonable or require negotiation with the exam team, and identify any potential material deficiencies.

4. **Document production processes and procedures:** Develop a process and tool (e.g., Excel matrix) to track all document requests, which include the initial requests and follow-on requests. Any requests received verbally should be reduced to writing and captured in the overall document production matrix. Firms should keep a copy of all documents provided to the exam team and periodically discuss the status of open items with the exam team.

5. **Document production "dry run":** Using a recent examination document request letter, load each request into the Excel matrix or other document request tracking tool, assign each request to a responsible party, and identify the source of the required information (i.e., systems/applications, files, archives and third-party record management vendors). Coordinate with your IT department and systems analysts, and provide them with the required data fields for each request that requires electronic information. Coordinate with external service providers so they know you are expecting an exam in the near future, discuss the anticipated test period (e.g., one to three years), and identify which documents are available electronically and how long the service providers will take to produce the information. Conduct a targeted sampling of selected requests to evaluate the time to produce the documents and the form of the output, and review output substantively to ensure it appears adequate.

   E-mail surveillance: Evaluate the firm's ability to produce and sort e-mails in 24 and 48 hour intervals. Firms should have surveillance programs in place, and CCOs should examine their files to ensure they have appropriate documentation to support their surveillance program and any actions taken as a result of e-mail monitoring. Additionally, CCOs should have appropriate staff on hand or available to review e-mails prior to their delivery to the exam team.

6. **Annual review files:** Evaluate the level and adequacy of any documentation retained as a result of the review, including changes to policies or procedures, updates to disclosure documents and changes in business processes. Each annual review should have an action plan with responsible parties assigned to each remediation and a documented process to ensure each remediation is completed in accordance with the plan. CCOs should make sure they have documented their forensic/periodic/transactional testing program, have documents that support this testing and action plans for addressing any issues noted, as this information is certainly going to be reviewed closely by examiners.

7. **Risk assessment and conflicts of interest analysis:** Review the existing assessments for currency and completeness. The risk assessment should be sufficiently detailed so as to allow CCOs to direct their monitoring and testing program to the business activities that pose a major risk to the firm's clients. Additionally, CCOs should have a documented conflicts of interest analysis that is aligned with client disclosures and registration statements, as this analysis will also direct the frequency and form of periodic testing and monitoring activities.

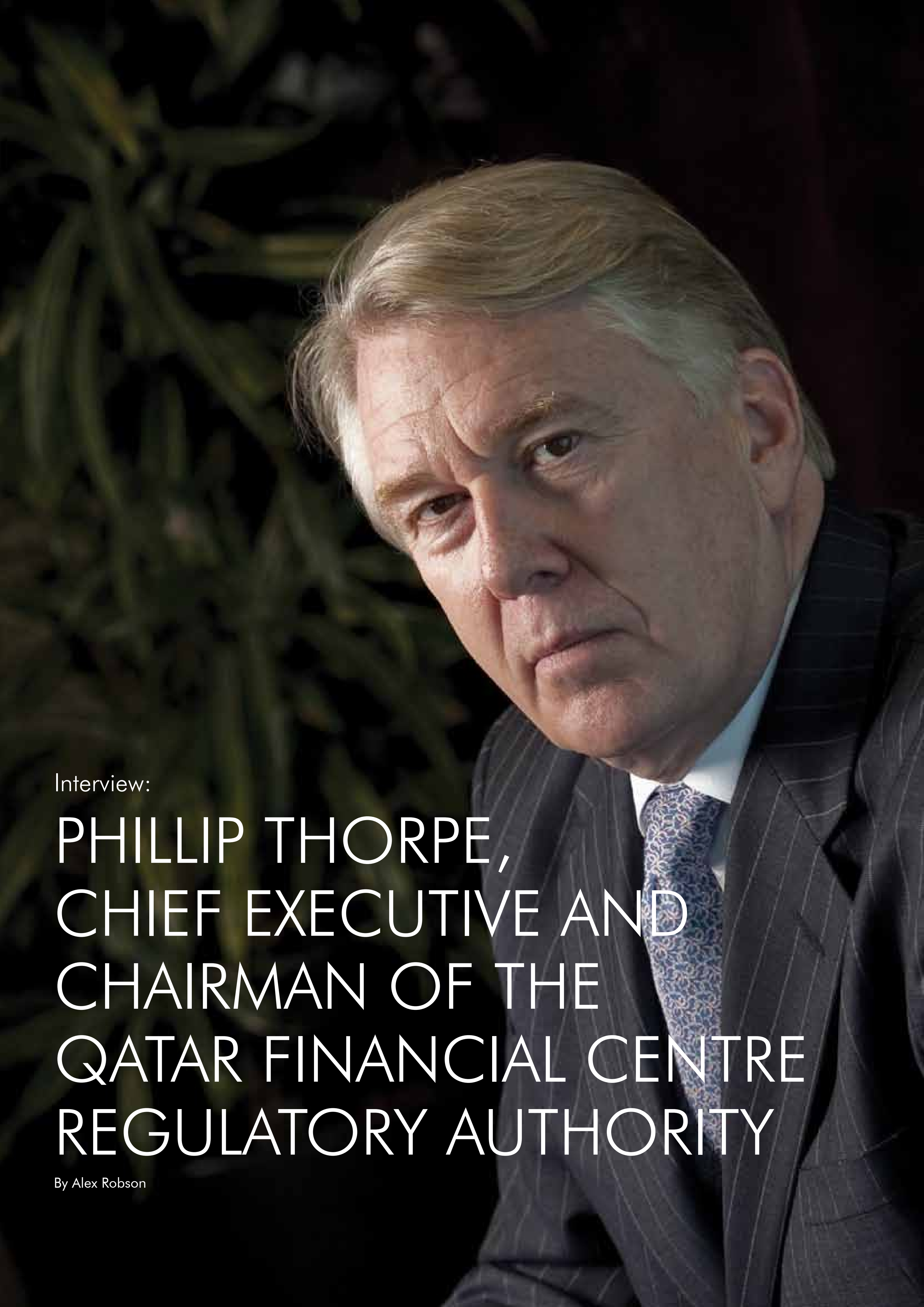
8. **Policy and procedure review:** Ensure policies and procedures are current, address existing business activities and practices, are consistent with actual business activities, and are properly dated (i.e., creating the audit trail). The annual review should capture this step but additional inquiry is warranted when preparing for an exam. Policies and procedures should be updated for current events and litigation, such as pay-to-play and material non-public information. CCOs should have a log or schedule of items currently in progress, including draft policies and procedures, as well as open remediation items from annual reviews.

9. **Control environment and oversight processes:** Evaluate each core process to ensure there is an appropriate segregation of duties among investment professionals, operations and control groups, and written procedures and accompanying control activities exist. Segregation of duties extends into processes within each activity and must be documented (i.e., ensuring portfolio managers are not pricing assets, traders are not approving soft-dollar payments and investment professionals do not have access to influence performance or fee calculations). Firms should have a robust committee structure, with documented charters or statements of purpose and minutes kept at each meeting. Policies and procedures should reference the relevant oversight committee and the documents required to be presented to and considered by the committee.

10. **Review client disclosures and registration statements:** Review marketing, request for proposal and advertising templates for consistency with applicable rules and current no-action letters. CCOs should pay particular attention to performance claims and companion disclosure requirements (e.g., GIPS compliant claims). CCOs should sample existing materials and evaluate the controls around who has access to create, modify and distribute material. Additionally, CCOs should evaluate existing registration statement disclosures (Form ADV Parts I and II) and offering documents (for private funds) for accuracy and consistency with existing business practices.

With some preparation, firms can well-position themselves to manage an exam. It is true that exams drain resources from the day-to-day management of the business; however, preparation will mitigate the level of resource allocation and better allow firms to respond to document requests. Additionally, firms will be able to provide consistent information during interviews and provide examiners with a high degree of transparency into the firm's activities, and the compliance and risk management programs that exist to manage those activities. Telling this story is the key to a successful exam.

Daniel Bender is a director and John Schneider a managing director in Navigant Consulting's Financial Services practice.



Interview:

PHILLIP THORPE, CHIEF EXECUTIVE AND CHAIRMAN OF THE QATAR FINANCIAL CENTRE REGULATORY AUTHORITY

By Alex Robson

"This financial crisis, as with others before it, has highlighted various issues that must be addressed within the financial services sector and, in doing so, has created a new agenda for the regulatory community around the globe."

The financial hurricane which has wrought havoc, mostly notably on Western economies, has been little more than a puff of wind to the resources-rich state of Qatar. The degree of insulation offered from the global financial crisis does not mean, however, that the Qatar Financial Centre Regulatory Authority can ignore the consequences or sit back and wait for others to devise solutions, said Phillip Thorpe, its chairman and chief executive, in an interview with Informer.

Thorpe said: "This financial crisis, as with others before it, has highlighted various issues that must be addressed within the financial services sector and, in doing so, has created a new agenda for the regulatory community around the globe. These issues range from concerns over capital and liquidity, the accuracy of risk assessments and the acceptability of branch operations, to the consequences, and desirability, of ever more complex financial transactions and institutions and the mechanisms needed to identify and mitigate systemic risk."

Thorpe was credited with clearing up some of the excesses in fund management after the Maxwell scandal in Britain in the early 1990s, when he was chief executive of the Investment Management Regulatory Organisation, a forerunner to the Financial Services Authority. He recognised that there would be change as a result of the crisis. Solutions were beginning to emerge from bodies such as the G20, he said: "It is inevitable that, as with all regulators, aspects of our rules and regulations have been called into question and we will need to ensure our requirements evolve to keep pace with what look certain to be significant adjustments to existing international regulatory standards. Our intention is to ensure that the QFC regime always remains up-to-date and in step with international standards and we will undoubtedly have our hands full keeping pace with and responding to the changes that are occurring elsewhere."

Furthermore, Thorpe said, the QFCRA was acutely aware of the threat of money laundering and counter-terrorist financing, despite their lack of evidence in Qatar.

"It would be foolhardy to be complacent and, given the continuing high levels of economic growth in Qatar and our expanding financial services sector, we recognise that Qatar could become a target for money launderers. We are, therefore, fully committed to Qatar's national AML strategy and we have been determined to make a significant contribution using the expertise and specialist skills we have within the regulatory authority.

"We continue working on developing robust AML measures in close partnership with other key national legal and regulatory agencies including the central bank, the financial intelligence unit, the legal and judicial authorities and various government departments.

"In addition, we have made efforts to strengthen our own AML resources and have recently created a specialist team to spearhead the work in this area.

"One other key component of our ongoing efforts is the introduction of a 2010 Anti-Money Laundering and Combating Terrorist Financing Rulebook which was published for consultation during late

THE LATEST ADDITIONS TO COMPLINET'S SOLUTION SUITE

By Paul Tasker and Vashinta Soobiah

Complinet strives to constantly add new and innovative functionality to its product suite to provide clients with the most relevant content, delivered through cutting edge technology. This product spotlight provides an update on the latest developments across the Complinet solution portfolio.

Global Screening – Vessel Data

One of the key challenges in today's highly competitive shipping market is to ensure that vessels and their owners are not on any sanction lists such as those issued by OFAC, Interpol or the UN Security Council. With ship names relatively easy to change, and the possession of vessels often hidden behind layers of ownership, this is not a simple or straightforward task.

Working with Lloyd's Register Fairplay, the global leader in maritime information and insight, Complinet has developed a single connected solution which allows users to quickly screen a vessels IMO number, beneficial owners, operators, managers and registered owners against live sanction data from around the globe.

For a free trial of Complinet Complete or trade sanction checks please go to: www.complinet.com/global/trial

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"We would expect to enforce those requirements if we discovered individuals failing to discharge those responsibilities. That said, we are conscious that there are some who do not fully appreciate the requirements under which they operate, or who discover that they are ill-equipped to comply through a lack of skills and knowledge. We will be discussing some of our concerns in this area at this year's summit, and we intend to strengthen our approach to those governance issues."

December 2009 and which will, when implemented later this year, underscore our continuing determination to address AML challenges," Thorpe said. The QFCRA anticipated a programme of "town hall meetings" and workshops designed to help familiarise firms with the changes being made.

Initiatives for 2010

The regulator will have a chance to air many of its priorities for 2010 when it hosts the Gulf Cooperation Council Regulators' Summit in late February for the second time, three years after hosting the inaugural event, which was a huge success. Qatar is certainly in a position of strength, with some 14 per cent of the world's gas reserves, oil reserves of 15 billion barrels and the highest GDP per capita in the Arab world, according to the International Monetary Fund.

Thorpe told Informer: "2010 looks certain to be an exciting year for the QFC Regulatory Authority. Quite apart from welcoming our fellow GCC financial regulators to the summit here in Doha, we have a number of initiatives underway.

"We are in the process of introducing a mandatory training and competence regime which will require all QFC firms to ensure that key personnel obtain satisfactory levels of qualifications. This is a first in Qatar and, with the assistance of internationally-recognised training providers; we hope to roll out the first training courses within the next few weeks."

Thorpe said work was also continuing on more strategic regulatory change which would culminate in the formation of a single integrated regulator in Qatar: "To that end, we will continue to develop the working relationships with our colleagues in the Qatar Central Bank and the Qatar Financial Markets Authority."

Corporate governance

Another major area of work concerns corporate governance. Analysts have expressed significant worries about name lending and a lack of transparency following the near collapse of the Saad and Algosaibi conglomerates in neighbouring Saudi Arabia. The QFCRA's rules place specific responsibilities on board members to discharge their duties but Thorpe was aware of the need for more work in this area.

"We would expect to enforce those requirements if we discovered individuals failing to discharge those responsibilities. That said, we are conscious that there are some who do not fully appreciate the requirements under which they operate, or who discover that they are ill-equipped to comply through a lack of skills and knowledge. We will be discussing some of our concerns in this area at this year's summit, and we intend to strengthen our approach to those governance issues.

"As you would expect, an essential component of our authorisation process relies on the provision of clear evidence that a firm operates within a robust, properly maintained and audited corporate structure. We expect to see that evidence alongside additional verification that those responsible for executive leadership, as well as those performing key customer-facing roles, are adequately qualified and capable of operating within recognised corporate and reporting guidelines," Thorpe said.

Monetary union

On December 16, 2009, Qatar was one of the signatories to the Gulf monetary union pact. Although any decisions concerning monetary union are matters for the leadership of each Gulf state, it would seem likely that any discussion would eventually touch on the coordination of financial regulation, Thorpe said. "Harmonisation of standards is also likely to be a matter of discussion, though in my opinion, better coordination among the GCC member states' various regulatory bodies is a first and more desirable goal, and probably more achievable in the short term.

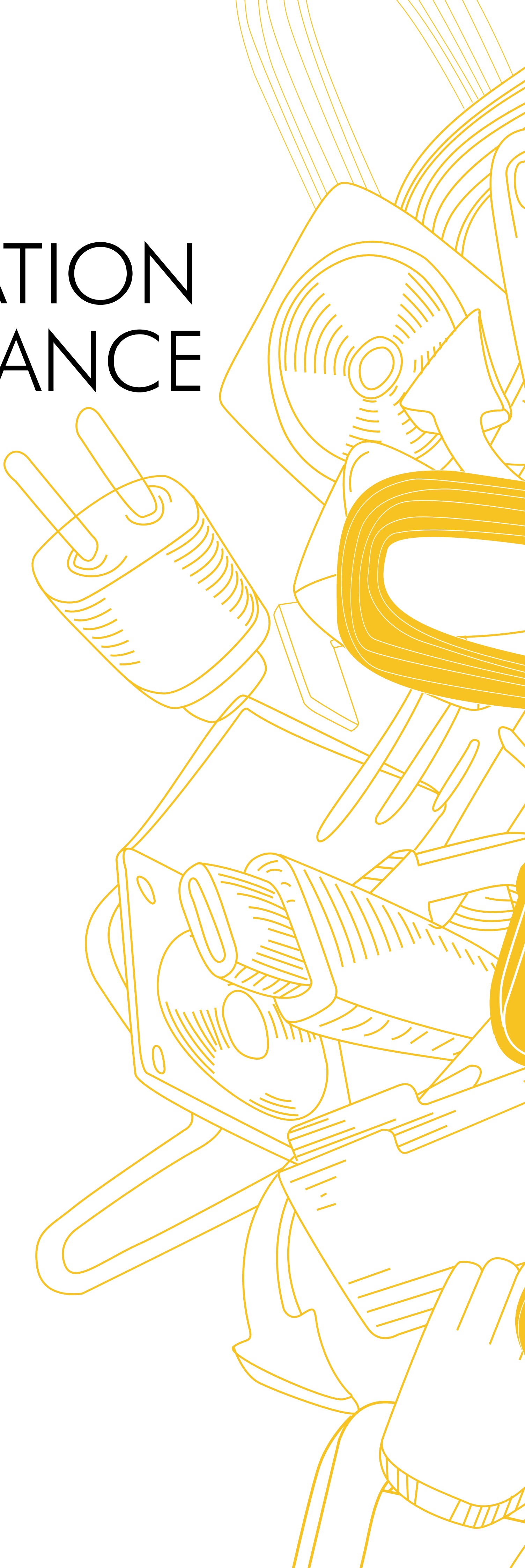
"Harmonisation would undoubtedly carry benefits for both financial services businesses wishing to operate within the GCC and for their customers, but the challenges of achieving successful harmonisation of regulatory standards should not be underestimated. It is also important that the pursuit of harmonisation does not come at the expense of the pursuit of high standards," he said.

Last, but not least, conference delegates at this year's GCC Regulators' Summit will see the QFCRA launch a new brand and visual identity, a decision the regulator took late last year. "The purpose of this exercise was to acknowledge that the regulatory authority has matured well beyond its start-up phase and to ensure that we have greater clarity around its identity. While we wish to retain the recognition that goes with our QFC connection, we have reached a stage in our evolution where our visual identity and some of our key messaging require clarification and enhancement," Thorpe said.

The Post-Madoff Reforms:

DOCUMENTATION AND COMPLIANCE GUIDANCE

By Genevievette Walker-Lightfoot



The Securities and Exchange Commission's Inspector General report spearheaded by David Kotz that purported to examine the agency's failings forensically, with respect to the Madoff fraud, helped the SEC to form the basis for its assertion that many SEC staff members that conducted the examinations and investigations into Madoff's trading activities were incompetent.

In hindsight, this finding is overwhelmingly true, as supported by the findings in Kotz's report which assert that various members of the different examination and investigation teams did not have adequate securities regulation experience. For example, several members of the 2003-04 exam teams had litigation specific backgrounds versus any specialized securities expertise, which is of particular significance given the complex options and equities trading in which Madoff was known to engage. As this finding has firmly established that the majority of the SEC examiners assigned to the SEC reviews of Madoff were inexperienced, the agency has been spurred to hire staff with more specialized experience in areas such as trading, compliance, options, portfolio management and investment strategies.

Nevertheless, as trading activities and investment advisory schemes become more complex in nature, fraud becomes even less obvious. Although more comprehensive examination guides and tools would most certainly be useful, SEC managers will need to become more skilled and adept at identifying patterns of fraud based on independent securities regulation knowledge and sound investigative skills. Again, although the SEC found that the various examiners made numerous mistakes and were insufficiently qualified while conducting their investigative work into Madoff's trading activities; the solution is not merely a matter of creating new examination modules and hiring subject matter experts.

So now the question turns to not only how to employ more experienced staff, but more importantly, how to address the issue of how SEC staff will become more adept at identifying patterns of fraud. The SEC IG has conducted several reviews, in particular, an audit review of the Office of Compliance Inspections and Examination's examinations (Audit Report) of Bernard Madoff Investment Securities. Although the 37 recommendations are clearly on point, there are two areas that warrant a closer look.

Documentation and compliance guidance

Documentation and compliance guidance are two areas that merit a keen review with respect to the change that OCIE is currently undergoing to implement the various recommendations that have been prepared by the IG's staff, as detailed in the Audit Report. In particular, with respect to documentation, OCIE may want to place a greater emphasis on e-mail correspondence, policies and procedures, and exception reports. OCIE may also want to place a greater emphasis on examination and investigation compliance guidance.

Documentation collection and review during a compliance examination is a major building block of any examination/investigation process. Not only does the documentation requested and received set the stage for the type of review that is conducted, but documentation will also determine whether the right questions are being asked during the analytical process of reviewing the documentation, as well as conducting interviews with the compliance personnel at the entity that is being examined.

E-mail correspondence

In today's business environment, almost all business transactions and ancillary discussions can be tracked back to e-mail correspondence, which makes e-mail a crucial building block to constructing or reconstructing how a compliance entity has operated over a particular time period. Absent specific minutes having been recorded, e-mail correspondence will give an examiner the best sense of what actually transpired in a given compliance scenario, without the taint of "forensic interpretation" that could misinterpret or reinterpret a scenario contrary to how it actually occurred. E-mail is also an extremely useful tool in terms of conducting an interview of compliance personnel, whether it is with respect to a particular trading scenario, how an exception report was reviewed or how onsite surveillance actually operates.

Not only can e-mail correspondence illuminate certain necessary clarifying questions that may need to be asked which are not obvious from merely reading the entity's compliance manual or conducting a field interview, but e-mail may also shed light on customary processes that give rise to a particular decision or result, or how a situation was handled. Oftentimes, customary processes that have been relied upon in a compliance scenario actually may not be highlighted in the subject entity's compliance procedures. Also of significant importance, e-mail correspondence may show whether a review should be a cause review, one focused on a specific problem or issue, or perhaps a broader review that encompasses an industry-wide problem or concern.

Audit-trail data

Audit-trail data is another source of documentation that provides a record of a subject entity's trading activity. Such data may also be a useful compliance examination tool, even in cases wherein trading activity is not a concern regarding potentially violative activity. For example, audit-trail data obtained from the subject

entity can provide insight not only as to how books and records are kept but also as to whether or not trading strategies are being effected based on the reasons stated by an entity, such as a broker-dealer.

In the case of Madoff, BMIS claimed that it was effectuating a split-strike conversion strategy which entailed trading in equities and options on behalf of its client funds. If in fact audit-trail data had been obtained in an examination of BMIS, it would have been immediately apparent upon verification that the trading activity that BMIS claimed to be performing on behalf of its client funds was fraudulent, as it would either have not appeared in the audit trail or been grossly inconsistent upon verification of the audit-trail data.

Other cases in which audit-trail data may prove useful include an inspection of a trading exchange's surveillance operations. Exchanges are charged with surveilling the trading effected across its platform and all such trading, with some exceptions of course, should ordinarily appear in its audit-trail data. Missing or incomplete data can indicate a problem with a subject entity's books and records. Such anomalies could also indicate a problem or concern with how a subject entity conducts its surveillance and investigatory processes, as vital data and, therefore, potential violations could be missed if audit-trail data is incomplete or missing.

The main decision not to obtain audit-trail data during the 2003-04 Madoff examination reveals another shortcoming that the SEC is tackling head on with its post-Madoff reform initiative: the improvement of fraud-detection procedures. Going forward, SEC examiners will be expected to be able to identify "less obvious" signs of fraud, as well as more subtle signals that warrant closer inspection, such as using an unknown accountant. Given the nature of fraud detection and the experience required to become skilled in this area, however, how will the SEC train its examiners to look for the less obvious types of fraud more effectively?

Professional certifications and licensure

The SEC IG Audit Report notes that SEC examiners will be provided training in the future via various methods, such as access to industry publications and third-party database subscriptions, participation in interactive/situational exercises, as well as inter-divisional and inter-agency collaboration. The SEC may also increase the number of examiners that hold professional certifications and licensure such as the Chartered Financial Analyst, Chartered Alternative Investment Analyst and Certified Fraud Examiner credentials. Although SEC examiners are not permitted to sit for FINRA licenses, examiners will still be provided the classroom training covered by the materials via a continuing education format.

But, again, how will examiners actually deploy the training provided? Will such training make a significant impact on how the SEC conducts its examinations and investigations, especially as examiners that participated on the Madoff exams actually had the benefit of some such training prior to Madoff turning himself in?

Consistency, coordination and collaboration

The clear answer is that this training will only benefit the SEC, as a whole, if there is adequate consistency, coordination and collaboration. SEC examiners must have training that is consistent in both substance and timeliness of delivery. The substance of the training must address current developments and practices in the industry so that examiners may keep pace. Training must be coordinated across divisions and agencies to ensure such consistency, as well as adequate saturation across SEC divisions and regions. Lastly, but still of great importance, training must be collaborative so that not only divisions, but also agencies other than the SEC that have securities regulation oversight may benefit from a 360-degree view versus whatever statutory purview that is normally taken.

For example, the SEC's main mission is to protect investors. Other agencies, such as the banking regulators, however, have a different and sometimes opposite mission, that of protecting the bank/banking organization. As we have seen during the enduring financial crisis that has spanned the last few years, certain products may bring these regulators to a regulatory crossroads, such as auction rate securities, variable

rate demand notes and mutual-fund company and advisory products and practices. It is at this juncture that collaborative training may benefit SEC examiners so that they understand how securities products affect not only consumers/investors, but also affiliated financial organizations such as banking organizations and even insurance companies. This is where a "diversity of thought" and even a "diversity of training" approach may prove most useful.

Detecting potential red flags

The same principle will hold true for future compliance guidance. As discussed in the Audit Report, similar to market surveillance staff at trading exchanges, SEC exam staff should implement protocols that will enable staff to detect potential red flags and violations. Fraud and other compliance issues and concerns, however, are mismatched when it comes to pre-formulated one-sized-fits-all examination modules. As a young SEC examiner, my examination methodology consistently focused on comparative analysis of trading strategies and accounts, with a view towards the identification of patterns and trends, when examining a broker-dealer. Fraud is more often than not an elusive finding. Examination guides and tools are an integral part of conducting a compliance examination; however, it is the skills, knowledge and experience of the examiner that will determine whether the fraud is actually uncovered. It is, therefore, important that examination modules be fluid and flexible in not only how fraud is defined but also in its detection.

It is notable that the SEC is redefining how it classifies its examination and investigations types, for example, "cause" versus "cycle," etc. Various components may need to be incorporated into the examination protocol analysis, outside of time period and category restrictions. These may include, but not be limited to, e-mail correspondence, trading account documentation, exception reports, and audit-trail data to detect and pursue the various types of anomalies that can amount to fraud at one end of the spectrum and perhaps poor maintenance of books and records at the other end. Fraud is malleable and examination staff and tools must also be so to keep pace and adequately enforce compliance with securities rules and regulations.

As to how compliance guidance should be implemented, I would answer that it should be one of many tools in the tool box. A compliance module is solely that, a reference tool to be utilized in a process that should ultimately be both interactive and cross-functional. A compliance module can provide a basis by which a compliance examination can be conducted, with respect to time periods to be reviewed, documents to be collected and rudimentary questions to be asked. The examiner must be sufficiently skilled in that the manual is a tool yet he is the ultimate craftsman that will dictate the architecture of the final product.

Ms. Walker-Lightfoot is currently employed in the Division of Banking Supervision and Regulation at the Federal Reserve Board in Washington, DC. She was formerly employed with the SEC's Office of Compliance Inspections and Examinations and was the lead attorney on the SEC's 2003-04 Madoff examination. Her views as expressed in this article are her own and do not reflect her views as a Federal Reserve staff member. Ms. Walker-Lightfoot obtained a BA from Georgetown University and holds a JD from the Columbus School of Law at the Catholic University of America and an MBA from the Smith School of Business at the University of Maryland at College Park. She is a member of the US Supreme Court and the state of Maryland bars.

Word on the street

Global regulator anyone?

by Susannah Hammond

So the financial crisis which brought global markets and firms to their knees may be almost over but has anything really changed? There is a huge debt hangover, lots of "get togethers" at G20 producing sweeping, but high level, statements and the widespread vilification of bankers. One eye-catching move to come out of the G20 was to upgrade the old Financial Stability Forum to the Financial Stability Board which was "established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability". In other words, to make sure there is not another monumental implosion in global financial markets. But does that make the FSB a global regulator in waiting?

On the one hand, it is far and away the most inclusive of the supranational financial services bodies with representation from countries such as Brazil, Saudi Arabia and Indonesia as well as all the usual suspects. The possible benefits of a global regulator, with a single consistent approach and risks assessed on a global basis, are all too apparent but that does not reduce the political and other challenges in getting even hovering off the ground. For instance, how on earth does a potential global regulator ensure that all countries follow its regulatory approach and requirements? Come to that, how does it even get its requirements agreed in the first place? The endless horse trading which happens all too regularly at the EU level is an object lesson in the trade-offs and special cases which come into place when trying to agree any new rules. That is before the thorny question of how to enforce is even attempted.

The intellectual consensus is that a significantly more international view of risk, regulation and supervision is required. How are complex global firms to be regulated if not by a global financial services regulator? Singular. The plethora of regulators around the world, often with several in a single jurisdiction, are not seen to have served the public well and it is that public which is footing the current clean-up bill.

So how close is the reality of a single global regulator? Well, with the creation of the FSB it is probably a good deal closer than before the financial crisis. That said, despite the likely benefits, there are some huge practical and political issues, not least of which is the "global in life, local in death" scenario. The consensus and the drive for reform coming out of the G20 are already fading but the first steps have been taken to begin to create a single global regulator for financial services. Sadly for the taxpayers around the world, it will probably take the next financial crisis for it to finally come into practical reality.


Wake up
wall
street

Preparing for Inconsistency:

WHY THE US AND EUROPEAN LEGISLATORS MAY DIFFER IN THEIR APPROACHES TO OTC DERIVATIVES REFORM

By Eric L. Foster

Many compliance professionals that I speak with are wondering what, if anything, the US Congress and the Obama Administration are likely to enact this year in terms of an over-the-counter derivatives reform bill. This article attempts to respond to these inquiries by reviewing where things now stand and why passage of a comprehensive new oversight regime for OTC derivatives trading is quite likely in 2010. It also discusses some of the political forces that are currently having an impact on the legislative process in Washington and the likely consequences for compliance professionals.

Background

The recent and surprising election of a relatively unknown Massachusetts Republican Scott Brown to former Senator Kennedy's Senate seat is widely seen as a loud wake-up call to the Democratic leadership. To regain political momentum, Democrats have made it clear that they intend to re-establish their populist credentials. One obvious way to reclaim the mantle of defenders of the people against the fat-cats of Wall Street is through the successful enactment of some sort of comprehensive financial services reform bill.

Despite provisions in the current legislation directing US regulators to coordinate with their foreign counterparts to establish a consistent approach to regulation, it is my contention that any financial services reform bill that emerges will lead inevitably to certain differences between how OTC derivatives trading is regulated in the US and the European Union.

The Wall Street Reform and Consumer Protection Act of 2009

The most likely legislative vehicle that the Obama Administration and Congressional Democrats will use to get tough on Wall Street is the lengthy and comprehensive bill that the House of Representatives passed late last year. The Wall Street Reform and Consumer Protection Act (H.R. 4173) (House Bill) is a comprehensive and far-reaching bill designed fundamentally to restructure and improve federal oversight of the financial services industry in the US.

Technically, the House Bill is currently before the Senate Banking Committee. The House Bill, however, is not a bipartisan package and, therefore, a poor indicator of what the Senate might be willing to approve, especially now that the Democrats have lost their supermajority vote.[1]

1. Democratic house members widely supported the House Bill in December (223 –27) while Republican house members unanimously rejected the bill (0 – 175). The House Bill includes a number of provisions that are unrelated to OTC derivatives and, therefore, will not be discussed in this article. These provisions basically expand the authority of the Federal Reserve; establish a new federal systemic risk regulator; provide the Federal Deposit Insurance Corporation with resolution authority to wind down failing financial firms; create a new Consumer Financial Protection Agency and greater oversight of credit rating agencies; increase the federal regulation of the insurance industry; expand certain investor protection provisions; enhance the regulation of hedge funds; and expand the regulation of certain executive compensation practices at banks and broker/dealers.

The Senate Banking Committee is, therefore, focused on developing its own financial regulatory reform proposal, using a discussion draft circulated by Chairman Dodd last fall as its starting point. To achieve the chairman's desired goal of developing a more bipartisan bill before Congress reconvenes in late January, Chairman Dodd asked committee members late last year to form two member working groups voluntarily to address member concerns regarding specific aspects of the proposed legislation. Senators Jack Reed (D-RI) and Judd Gregg (R-NH) head the team that addresses the regulation of the OTC derivatives markets.[2] I suspect that a bipartisan bill generally reflecting these efforts will be introduced in the Senate sometime in the next few weeks.

Forces likely to shape the final OTC derivatives reform bill

There are several aspects of the current US political climate that suggest any successful reform legislation will be fairly prescriptive and punitive on both derivatives dealers and the OTC markets in which they operate. These characteristics are: (i) the suddenly populist tone coming out of Washington (i.e., the sudden need for legislators and regulators to appear tough on Wall Street firms prior to the mid-term elections); (ii) Congress' general inclination not to approach derivatives reform in a manner consistent with internationally agreed upon standards; and (iii) Congress' propensity to legislate in a vacuum, thereby ignoring the considerable investments that market participants have made in both settlement and disclosure systems as well as market practices to reduce risk and improve the infrastructure supporting the global OTC derivatives markets.

Let's take them each in order.

1. The increasingly populist tone coming out of Washington.

Enactment of sweeping financial services reform legislation remains an extremely high priority for Democrats in Washington these days. This is especially true now that health care reform is widely viewed as stalled, thanks to the Democrats losing their filibuster proof majority in the Senate on January 20.

All hopes for a quick and significant legislative victory of sorts by Democrats prior to the mid-term elections now rest on legislation pending in the Senate to reform the financial services sector. As mentioned earlier, President Obama has reacted swiftly and forcefully to the election of an unknown Republican into the seat that Senator Kennedy previously held. The administration has, therefore, signaled its clear intent to use the passage of financial services reform legislation in 2010 as a catalyst for the mid-term elections.

This shift has actually been underway for some time now, but it clearly accelerated this week. The first hint that something was up occurred when President Obama made time to meet with soon-to-be-retired Senate Banking Committee Chairman Christopher Dodd to discuss specifically how to shepherd reform legislation through the Senate efficiently. A renewed anti-bank sentiment among Democrats became even clearer with the President expressing the view in a private interview this week that "[w]e've got a financial regulatory system that is completely inadequate to control the excessive risks and irresponsible behavior of financial players all around the world."

Most importantly, the day after this interview, the President held a White House press conference in which he unveiled a significant proposal to go after the banks by curbing excessive risk-taking by financial services firms.[3]

2. The other working groups are: prudential regulation (Chairman Dodd and Ranking Member Richard Shelby (R-AL)), consumer financial protection (Chairman Dodd and Ranking Member Shelby), resolution authority for failed financial firms (Senators Mark Warner (D-VA) and Bob Corker (R-TN)), and executive compensation and corporate governance (Senators Charles Schumer (D-NY) and Mike Crapo (R-ID)).

3. "Obama Hammers the Banks," Financial Times, January 22, 2010.

It is at times like these (think of Sarbanes-Oxley and Enron) when legislators and regulators, who might otherwise engage in more prudent policymaking, face the political reality of getting re-elected (or reconfirmed). In this case, the sudden upshot of populist anger is likely to be legislation designed to generally penalize banks and, therefore, pay little heed to either the bill's impact on the need for a harmonized international regulatory approach or any potential decline in the competitiveness of the US OTC wholesale financial markets or its financial centers as a whole. In other words, US fixed income and derivatives compliance fixed professionals at major banks should begin preparing for the worst.

2. Unwillingness to approach regulation in a manner more consistent with the Europeans and IOSCO's recommendations.

There is a growing realization in some quarters that the US and Europe may end up with slightly dissimilar approaches to the regulation of OTC derivatives markets and market participants, especially with respect to dealer ownership, governance and access to any non-exchange affiliated swaps clearing corporations. In my view, any such divergence would be the result of disagreement between legislative bodies and not due to a lack of consensus among international regulators. It would also most likely arise if regulators are unable to convince legislators in the US that they should be granted fairly broad exemptive authority with respect to swap dealers, swap execution facilities and other regulated entities. The adoption of a unique, prescriptive and somewhat bifurcated approach by the US to the regulation of swap dealers and swap markets in general would not be surprising, particularly given the current battle among US banking, securities and commodities regulators over who should take the lead in regulating our swaps and swaptions markets.

Such a result would be disappointing for US-based dealers and their customers that are seeking competitive pricing for execution and clearing services. It will be even more disappointing to US and European regulators who have worked long and hard in recent years to ensure a coordinated and consistent approach to the oversight of the international OTC derivatives markets. After all, creating opportunities for financial firms to engage in legal or regulatory arbitrage by shifting their derivatives trading activities to another jurisdiction was just the outcome that US regulators were seeking to prevent.

If the US and European approaches to regulating the OTC derivatives markets ultimately do diverge, it certainly will not be due to a lack of effort by the globe's leading regulators. Building off of the 2005 Committee of European Securities Regulators' Recommendations for Central Counterparties and similar guidance by the International Organization of Securities Commissions, regulators have sought in recent years to reach specific agreement on the regulation of OTC derivatives, including in the area of recommended practices by central counterparties that clear such derivatives. For instance, with respect to credit default swaps, leading international regulators recently agreed that dealers and significant swap participants should not only be required to be shareholders in any CCP and control the terms of any CDS product that is accepted for clearing, but that such CCPs should also meet the CESR Recommendations for CCPs.[4]

Likewise, a large group of the leading financial regulators just recently established an OTC Derivatives Regulators' Forum. This forum was the result of several previous meetings aimed at improving international coordination, including a February 19, 2009 session at the Federal Reserve Bank of New York where the development of a global framework for cooperation among the regulators of CCPs that clear CDS was discussed.[5] The primary focus of their earlier discussions were on mutual support in applying consistent standards and achieving similar policy objectives, as well as a general effort at coordinating their approaches to the oversight of CDS CCPs. The mission of the OTC Derivatives Regulators' Forum was later expanded to include adopting, promoting and implementing consistent standards — such as the CPSS-IOSCO Recommendations for Central Counterparties — in setting oversight and supervisory expectations, as well as the coordination of the sharing of information routinely made available to regulators or to the public by OTC derivatives CCPs and trade repositories.

It is also important to note that this type of international coordination is not new to financial services regulators. Members of IOSCO and the Basel Committee on Banking Supervision have long understood that modern financial markets in a truly interdependent and global system have fungible and extremely portable attributes. In fact, even before the first Basel capital accord, significant multilateral efforts have sought to foster a coordinated approach to bank capital rules and the adoption of common recommendations in the area of disclosure, legal documentation, risk management, banking supervision and the general regulation of these markets.

4. The CESR CCP Recommendations are similar to the IOSCO/CPSS CCP Recommendations while more specifically addressing CCP corporate governance issues such as preventing derivative dealers from exercising undue influence over a CCP. They call for the appropriate representation of users in the governance of a CCP and consultation by the CCP with dealers and other users regarding any material decisions. This recommendation sharply contrasts with the language in the Lynch Amendment that was added to the House Bill. That amendment seeks to bar derivatives dealers as a whole from having a significant financial stake in a CCP or a say in its governance.

5. Attendees at that meeting included representatives from the Fed, the Commodity Futures Trading Commission, the UK Financial Services Authority, the German Federal Financial Services Authority ("BaFin"), the Deutsche Bundesbank, the New York State Banking Department, the Securities and Exchange Commission, and both the European Central Bank and the Hungarian Financial Services Authority in their roles as co-chairs of the joint ESCB-CESR Working Group on Central Counterparties.

Today, IOSCO, the BCBS, the European Central Bank, CESR, the UK Financial Services Authority and the members of the US President's Working Group on Financial Markets all recognize the international nature and critical role of these markets. As a result, they have all agreed to try and promote a coordinated and consistent approach to the oversight of these markets. There is a clear and broad consensus today among international regulators regarding the systemic importance of OTC derivatives markets, their significant role in the 2008 crisis and the changes needed to reduce and contain future risks arising from these markets.

International regulators agree that under-collateralized (and sometimes, uncollateralized) counterparty credit exposures of systemically significant financial institutions arising from the CDS markets contributed to the 2008 financial crisis and lead directly to the US government having to take over control of the American International Group. They have already reached a general consensus (such as within IOSCO) on two immediate steps for reducing such risks to the global financial system — centralizing the risks so they can be more closely supervised, and enhancing transparency within the price-discovery process so manipulation can be detected and investor confidence in these markets better ensured. As a result, both the Obama Administration and the EU are now widely expected to require standardized swaps (single-name and index CDSs, as well as other standardized interest rate, commodity and equity swaps) to be traded generally only on an exchange (or similarly regulated execution system) and settled through a CCP.

Despite regulators reaching a general agreement on a common approach to reigning in the OTC derivatives markets, I anticipate that there will still be major differences between how these principles are implemented in a new statutory regime by the US and Europe, especially given the bifurcated nature of the US regulatory regime. Unfortunately, this will mean plenty of headaches and challenges for compliance professionals as they scramble during the period after any reform bill is signed into law (but not yet in effect) to review rule proposals and generally come into compliance with the new regime.

If I am correct that the Congress will ultimately require a US approach that is more prescriptive and restrictive than Europe's, the relative competitiveness of certain parts of the US' wholesale OTC derivatives markets are likely to be the first casualty of the reform process.[6]

3. Propensity to legislate in a vacuum, thereby ignoring recent improvements that the industry has adopted.

There is a propensity, in my view, for legislators to fail to realize sometimes that statutory reform efforts do not occur in a vacuum. Attempting to reform financial markets always involves hitting a moving target, especially when a market is already under considerable regulatory pressure to improve its infrastructure and modify market practices. In the case of OTC trading in CDS, for instance, the industry is rapidly moving closer to completing its migration toward centralized clearing of index CDSs, in both the US and Europe.[7] Likewise, the Securities and Exchange Commission, the Commodities Futures Trading Commission and other domestic and foreign regulators have not simply been waiting for someone to grant them new authority before trying to reign in and reform the OTC derivatives markets.

With respect to recent industry efforts to learn from the crisis, market participants and key service providers have made progress to improve the post-trade infrastructure that supports the OTC swaps markets in both the US and Europe. This has been especially true for the credit default swaps markets in the US where exemptive orders by the SEC[8] have facilitated the migration to centralized clearance and settlement of index CDS trades, as well as some single-name CDS transactions.

Likewise, the industry has also been working, since before the global financial crisis of 2008, to reduce the backlog of unconfirmed or unsettled CDS transactions and generally to ensure that the OTC derivatives markets reduce the level of bilateral counterparty credit risk and operational risk unnecessarily overhanging the marketplace. For over three years now, the industry has been under significant and coordinated pressure from regulators to improve transparency and operational efficiency significantly in the OTC derivatives markets in general, and the OTC CDS market in particular.

The International Swaps and Derivatives Association has facilitated much of this progress. ISDA has spearheaded several initiatives designed to reduce risk and improve efficiency and transparency within the post-trade infrastructure (i.e., greater standardization, improved documentation, clearer trading practices, and more robust clearance, settlement, and margining, plus other infrastructure that support OTC derivatives trading.)

6. Not that such inconsistency is all bad. In fact, it also creates unique opportunities for sophisticated market participants to gain competitive advantage by duly taking into account the potential for new regulatory restrictions (such as those the Obama Administration has proposed on proprietary trading) when making strategic decisions regarding the products, counterparties and markets where they want to expand their OTC derivatives operations.

7. See "CDS Clearing Reaches $5 Trillion on a Global Basis; ICE Clear Europe Crosses euro 1 Trillion", January 25, 2010, PRNewswire via COMTEX News Network.

8. See SEC Release No 34-59164 (December 24, 2008); SEC Release 34-59165 December 24, 2008).

These steps have included the establishment of a Credit Derivatives Determination Committee in March 2009 and the development of a special ISDA protocol (Big Bang Protocol), whereby parties to pre-existing CDS transactions can adhere to a new auction settlement process.

Other steps have been achieved under the auspices of a public/private partnership in the form of a joint industry working group that the NY Fed formed. The NY Fed has hosted six meetings so far with the major participants in the OTC derivatives markets and their supervisors to discuss efforts to improve the infrastructure currently supporting the market. At these meetings, market participants update US and international regulators on developments in the OTC derivatives markets in general, while also agreeing to make further improvements to support the overall goals of reducing risk and increasing transparency. This effort has resulted in a meaningful reduction of the risks posed by, and improvement in the transparency of, the OTC derivatives markets, without the need to enact substantial reform legislation. As a result, there has been an expansion of centralized clearing and novation of interest rate and credit derivatives trades that are already eligible to be cleared, as well as improvements in regulatory reporting on OTC derivatives transactions, thereby helping regulators identify and target opportunities for improvements to increase clearing and standardization.

Still, it seems unlikely that there will be a fully consistent approach by Washington and Brussels in regard to enacting a new statutory regime for the OTC derivatives markets. The reason is simple: the upcoming elections in the US will mean legislators will be more interested in obtaining payback from the big banks that they had to recapitalize than in ensuring New York and Chicago operate at a level playing field with London.

Despite reaching a general agreement on a common approach to reigning in the OTC derivatives markets, the unfortunate news is that the main differences between the US and EU approaches will remain. The good news is, as I noted earlier, that this should mean plenty of work for compliance professionals in late 2010 and well into 2011.

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DUBAI 2009 MELTDOWN AND LESSONS LEARNT

By Professor Mahmood Faruqui, senior adviser, Bank of London and the Middle East

The November 25, 2009 Dubai World announcement for a six-month standstill period was unexpected, but not a completely unforeseen tsunami in the still waters of the Gulf. Sukuk and Islamic financial institutions had periodic murmurs since late 2008.

They were disregarded. The G7 and the G20 were consumed by the banking crisis. A recap will recall:

1. Oct 2008: East Cameron Gas defaults on $166m sukuk, files for bankruptcy in Florida and pleads to recharacterize the sale as a loan.
2. Dec 2008: Investment Dar, Kuwait, works on sale of partial stake in Aston Martin and refinancing of $1bn debts.
3. Dec/Jan 2009: Global Investment House Kuwait debt default.
4. May 2009: Investment Dar defaults on $100m sukuk.
5. June 2009: AHAB and Saad Groups $10bn restructuring.

6. July 2009: New York court litigation between AHAB and Saad Groups. Saudi Central Bank forms committee to resolve issues involving creditors of AHAB and Saad. Central Bank of the United Arab Emirates requires banks 50-75 per cent provisioning for Saad and AHAB exposures.
7. Sept 2009: Abu Dhabi Commercial Bank discloses $600m exposure against AHAB and Saad. Rumors that with passive blessings of Saudi authorities, Saudi creditors of Saad given unreasonable priority. International creditors unreasonably postponed.
8. Dubai World standstill proposal announced. Guesstimated debt $59bn, with $22bn of Islamic financing, including $3.5bn due under Nakheel sukuk on December 14, 2009.
9. Standard & Poor's, Moody's and Fitch downgrade several GCC banks.
10. Dec 14, 2009: Abu Dhabi gives $10bn line to Dubai. Nakheel $3.5bn paid on due date.
11. Jan 2010: DP World and Amlak pay amount due on due date.

Nature of sukuk

Sukuk are structured products that use Islamic nominated contracts (uqud-mussamat) of murabaha, mudaraba, musharaka and ijara as building blocks as effective and efficient alternative competitive products with different legal attributes, but similar economic results, compared to conventional covered bonds. Generally, the nature of sukuk is not fully understood, not least because they are termed Islamic bonds. This misperception muddies the water when disingenuous and media savvy comments articulate the "foibles" of Islamic finance instruments.

In essence, sukuk are a combination of: (i) equity-type undivided ownership interest in the underlying assets held by a trust for the benefit of the sukuk holders; and (ii) a creditor-type claim against the trust, up to the value of trust assets, for payment of coupons and principal of the sukuk. This, embellished by a charge on the underlying assets, propels sukuks' confusing misalignment with conventional covered bonds.

Nakheel sukuk analysis

The Nakheel sukuk model may be summarized as: the government of Dubai owns Dubai World, which owns Nakheel World LLC, the holding company of three companies (NH1, NH2 and NH3). NH1 has leasehold rights over two barren land strips valued at $4bn due to their proximity to two future prestigious developments valued at $11.7bn on completion. NH1 sold its leasehold rights to Nakheel Development Ltd, which funded the purchase by issuing the Nakheel sukuk. NDL leased the plots to NH2 and funded the sukuk coupons from the rent it received from NH2 under the lease. The payments are guaranteed by NH1, NH2, NH3 and Dubai World, which does not publish its financial statements and its liabilities are not guaranteed by the government of Dubai, its 100 per cent owner.

It was not sufficiently stressed that: (i) in reality, as the project was non-existent, the money it paid to NDL was not rent it received from its flat occupiers; and (ii) there was indifference to the Sharia'h requirement that the income generating underlying asset must be in existence. NH2 was not receiving any rent, the valuation of the sukuk assets was based on (if and when?) completion of the development. The UK prestigious firm's executives who assessed the valuation, later joined Nakheel as head of valuation and research.

One conservative scholar criticized the Nakheel structure as the triumph of form over substance. It will be appreciated that the unsavory element was not so much in the structure of the model itself, as in its lax execution.

Cross-border legal issues

Dubai sukuk were, and are, purchased by international investors who are searching for higher yields. In some issues, conventional and Islamic streams were used as co-financing sources. This necessitated "inter creditor agreements" and similar arrangements dealing with priorities in disbursements, repayments, early termination or bankruptcy. Although conventional banks are not much concerned with Sharia'h-compliant certification of the Sharia'h board, they are particular in ascertaining the stability and outcome certainty of judgment in enforcement proceedings. Consider a $160m dispute in a Florida court where the sukuk issuer files for bankruptcy. What is the scope of application of Sharia'h in the dispute and the familiarity of the judge with Sharia'h principles? Or a Japanese asset manager investing in a large energy project in Saudi Arabia. Who would resolve a dispute and enforce the decision? The expertise of a local Qadi adjudicating on sukuk governed by New York law, and whether New York law is at all applicable on assets in Saudi Arabia? This raises questions of private international law, recharacterization of sale as a loan, tax issues etc.

These issues underline the importance of the choice of law and the governing law clause in the sukuk documentation. Almost all cross-border contracts stipulate English law or New York law; however, there is little legal precedent. The English Court of Appeal, in Beximco's case [EC (2004) EWCA Civ 19], held that parties could agree to import Sharia'h principles (e.g., just as they could import specific provisions of the Hague Rules or the French code) as their agreed terms in their Islamic finance contract, even though English law is the agreed governing law of the contract. There is no legal inconsistency in this. It is incumbent upon drafting lawyers, however, that instead of a general reference, to "Glorious Sharia'h", as in this case, the agreement should stipulate specific references to the various precise points of Sharia'h. (Para 42 to 55 of the judgment encapsulate the rationale).

Dubai Decree 57 for 2009

The above decree is a wise decision to exclude existing multiple and untested UAE, Dubai and Dubai International Financial Centre restructuring and insolvency laws. It establishes a tribunal with exclusive jurisdiction to adjudicate upon claims relating to Dubai World and its subsidiaries. It imports principles of English insolvency law and US Chapter 11 principles, and heavily draws upon DIFC Insolvency Regulations. It envisages an automatic standstill (moratorium). The circuitous uncertainty of obtaining a foreign judgment and its recognition or not by the local Dubai court has been removed. It, therefore, puts to rest aggressive creditors' veiled threats to take action on DP World's foreign assets. Another sympathetic consequence is the appointment of a separate committee with exclusive powers to resolve financial disputes of Amlak and Tamweel.

More favorable consequences of the decree are announcements by Nakheel, Amlak and Dubai World to pay amounts falling due in the immediate weeks. With the air less stuffy, on December 19, Dubai World held a meeting with its major creditors. The advisers, Deloitte, Rothschild, Clifford Chance for DW, and KPMG for lenders also attended. Major banks included HSBC, Lloyds TSB, Standard Chartered, Emirates NBD and ADCB. They discussed preliminaries and agreed to meet in the second half of January to further narrow down differences and evolve a balanced burden sharing approach among major stakeholders. Amlak and Tamweel, the biggest mortgage lenders in the region in 2005-7, have a separate committee to resolve their financial issues. This may expedite the long awaited merger of the two, with or without a Dubai bank to consolidate a Dubai real estate bank.

Looking ahead

Causes of the problem

The Dubai crisis is unlike the conventional banking crisis, not just in numbers (Lehman alone had $600bn gross liabilities) but in the source. There, the culprit was decoupling of financial capital from the real economy spawning a plethora of collateralized debt obligations, CDO squares and cubes and derivatives. Now it is being realized that:

1. The Dubai crisis is a real estate bubble compounded by a long period of cheap credit and lax regulation, until the lack of market liquidity congealed banks funding capacity.
2. The close and complex links between Dubai government entities, the Dubai government and the Ruler of Dubai's commercial activities fanned a delusionary perception that the governments of Dubai and Abu Dhabi will fully cover all Dubai Inc. write-downs. This is not a problem of Islamic finance, rather it contravenes the principles of Gharar and Jahala.

Suggested solution

1. New Islamic instruments should have authenticity before innovation. They should restrain, not promote, swings in cyclicality. Standardization of Sharia'h is an ambitious aspiration. We should aim for harmonization and model clauses.
2. Regulators and market players must work together to reform executive compensation and rigorously control market manipulation.
3. Banks have had to make high provisions. Regulators and credit analysts will increase pressure for cleaner balance sheets. This could be achieved by encouraging forced mergers of smaller banks for tighter synergies, cost cutting and affordability of new technologies and IT systems.
4. Merger of Amlak and Tamweel and establishing a real estate bank.
5. GCC regulators must extend their mutual reach by increased and fuller exchange of information to suppress regulatory arbitrage by swift traders and asset managers.
6. The establishment must enforce a credible transparency and governance regime.
7. Tough political decisions will have to be taken in Dubai and its relationship with Abu Dhabi. The renaming of Burj Dubai to Burj Khalifa is a significant move.

Conclusion

Understandably, the November 25, 2009 announcement released knee jerk negative criticism, excusable by suppressed Schadenfreude on the exhibitionism in Dubai. The negatives of Dubai were regurgitated: it has little oil, its debts are almost 100 per cent of GDP, the real estate bubble will continue to shrink and slump down, and there is no fiscal surplus. This is old public knowledge, however; no black swan here.

Dubai's crisis is a mini re-run of many major crises following Greenspan's famous "irrational exuberance". The strengths of "Dubai Miracle" should not be underestimated: its excellent infrastructure, its development of tourism and emphasis on modern technologies, its leadership and prime position as the best example in the region of a liberal capitalist market economy, its enterprise and aspirational culture provide strong attractions for doing business not only in and for the UAE market, but harness its resources as the gateway to the huge Indian subcontinent market.

For these positive reasons, I am unable to agree with the pessimistic prognosis that the 2009 Dubai capital market meltdown is the harbinger of a sizable and sustained junk sukuk market. The promulgation of Decree 57, the appointment of internationally well respected members of the tribunal and the separate committee for Amlak and Tamweel give a window of opportunity to the Sheikh Rashid and his advisers to learn the lesson and raise Dubai's stature as a liberal civil society.

Professor Mahmood Faruqui is a senior lawyer advising Islamic financial institutions and prestigious professional firms. He has been a board member/adviser to several Islamic and conventional financial institutions and his present clients include Bank of London and the Middle East, where he is senior adviser, and Thomson Reuters Westlaw, where he is an advisory board member.

Disclaimer: The above article reflects the professor's personal views.

DUBAI ROUND UP

What might be the impact of the recent crisis on the financial services industry in Dubai, beyond the short term?

Andrew Henderson, counsel, Clifford Chance LLP

"As long as the region has the potential to prosper (and provided the demand for oil remains, there is no reason why it should not), Dubai will remain the hub for financial services giving its bankers access to any market to which Emirates Airlines flies (and there are many). The financial crisis cannot remove what Dubai has put in place in the form of the DIFC which, over and above its strong legal and regulatory regime, provides a working environment to rival most western financial districts.

"Most importantly, a banker's decision as to location will often be determined by his family. Here, it is difficult to see any other city in the region trumping Dubai for a long time to come. The hare may have run out of breath but it is still miles ahead of the other tortoises."

Ashley Painter, partner and head of financial services, Middle East, Clyde & Co

What might be the impact of the recent crisis on the financial services industry in Dubai, beyond the short term?

"Following what is likely to be a lengthy period of reorganisation and consolidation, in the longer term I would expect to see a cautious return to lending and investment, coupled with greater regulation of the industry. No longer will banks and investors lend on a name-only basis and established relationships between banks and their customers will be crucial.

"Corporate and government entities may still seek to rely on the corporate bond market to obtain finance — the question of whether or not such issuances will be government-backed likely being a key consideration for investors in respect of government entities.

"The property market, in particular, which was previously so fundamental to Dubai's growth, will take a longer time to recover and we can almost certainly expect to see a continuance, or even a rise in, infrastructure projects in the Emirate."

Robert Finney, partner, Denton Wilde Sapte

"In Dubai the financial crisis has prompted a move to increase consumer protection (in respect of dishonoured cheques, for example, a big issue locally) and has revealed substantial differences between participants in the Islamic finance market (investors, issuers, and other providers and users of, Islamic finance products). In some cases the two coincide, such as where buyers of new homes under ijara contracts have lost protections (for example, in respect of completion dates and remedies for delays) due to mismatches between original building contracts and the ijara (similar to a lease) contracts with Islamic finance institutions to which the buyer assigns the building contract.

"But the crisis is also accelerating a trend in the wholesale and corporate IF market: serious discrepancies have been found between Sharia'h requirements and actual transaction documentation, and there are increased concerns about the form-over-substance approach of many transactions. Both of these concerns will result in much closer scrutiny in future by the Sharia'h boards."

Alexis Roberts, partner, Pinsent Masons

"The current, well-publicised woes of the Dubai economy are unlikely in the long term to affect its leading position in the region's financial services sector. Albeit Dubai faces increasing competition from other regional financial centres including, for example, Qatar, it continues to have many advantages as a hub for international financial services firms operating in the region. Given that the projections for growth in the region in relation to this sector remain very positive, Dubai will doubtless continue as an important international capital for financial products."

Sarah Ingram, chief compliance officer and board director, Essdar Capital Limited and Essdar Capital Managers Limited

"The financial crisis has created an ideal opportunity for Dubai to lead the region in addressing some of the issues and legal and regulatory shortfalls witnessed in recent months. Fundamental areas that Dubai could focus on would include: revision of the legal framework to ensure that commercial law, including bankruptcy, property and company law are brought in line with international best practice; improvements in corporate governance; harmonisation of legal and regulatory requirements across the free zone and non-free zone jurisdictions to prevent regulatory arbitrage; improvements in monitoring and enforcement by regulators and legal bodies; and greater transparency and debt management at both a corporate and sovereign level.

"Dubai has been a leader in the region in relation to financial services and it is hoped that it has the foresight to lead the region in implementing these improvements over the foreseeable future."

Hari Bhambra, senior partner at Praesidium LLP, which is headquartered in the Dubai International Financial Centre

"Beyond the short term, setting aside all the criticism which Dubai has received, some of which has been disproportionate, one should note that the real test of a financial centre is the confidence which investors have in it. However, this can only truly be judged by witnessing how a financial centre recovers from financial stress. Dubai is still young and this economic crisis is perhaps the first real challenge to impact Dubai, yet Dubai has been harshly judged against other more mature financial centre's which have experienced numerous peak and trough cycles. Surely the question of equal footing needs to be asked.

"I think a lot has been learned here and Dubai's financial system will recover quickly and stronger, and this period of recovery is what should be the key factor that should be considered when assessing the long-term strength of the financial system in Dubai, not how Dubai was impacted. Beyond the short term, Dubai will become a more mature financial system than before, the appeal of Dubai is still prevalent today, the cynics will remain but the proof will be in the pudding which stills looks a lot more tempting for its regional investors, most of whom may have sat on the side lines but are far from deterred from re-entering."

Philip Jolowicz, head of financial services and regulatory, Hadef & Partners

"Dubai has had a battering of late, first in the wake of a global crisis whose impact for Dubai was most profound in its property sector but which has been felt across the board. Now with recent events surrounding Dubai World and, in particular, Nakheel, the Emirate has an intense spotlight dedicated entirely to its scrutiny. Its neighbour, Abu Dhabi, has plucked it from the fire, and for the foreseeable future one cannot regard the position of Dubai outside the context of Abu Dhabi or, indeed, the UAE as a whole.

"The same goes for the financial services sector in Dubai. For banks, it is about repairing damage, restoring stability and confidence so that they may safely lend again, but perhaps this time on a sounder basis. Regulatory and legal factors that will assist in this process include: i) increased transparency, particularly as to the real exposure the banks face on their books; ii) the demise of "name" lending; iii) thoroughgoing implementation of Basel II (with proper account taken of the treatment for Islamic financing structures); iv) enhanced transparency and corporate governance within the corporate sector — i.e., the customers of banks; v) a federal level credit reference agency; and, crucially, vi) a comprehensive federal level bankruptcy law. It is encouraging that most of these initiatives are under way but there can be little doubt that a renewed confidence in the financial services sector will be reliant on the speed and effectiveness with which they are achieved."

Fussing and fuming about fair value and financial institutions

FACT OR FICTION?

By Thomas Porter

Financial institutions have faced a long-standing requirement to report investments in most financial instruments at "fair value" when they prepare financial statements. "Fair value" was generally regarded as the amount at which an instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. There had been little complaint about the use of fair value in financial reporting until the recent credit crisis when markets collapsed and quoted market prices, a common source for determining fair value, plummeted. Lower valuations caused enormous write-downs of financial assets that were "mark-to-market,"[1] causing a massive shrinkage of reported capital and prompting a need for additional liquidity.

Just prior to the meltdown of the markets, the Financial Accounting Standards Board released the Statement of Financial Accounting Standard No. 157, Fair Value Measurements (SFAS 157). Most companies were required to adopt it as of January 1, 2008 — right after the markets began to collapse. Critics claim that the requirements of SFAS 157 contributed to the credit crisis and called for its rescission. Their argument was that heightened liquidity needs could only be satisfied by fire sales at depressed prices, which then led to a further spiraling down of prices, all of which could have been avoided if SFAS 157 had never been issued.

There is no empirical evidence that supports the critics' arguments. Indeed, there is evidence to the contrary.[2] Unfortunately, the uproar caused by the critics was so distracting that users of financial information failed to appreciate

1. "Mark-to-market" is not synonymous with "fair value." As will be discussed later, market values may not be indicative of fair value as that term is defined in SFAS 157.

that SFAS 157 gave them exactly what they had long been clamoring for — heightened transparency. They also seemed to miss the fact that SFAS 157 did not require any new fair value measurements; the standard itself states "this Statement does not require any new fair-value measurements."[3] This article will highlight how SFAS 157 provides better information to users because it increases and standardizes (across firms) disclosures about fair-value accounting measurements, providing users with more transparency about how reported amounts are determined.

SFAS 157

SFAS 157 is one of many standards that FASB has issued that comprise generally accepted accounting principles. When it was issued, FASB said that SFAS 157 "responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings."[4] In short, the expanded information required by SFAS 157 increases transparency. Prior to SFAS 157, users had limited and comparatively inconsistent information about the manner in which fair value was determined. It could have been the latest quote from an active market, a quote from brokers or dealers if an instrument was thinly traded, or it could be entirely estimated.

SFAS 157 made two major improvements to GAAP. First, it provided a single definition of "fair value" that, in some cases, distinguishes fair value from "mark-to-market." Second, it requires structured disclosure in the notes to the financial statements using a hierarchy that communicates how fair value is determined. Is fair value the latest market quote? Is fair value an adjusted market quote? Or, is fair value estimated? If it is estimated, how was it estimated? SFAS 157 provides the answers to those questions.

A single definition of fair value

Previous accounting standards that require "fair value" have defined that term differently. SFAS 157 defines it as follows:

"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[5]
The definition of fair value in prior standards has been replaced with the above definition and it is contemplated the same definition of fair value will be used in future standards.

It is important to note that to determine the fair value of an asset or liability, one must consider a hypothetical transaction in which an asset or liability is disposed of in an orderly transaction. Since the asset or liability is not really disposed of, preparers of financial statements must determine the price at which the transaction would take place if it were disposed of — even if the entity has no intention of disposing of the asset immediately, later or ever. Further, this definition accommodates the potential for concluding that the current market price is not representative of fair value. Because the hypothetical transaction should be construed as an orderly transaction, if there are indications that a market is not functioning normally, then current market prices would not provide a measure of fair value under SFAS 157.[6]

Fair value hierarchy

The hypothetical exit price used to measure fair value can be determined using different types of information. It can be the market price for the latest transaction for an identical item, the adjusted market price of a similar item or it can be completely estimated. SFAS 157 requires companies to disclose how they determined fair value by describing the inputs that are used.

SFAS 157 defines a three-level hierarchy of inputs. The levels are creatively named level one, level two and level three. "Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities…"[7] If a particular asset or liability has an identical twin that is currently trading in an active market that is functioning in an orderly fashion, the latest transaction price is representative of its fair value.

"Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly."[8] If a particular asset or liability does not have an identical twin that is currently trading, then the price of a similar item may be used. Adjustments may be made to that price to account for the differences in the item.

"Level 3 inputs are unobservable inputs for the asset or liability."[9] In cases in which there are no identical or similar assets trading, an entity may use unobservable inputs (i.e., assumptions) to determine the fair value of a particular asset. Those inputs are used to model the amount at which an asset would be priced if it were to be sold in an active market. This approach is often referred to as "mark-to-model."

SFAS 157 requires that entities include, in the notes to their financial statements, information that enables users to assess the inputs, by level, that are used to determine fair value. That way, a user can decide if a fair value amount that is reflected in the financial statements is based on a quoted market price, an adjusted market price or is completely estimated.

Mark-to-market may not be fair value

An underlying assumption of the hypothetical transaction on which fair value is based relies on the existence of an active market and an orderly transaction. If the market for a particular item is not active, or if there is reason to believe that market prices are not representative of fair value, SFAS 157 permits the use of an alternative measurement approach, including estimation. That means that the current market quote may not be the fair value. Unlike prior standards, the disclosure requirements of SFAS 157 reveal how the amounts were estimated and thereby yield more transparency about how fair value is determined.

Bank of America example

The Bank of America provides a good example of the additional disclosure that SFAS 157 requires. The Bank of America adopted SFAS 157 as of January 1, 2007.[10] A comparison of the amount of disclosure on either side of its adoption date highlights the contribution of SFAS 157.

In its Form 10-K for the fiscal year ended December 31, 2006, the Bank of America devotes about a single page to its description of fair value for its financial instruments.[11] It provides brief descriptions, in general terms, about how fair value amounts were determined for its various groups of financial instruments.

In its Form 10-K for the fiscal year ended December 31, 2007, the note related to fair value measurements is four and one-half pages long.[12] In addition to a table that shows the level of inputs used to determine fair value for each class of financial instruments, there are detailed descriptions of each class of financial instruments, the inputs and models used to determine their fair value and the amounts of unrealized gains and losses that resulted from changes in those fair-value measurements.

Conclusions

SFAS 157 cannot be blamed for causing the credit crisis, mainly because it did not require any new fair-value measurements. One of its main contributions to GAAP is the expanded and standardized disclosure requirements about fair value. Further, because SFAS 157 and its subsequent interpretations accommodate the possibility of imperfect markets, the timing of its release (as the markets were collapsing) was almost perfect. As a result of its structured and expanded disclosure requirements, users now have more and better information about when firms depart from "mark-to-market" accounting when fair value measurements are required.

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2. See Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, Securities and Exchange Commission, October 18, 2008 (http://www.sec.gov/news/studies/2008/marktomarket123008.pdf) and Laux and Leuz, Did Fair-Value Accounting Contribute to the Financial Crisis?, NBER working paper 15515 (http://www.nber.org/papers/w15515).

3. Statement of Financial Accounting Standards No. 157, Fair Value Measurements, Summary.

4. FASB News Release, September 16, 2006.

5. Ibid., paragraph 5.

6. When one ignores the status of the market, current market quotes are frequently referred to as "fair market value," which is not equivalent to SFAS 157's notion of "fair value."

7. Ibid., paragraph 24.

8. Ibid., paragraph 28.

9. Ibid., paragraph 30.

10. Firms were encouraged to adopt SFAS 157 prior to its stated effective date.

11. Bank of America, Inc., Form 10-K, December 31, 2006, pp. 161–162.

12. For the fiscal year ended December 31, 2008, there are almost six pages of disclosures about fair value.

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