

Agenda

- ❑ Why is buy side worried?
 - ❑ Explosion of regulation
 - ❑ Increased regulatory action
- ❑ Regulation of sell side
 - ❑ Dark pools
 - ❑ Derivatives
 - ❑ Clearing house proposals

Regulatory Explosion and Why Buy Side is Worried

Subprime Crisis

- ❑ March 2008 SEC investigates false Lehman Brothers and Bear Stearns rumours
 - ❑ Subpoenaed hedge funds and equity dealers
- ❑ July 2008 SEC warns extending investigations into rumours
- ❑ Emergency order on 15 July to ban short selling in 19 protected financial institutions
- ❑ 19 September 2008 UK FSA bans short selling in 29 financials
- ❑ 21 September 2008 ASIC bans covered short sales for all listed stocks
- ❑ October 2008 Japan FSA bans naked short selling
- ❑ Taiwan and Korea implement new rules

Regulatory Events 2008

- G20 in November 2008
 - *All financial market products and participants should be regulated or subject to oversight as appropriate to their circumstances*
 - *Particular focus on problems with hedge funds*
- G30 - hedge funds to register with national regulator
- IOSCO established 3 task forces to report to G20
- EU Commissioner for Internal Market and Services
 - Reported to EU in December 2008
- President's Working Group Asset Management Committee
 - Best practices report in January 2009
- Treasury Secretary testimony to House Financial Services Committee Hearing

UK Response from FSA and HM Treasury

- ❑ Hedge fund behaviour not unique to that sector
 - ❑ Most funds have lower leverage than banks
 - ❑ Regulatory intervention specifically for funds not effective
 - ❑ Short selling and market abuse not unique to hedge funds so ineffective to only control their activities
- ❑ Most funds or managers subject to some regulation
- ❑ Quality of risk management in UK hedge funds generally better than other market participants
- ❑ Detailed disclosure regime not appropriate as strategies vary too much
- ❑ Response must be global or regulatory arbitrage will occur

FSA Turner Report March 2009

- ❑ Changes to bank capital and liquidity regulations and to bank published accounts
- ❑ Better quality bank capital with more capital required to support risky trading activity
- ❑ Counter-cyclical capital buffers building up in good economic times to be drawn on in downturns
- ❑ Tighter regulation of liquidity
- ❑ Regulation of "shadow banking" activities on basis of economic substance not legal form
 - ❑ Increased reporting requirements for unregulated financial institutions such as hedge funds
- ❑ Regulation of Credit Rating Agencies
- ❑ Action to ensure remuneration policies discourage excessive risk-taking
- ❑ Changes in FSA's approach to focus on business strategies and system wide risks not internal processes
- ❑ Reform Euro banking market by combining European regulatory authority and increased national powers to stop risky cross-border activity

US Government Approach

- ❑ Create single US entity with responsibility for systemic stability over major institutions, critical payment and settlement systems
- ❑ Comprehensive oversight for OTC derivatives market
- ❑ Leveraged private investment funds with large AUM to register with SEC
 - ❑ *No comprehensive data to assess if funds pose individual or collective threat to financial stability*
- ❑ US Congress introduced new acts requiring all funds and their managers to register with SEC

IOSCO Working Groups

- ❑ Short Selling Task Force
 - ❑ Eliminate gaps in regulation
 - ❑ Consider naked short selling, delivery requirements and reporting
 - ❑ Minimise impact on stock lending
 - ❑ Chaired by HK SFC
- ❑ Unregulated Financial Markets and Products Taskforce
 - ❑ Greater transparency to OTC markets
 - ❑ Chaired by ASIC and AMF of France
- ❑ Unregulated Financial Entities
 - ❑ Eliminate hedge fund risk
 - ❑ Chaired by FSA and CONSOB of Italy

G20 Communiqué April 2009

- ❑ Financial Stability Board with strengthened mandate include all G20 countries, FSF members, Spain and EC
- ❑ FSB and IMF to provide early warning of macroeconomic and financial risks
- ❑ New regulatory systems so that authorities can identify macro-prudential risks
- ❑ Extend regulation and oversight to all systemically important financial institutions, instruments and markets including hedge funds
- ❑ Implement tough new principles on pay and compensation
- ❑ Take action to improve quality of capital in the banking system. Prevent excessive leverage and require buffers of resources to be built up in good times
- ❑ Take action against non-cooperative jurisdictions, including tax havens. Era of banking secrecy is over
- ❑ Accounting standard and regulators to improve standards on valuation and provisioning and single set of global accounting standards
- ❑ Extend regulatory oversight and registration to Credit Rating Agencies

Other

- ❑ Stop Tax Haven Abuse Act
 - ❑ Impose AML requirements on funds in US to prevent tax evasion
 - ❑ Are Cayman structures under TPA pressure?
- ❑ FASB proposals on fair valuation accounting standards
- ❑ New rules for selling complex investment products
 - ❑ Hong Kong and Singapore
 - ❑ Area of FSA interest
 - ❑ US potential changes to professional investor definition

Regulation of Hedge Funds

- ❑ Proliferation of industry groups
 - ❑ AIMA
 - ❑ MFA
 - ❑ President's Working Group
 - ❑ Hedge Fund Standards Board
- ❑ All different proposals but clear hedge fund managers to be regulated
- ❑ US Congress
 - ❑ Hedge Fund Transparency Bill
 - ❑ Hedge Fund Advisers Amendment Act
- ❑ SFC – status quo but increased inspections and new survey for hedge fund managers
- ❑ MAS – inspecting all exempt fund managers and have asked AIMA and other industry members for proposals on how to regulate hedge fund managers

What is on Asian Regulatory Agenda?

SFC in 2007

Type of Case	Major cases	All Cases
Corporate Governance	32%	13%
Insider dealing	26%	16%
Market manipulation	20%	32%
Intermediary misconduct	18%	25%
Unlicensed dealing	1%	9%
Disclosure of interests	Nil	9%
Others	3%	1%

Breakdown of penalties in 2008

Type	Oct 07 - Jan 08	Jan 08 – Apr 08	May – Jul 08	Aug-Sep 08	Oct – Dec 08	Jan – Apr 09
Compliance Advice Letters	30		135	52	86	25
Enforcement actions completed	30	65 and 25 notices of decision	56	29	57	64 and 20 notices of decision
Criminal proceedings commenced		1	14	5	11	6
Civil action commenced		19	1	7		1
Administrator appointed				1		1

Change in disciplinary approach

- ❑ December 2007 Ho Lai was first person jailed under SFO
 - ❑ 14 offences of market manipulation
 - ❑ Six month custodial sentence reduced because of guilty plea
- ❑ August 2008 first indictable prosecution for market manipulation before District Court
- ❑ Postpone suspension of licence if firm agrees to independent reviews of activities without prior notice
- ❑ Imposition of highest fine ever in July 2008
 - ❑ Punitive nature of fine was appealed to SFAT
 - ❑ SFAT upheld SFC decision to increase fines due to changing nature of marketplace

Algorithmic Trading

- ❑ Lack of human control can pose compliance problems
- ❑ Disciplinary case
 - ❑ Programme aggressively sold low liquidity stock in limited time
 - ❑ No time limit parameter for execution
 - ❑ Share price pushed down
 - ❑ Inconsistent with duty under Code of Conduct to act in best interests of market integrity
- ❑ Firms must
 - ❑ Understand how system executes trades
 - ❑ Set proper parameters for execution to ensure market not affected
 - ❑ Ensure staff properly trained in setting parameters and system
 - ❑ Use systems appropriately
 - ❑ Monitor trading results during and after trading hours

Conflicts of interest

- ❑ SFC issued reprimand to Deutsche Securities Asia and fined it HK\$6 million
- ❑ SFC investigation into DSAL's services provided to institutional clients through facilitation trading desk found DSAL did not:
 - ❑ Have adequate system to identify and resolve potential conflicts of interest arising from commingled proprietary and client trades executed by the facilitation trading desk
 - ❑ Have appropriate and effective compliance function to detect and manage risks to clients involved in dealing with other clients as principal
 - ❑ Keep adequate audit trails of client order instructions

Market Manipulation

- ❑ Fined Macquarie Equities \$4 million
- ❑ Commission rebate scheme for derivative warrants in breach of obligation to act with due skill, care and diligence in best interests of integrity of Hong Kong market
- ❑ Scheme reduced transactions costs for investors and stimulated trading in MB warrants by reimbursing investors through their participating brokers for brokerage costs
- ❑ January 2002 SFC warned Macquarie to ensure scheme did not facilitate trading of MB warrants
 - ❑ Heavy trading activities in MB warrants between 2 clients
 - ❑ Trading warrants at same prices close together to create increased turnover
- ❑ The brokers got commission rebate and clients got brokerage discounts for large volume trading so clients got risk-free profit from difference
- ❑ Macquarie failed to check if commission rebate was higher than actual brokerage costs
- ❑ Macquarie should have checked if scheme distorting market for warrants

Upcoming criminal proceedings

- ❑ Insider dealing trial involving the shares of CITIC Resources Holdings Ltd in District Court on 4 May 2009
- ❑ Pre-trial review and trial re disclosure of interests in shares of Longlife Group Holdings and Warderly International Holdings in Eastern Magistracy on 4 May 2009
- ❑ SFC appeal against High Court decision to discharge injunction to prevent dissipation of assets in insider dealing investigation in Court of Appeal on 8 May 2009
- ❑ Director disqualification hearing in High Court for former chairman of Wah Sang Gas Holdings on 22 May 2009
- ❑ Pre-trial review for alleged provision of false or misleading statements regarding shares of Green Energy Group at Eastern Magistracy on 22 May 2009

MAS Enforcement Actions

Type of Case	Number in 2007	Number in 2008	Number in 2009
Insider dealing	3	2	2
Failing to notify of change in substantial shareholding	8	0	1
Unlicensed activity	1	2	0
False trading	2	0	0
Reprimand / revocation of licence for breach of fit and proper criteria	2	2	1
Late returns		3	0

MAS Action

- ❑ MAS reprimanded UOB Kay Hian for breach of SGX-ST Rules and failure to meet the standards expected of CMS licensee
- ❑ UOBKH not satisfy MAS that it had adequate internal control systems and procedures to ensure that representatives possess competence and capability to conduct regulated activity
 - ❑ UOBHK administering exam for representatives to deal in SGX Extended Settlement Contracts
 - ❑ not take adequate measures to safeguard integrity of the examination and ensure confidentiality of examination papers

CSRC Priorities for 2009

- ❑ CSRC priorities for 2009
 - ❑ Open stock market for growth orientated companies
 - ❑ Introduce stock index futures
 - ❑ Spur mergers of listed companies
 - ❑ Develop corporate bond market
 - ❑ Improve regulatory oversight
- ❑ CRSC consulting on allowing institutional investors and asset managers to invest in Chinese futures
- ❑ Pilot programme for listed banks to buy and sell bonds on exchanges
 - ❑ Interbank market for government bonds not open to individual investors
- ❑ New rules for sponsors of IPOs
 - ❑ Improved standards for prospectus disclosure
 - ❑ New standards for keeping working papers prepared during DD process

SEC Extra-Territoriality

- ❑ SEC enforcement action against non US firms failing to register as broker-dealers
- ❑ Contacts with US investors initiated by offshore firms may require registration as B-D
 - ❑ Regime will cover issuers who offer financial products or services to US investors
 - ❑ Managers and employees could be caught if receive sales based commission or active in calling on US investors
- ❑ Erroneous assumption that if offering by private placement registration not required
 - ❑ Registration triggered by engaging in business of offering or facilitating securities transactions
- ❑ Problems with non US firm leveraging off US affiliate
 - ❑ Recent action against non US firm as employees traveled to US on regular basis, made presentations to professional investors at meetings arranged by US affiliate
 - ❑ Non US affiliate also sent reps to client events organised by US affiliate

Regulating Markets and Products

Regulating Markets and Products

- ❑ ISDA Big Bang for CDS auctions and clearing
- ❑ Strengthen clearing arrangements after Lehman Brothers collapse
 - ❑ FSA examining responses to lack of segregation / netting
 - ❑ FSA working on improvements to CREST settlement system
- ❑ US Treasury to improve regulation of
 - ❑ Overnight and short term lending market
 - ❑ Tri party repos
 - ❑ OTC derivatives and CDS market by requiring all dealers to register, force standardized contracts, supervise settlement systems, require reporting of aggregate data on trading volumes publicly and individual positions to regulator

Dark Pools

- ❑ Exchanges been negatively impacted by dark pools
 - ❑ April 2009 22% of average US daily stock volume in dark pool or off exchange by brokers in dark
- ❑ NYSE criticism
 - ❑ Free riding on exchange prices as dark pools look at current exchange-listed price but not actually contributing to the price
 - ❑ Makes stock prices on exchanges less legitimate if large amount of volume is dark
- ❑ US exchanges licensed under Regulation NMS for trading
- ❑ Dark pools regulated under Reg. ATS with less stringent requirements
 - ❑ No need to report volumes monthly
 - ❑ No need to print bids
 - ❑ No need to identify who is trading what stocks
- ❑ *"Here, take our exchange license back if we have all these requirements we don't need,"* Larry Leibowitz, NYSE Head of U.S. Execution & Global Technology

Some Sell Side Concerns

Best Execution

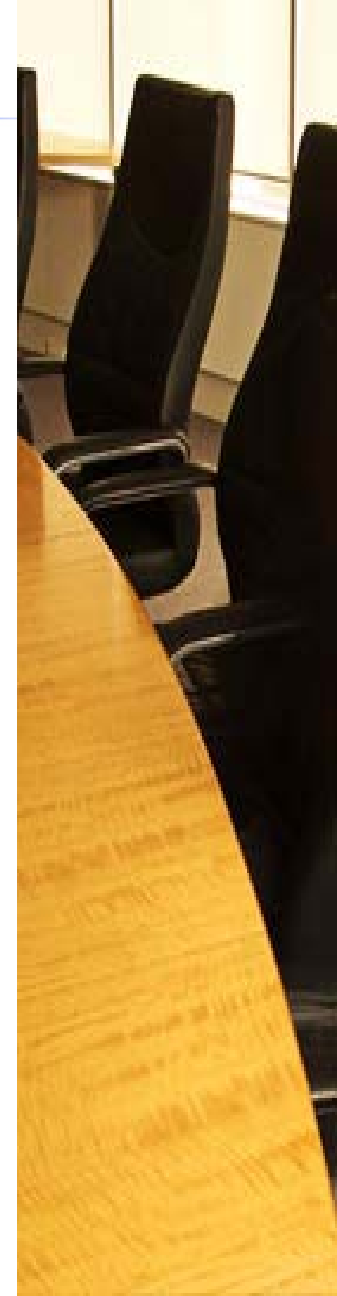
- ❑ Buy-side under pressure to deliver on best execution esp fixed income
- ❑ Qualitative Considerations
 - ❑ Research and /or ability to provide investment ideas
 - ❑ Execution capability
 - ❑ Financial stability
 - ❑ Available liquidity
 - ❑ Willingness and ability to commit capital
 - ❑ Responsiveness
 - ❑ Reputation and integrity
 - ❑ Access to underwriting offerings and secondary markets
 - ❑ Reliability in executing trades and keeping records
 - ❑ Fairness in resolving disputes
 - ❑ Timing and size of orders
 - ❑ Current market conditions
 - ❑ Ability to maintain anonymity of trading intentions

Best Execution

- ❑ Quantitative Considerations
 - ❑ Get benchmark comparisons from third party vendors
 - ❑ Identification of outliers
 - ❑ Measuring transaction costs
 - ❑ Measuring market delay and market impact costs
 - ❑ Cost of not getting order to market in timely way
 - ❑ Movement in price of security caused by executing order
 - ❑ Brokerage allocation in dollars traded and number of trades
 - ❑ Multiple broker quotes
 - ❑ Evaluation of execution from brokers used

Counterparty Review

- ❑ Following methods most frequently reported as monitoring techniques
 - ❑ Use of approved broker list
 - ❑ Broker survey / votes
 - ❑ Brokerage budget
 - ❑ Brokerage allocation reports
 - ❑ Portfolio turnover rates
 - ❑ Contemporaneous price monitoring by traders
 - ❑ Third party execution quality reviews
 - ❑ Best execution committees
 - ❑ Reports to Board of Directors of funds



Thank you.

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