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Industry Guidance

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Background

In November 2006, the Financial Services Authority (FSA) issued its discussion paper 06/5 entitled "FSA confirmation of Industry Guidance" (DP).

The context under which the DP has been issued is the placing by the FSA of more reliance on the eleven Principles for Businesses and high-level rules. The FSA stated that this approach provides firms with greater flexibility to decide how best to meet its requirements, encourage greater innovation and align good regulatory practice with good business practice. Specifically the FSA envisages that organisations, such as trade associations like AIMA, will play a significant role in helping the industry develop suitable practices to meet regulatory obligations.

For these purposes the FSA has defined "Industry Guidance" as; "information created, developed and freely issued by a person or body, other than the FSA, which is intended to provide guidance from the body concerned to the industry about the provisions of our Handbook." In the case of AIMA, it has already had its first taste of regulation by proxy, having produced guidance in consultation with the FSA concerning hedge fund side letter disclosure.

Whilst the FSAs "principles based" approach to regulation has the advantage of flexibility, some concerns have been raised as to whether it is in fact abdicating responsibility to trade bodies and others in putting the onus on them to produce appropriate guidance. One often mentioned and glaring weakness of the principles based approach, is that where there are fewer rules, situations are vulnerable to more open interpretation - hence possible litigation and enforcement action, based on the differing interpretation of the regulated on the one hand and the regulator on the other.

In the DP the points the FSA focused on are;

- defining Industry Guidance;
- formalising how the FSA proposes to recognise Industry Guidance by way of giving "FSA confirmation" (discussed below), including the use of standardised wording;
- providing clarity concerning the legal status and implications of recognising Industry Guidance;
- outlining the parameters that Industry Guidance should fall within, in order to gain recognition;
- detailing the FSA's clear, fair and transparent processes for dealing with requests for "FSA confirmation"; and
- providing case studies to illustrate its proposals.

The Legal Implications of Recognising Industry Guidance

The FSA sets out three ways in which guidance can be given, namely as:

- a safe harbour;
- a sturdy breakwater; or
- implicit recognition.

Safe harbour: Guidance by way of a safe harbour has an effect on the FSA and potentially third parties and would require Handbook rules to give the guidance effect.

Sturdy breakwater: Framing guidance by way of a “sturdy breakwater” would have an effect on the FSA but not on anybody else, having the effect of preventing the FSA from taking action but not affecting the rights of third parties.

As for implicit recognition, this has no legal effect on the FSA or anybody else. The FSA cites the provisions of the Banking Code under this heading. When the FSA gives guidance it must follow statutory processes, among other things.

FSA Confirmation

The definition the FSA proposes is set out above. However, not everything that falls into the definition of Industry Guidance will be brought forward for FSA confirmation. For these purposes “FSA confirmation” is defined as the FSA’s review and sign-off of Industry Guidance accompanied by an FSA statement.

The FSA proposes the following parameters, among others, for giving its confirmation. Industry Guidance;

- should explain how it relates to a relevant FSA rule and /or principle;
- must not claim to limit or affect the rights of third parties;
- must be optional and be one way (not the only way) to comply;
- must not claim to be an exhaustive or definitive statement of what the FSA rules or guidance are or require;
- must be publicly available;
- must detail who its intended audience is; and
- must not be anti-competitive.

The FSA has proposed standardised wording to be used when it provides confirmation of guidance. The recommended wording is: “The FSA has reviewed [this Industry Guidance] and has confirmed that it will take it into account when exercising its regulatory functions. [This Industry Guidance] is not mandatory and is not FSA Guidance. This FSA view cannot affect the rights of third parties”.

The use of Industry Guidance for areas covered by EU Directives will vary depending on the individual Directives. In general, however, it will not be possible to use Industry Guidance to implement EU Directives unless the FSA makes a rule to require firms to comply with a piece of Industry Guidance.

What Does This Mean In Practical Terms?

If a firm uses FSA Industry Guidance to meet the FSA’s minimum requirements, then it is the firm’s responsibility to make the FSA aware of this. The FSA will not, however, monitor compliance against individual pieces of Industry Guidance.

In enforcement matters, the FSA will continue to consider whether a firm has failed to meet FSA requirements. Where it has followed confirmed Industry Guidance to comply with an FSA requirement, the FSA will take that into account. However, non-compliance with Industry Guidance creates no presumption that the FSA requirements have not been met. The onus is on a firm's senior management to be sure that the firm applies Industry Guidance appropriately.

Reaction to the Guidance Proposals

The key investment management related trade bodies in the UK, AIMA and the IMA have both responded to the questions raised in the DP, namely:

Q1: Do you anticipate the demand for FSA confirmation from providers of Industry Guidance will be significant?

Q2: Do you agree with our proposed parameters for considering whether we should grant FSA confirmation? If not, why not?

Q3: Do you agree with our proposed approach to facilitate the use of Industry Guidance? If not, why not?

Q4: Do you have any other comments or proposals?

Unsurprisingly financial services industry associations are concerned that they may be becoming regulators by proxy, stepping into the shoes of the FSA and dealing with areas that the FSA is unable or unwilling to address directly itself. Being de facto, a source of indirect regulation has implications for a trade association, not least with regard to its own resources and, more importantly, potentially compromises it in its role and exposes it to liability.

Indeed, the shift of emphasis by the FSA towards principles based regulation supplemented by Industry Guidance, amongst other things, smacks of a return to an SRO-type regulatory culture (a point made by one trade body). Also trade bodies, like AIMA, will have to ensure that their members pay close regard to Industry Guidance produced by other parties, consider its potential impact on the investment management industry and respond formally, perhaps post-FSA confirmation.

On the plus side, it is clearly of benefit to have carefully drafted guidance which applies to specific sectors of the regulated world, including that inhabited by investment hedge fund managers, advisers and promoters. What remains to be seen, however, is the extent of which FSA will pick and choose between proposed topics for guidance and, within those topics, what aspects of guidance it is prepared to endorse or "confirm".