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INVESTMENT FUNDS NEWSLETTER

Legislative Proposals for U.S. Private Equity Funds and Hedge Funds

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IN THIS ISSUE

Two bills introduced in Congress this past June contain provisions that, if enacted, would have a significant impact on sponsors of, and investors in, private equity and hedge funds. The bills, put forth in the wake of the Fortress and Blackstone IPOs (and future IPOs being considered by similar funds, such as KKR and Och-Ziff Capital), reflect a Congressional focus on this industry and a perception, at least in some quarters, that such funds, and their sponsors, are not paying their fair share of income tax.

"PTP" Bill

The first bill, introduced in the Senate on June 14, 2007, one week before the launching of the Blackstone IPO, would change the existing rules dealing with "publicly traded partnerships" ("PTPs") by eliminating an existing exception to treatment of a PTP as a corporation where the PTP (i) earns sufficient levels of passive ("qualifying") income (including interest, dividends, real property rents and gains from dispositions of real property, and most other capital assets) and (ii) is not required to register as an investment company under the Investment Company Act. Both Blackstone and Fortress qualify for this current law exception to corporate treatment. As such, and in contrast to the situation of other businesses operating in corporate form, these funds are subject to no U.S. income tax in their own right; rather investors therein are taxed directly on their shares of fund income.

Under the proposed legislation, the above-described exception would not apply to any partnership earning income derived from services provided as an investment adviser under the Investment Advisers Act of 1940, whether or not registration under such Act were required. Thus, a fund would pay a first level of tax at the fund level and investors would be subject to a second level of tax on dividends and certain other distributions.

As introduced, the bill would be effective for taxable years of partnerships beginning on or after June 14, 2007, with a grandfathering rule delaying the effective date for five years in the case of partnerships (including Blackstone and Fortress), interests in which were traded on the June 14 effective date or which, by such date, had previously filed with the SEC to undertake an IPO. This effective date may slip. On the other hand, there has been talk of shortening, or eliminating, the five-year "grandfather" rule.

Although the new rule would not impact fund principals directly (and does not cover interests held outside the IPO vehicle), it would clearly reduce the overall IRR available to fund investors.

"Carried Interest" Bill

Another bill, introduced in the House of Representatives on June 22, 2007, is aimed at "carried interests" typically earned by fund sponsors and eligible, under current law, for capital gain treatment to the extent funded by capital gains. Under this bill, income from any "investment services partnership interest" (and any gain on disposition of such an interest) would be treated as ordinary income from the performance of services, taxable at ordinary income rates (currently 35%), rather than as capital gain (currently taxed at 15%), regardless of the source of income earned. An "investment services partnership interest" would be defined as any interest in a partnership held by any person, if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of services to the partnership consisting of investment, valuation and related advice in respect of any "specified asset." "Specified assets" include securities, real estate, commodities, or options or derivative contracts with respect thereto. A limited exception would preserve the potential for capital gain treatment on income representing a "reasonable" return on invested capital. The provision would impact the characterization of income allocated to REITs, but specifically would not affect REIT qualification. No effective date has been provided to date.

Although the two measures ... are the only ones that have emerged in bill form to date, other potential proposals aimed at hedge funds and private equity funds have been the topic of recent discussion on Capitol Hill. These include limiting the ability of fund sponsors to defer income by receiving management fees in offshore vehicles and limiting use of corporate "blocker" structures that facilitate avoidance of so-called "unrelated business taxable income" by pension funds, endowments and other tax-exempt investors.

The "carried interest" bill has a potentially broader impact than the PTP bill described above in that it would apply to interests in a wide range of partnerships, whether or not publicly traded. In addition, by treating income from an "investment services partnership" as services income, this bill effectively would render the PTP bill provision unnecessary, *i.e.*, a PTP, more than 10% of the gross income of which was derived from "carried interests" in funds, would automatically fall out of the current law exception from corporate treatment for PTPs with sufficient "passive" income described above. Finally, the definition of "specified asset" means that "carried interests" received in respect of a broad range of services would be covered.

Consistent with the foregoing, the "carried interest" bill has been spoken of as a major revenue raiser (including, in particular, as an offset to the cost of reform of the "alternative minimum tax"). This is in contrast to significantly lower estimates linked to the PTP bill.

Going Forward

Although the two measures described above are the only ones that have emerged in bill form to date, other potential proposals aimed at hedge funds and private equity funds have been the topic of recent discussion on Capitol Hill. These include limiting the ability of fund sponsors to defer income by receiving management fees in offshore vehicles and limiting use of corporate "blocker" structures that facilitate avoidance of so-called "unrelated business taxable income" by pension funds, endowments and other tax-exempt investors.

Hearings on the "PTP" and "carried interest" bills, and on related issues, were held in the summer before the Congressional autumn recess and have resumed this month. Congress has also asked the SEC and the Treasury Department to examine the impact on the markets of the PTP bill. At the same time, lobbying has been vigorous and at least some legislators are expressing caution, particularly in respect of the "carried interest" bill. Recent developments on the subprime mortgage front and the resulting crisis in the credit market have shifted some attention away from the hedge fund and private equity fund sector. That said, it is not unlikely that one or more tax measures related thereto will find their way into law this year.

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CFIUS Reform Legislation Promises More Rigor for Investment Reviews

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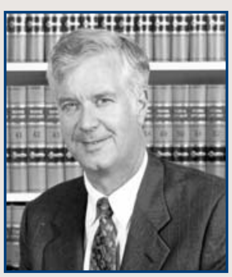

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On July 26, President George W. Bush signed the "Foreign Investment and National Security Act of 2007." The new law strengthens and formalizes the existing process for Presidential review of foreign acquisitions that could affect the national security of the United States. The legislation received strong support from Congress and the U.S. business community. It is not expected to have an adverse effect on foreign investment, but it does ensure greater rigor in investment reviews and enhanced political oversight of the multi-agency Committee on Foreign Investment in the United States ("CFIUS"). Foreign private equity funds and other non-U.S. investors in sectors covered by CFIUS should consider the impact of the new legislation on any proposed acquisitions to ensure a successful outcome.

CFIUS Membership

The law retains the current membership of CFIUS, with the exception of the U.S. Trade Representative and certain members of the Executive Office of the President, such as the Budget Director. It adds the Secretary of Energy as a voting member. In addition, the law adds—as *non*-voting members—the Secretary of Labor and the Director of National Intelligence ("DNI"). Since the President can supplement the Committee membership, however, either generally or on a case-by-case basis, it would not be surprising if all current members of the CFIUS remain on board.

Under the new law, the Secretary of the Treasury (who chairs CFIUS) must designate a member of the Committee to be the "lead agency" for the negotiation of any mitigation agreement limiting foreign control of the acquired company, and for ensuring thereafter that the mitigation agreement is honored. Additionally, the DNI must assess the threat to national security posed by a covered transaction. This is not a new practice. Threat assessments have long been conducted for covered transactions.

Investigation of Government-Controlled Acquisitions

All covered transactions are and always have been subject to a 30-day *review*. The amendments strengthen the provisions of the law that require mandatory *investigation* of any acquisition by a foreign government-controlled entity—*i.e.*, an additional 45-day review, followed by a 15-day Presidential assessment—but exempt from such investigations, transactions that, in the view of the Secretary of the Treasury and the head of the lead agency, "will not impair the national security of the United States."

This provision effectively codifies current practice. Although the requirement that the Secretary or Deputy personally sign off on any decision *not* to investigate may push more cases into investigation, it is unlikely that we will see investigation where there is no colorable risk to the national security. For example, the presence of a Golden Share, without more, is unlikely to prompt investigation. At the same time, even where the perceived national security risk is small, increased political oversight may result in the investigation of acquisitions by companies controlled by the governments of non-NATO countries, or acquisitions involving critical infrastructure.

Critical Infrastructure

The new law expressly provides for investigation of acquisitions that "would result in control of any critical infrastructure" if CFIUS determines that the transaction "could impair national security" and that such impairment "has not been mitigated by assurances provided or renewed with the approval of the Committee. . . ." The term "critical infrastructure" is defined to mean "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security." Here again, the new law effectively codifies current practice.

What is instructive is that Congress declined to expand the definition to include "economic security," as proposed in earlier drafts of the legislation. At the same time, Congress has removed any doubt that it expects CFIUS to review acquisitions that affect "vital . . . systems and assets," which will likely extend beyond the traditional defense sector of the economy. The addition of the Secretary of Labor as a member of CFIUS, albeit nonvoting, indicates that job protection may get closer scrutiny, especially in cases where a transaction could result in skilled labor being outsourced to foreign countries. It is noteworthy that the law provides for regulations ensuring "an appropriate role for the Secretary of Labor with respect to mitigation agreements," a new requirement.

Additional Factors for Consideration

The new law makes the statutory factors for review mandatory (they were previously discretionary) and adds new factors, including whether the acquisition presents a regional military threat to the interests of the United States, the effect of the transaction on major energy assets, the effect on critical technologies (defined as "essential to the national defense"), whether the acquiring firm is foreign government controlled, the adherence of the subject country to nonproliferation control regimes, the relationship of the subject country with the United States (particularly its record on cooperating in counter-terrorism efforts), the potential for transshipment or diversion of technologies with military applications (including an analysis of national export control laws), and the long-term projection of U.S. requirements for sources of energy and other critical resources and material.

Mitigation, Tracking, and "Postconsummation Monitoring"

For years, casual observers of the CFIUS process have complained that few cases went to investigation—and that only one has been vetoed in the history of CFIUS. The reality is much more complex. Transactions are often restructured to meet U.S. government concerns, and some deals are withdrawn when it is clear that they will either not be approved—or when the conditions for approval appear too onerous. Most transactions go forward, but, as noted above, approval may hinge on a formal agreement to mitigate foreign control. For example, government contractors with security clearances *must* enter into an agreement with the government to mitigate foreign ownership, control, and influence ("FOCI Agreements") in order to maintain their clearances. These agreements will generally require the appointment of independent Outside Directors, board oversight of security, and restrictions on foreign nationals in key management positions. Even in cases that do not involve security clearances, similar agreements may be a condition of approval. The new law provides for oversight of the parties' compliance with these agreements.

As FOCI Agreements have always been closely monitored by the government agencies with oversight for the affected clearances, we anticipate no change in the treatment of companies holding clearances. The burden outside the cleared defense sector remains to be seen. The new law also provides for establishment of a tracking mechanism for deals that are withdrawn from review—for any reason.

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Congressional Oversight

At various times over the last few years, Congress considered opening CFIUS reviews to Congressional scrutiny while the reviews were ongoing. Because of concerns that this requirement could chill foreign investment, the new law does not do that, but instead provides for reports to key committees and members of Congress—at the conclusion of the CFIUS review.

Nevertheless, although the new law provides some measure of protection against political interference in the CFIUS process, we note that the Dubai Ports World acquisition of British-owned P&O Ports (and its contracts to manage U.S. ports) was derailed by political opposition *after* it had cleared CFIUS. This highlights the importance of addressing the political implications of sensitive transactions; prudence argues for briefing Members of Congress in advance of a sensitive filing to ensure that the transaction is fully understood and that Congressional concerns are appropriately addressed.

Conclusions

The new law does not effect radical change in the CFIUS process. In the final analysis, as the nonpartisan Congressional Research Service has observed, "CFIUS reflects the President's priorities and policies relative to foreign investment." We agree. The CFIUS process has always been—and remains—subject to the broad discretion of the President.

Procedural reforms in the law, such as the current amendments, will effect marginal change, but the outcome in any given case will be driven by the facts, the political climate, and how the Administration strikes the balance between foreign investment and national security.

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The Revised Investment Manager Exemption—Good News for the UK Hedge Fund Industry

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On 20 July 2007, HM Revenue & Customs ("HMRC") issued the long awaited revised *Statement of Practice 1/01* ("*SP 1/01*" or "*SP*"), substantially updating its guidance on the application of the Investment Manager Exemption ("IME"). Broadly, the IME exempts offshore funds with UK investment managers from UK tax on their profits. The new SP 1/01 applies with immediate effect, except where changes to existing arrangements are required to comply with the new SP (in which case the original SP 1/01 can be applied until 31 December 2009). The UK fund industry has grown exponentially in size and importance over recent years, and commercial uncertainty under the old SP 1/01 created increasing difficulties in accommodating innovative investment structures that came with the industry's development. The new SP 1/01 is the result of an extensive consultation process by HMRC with the hedge fund industry and brings the IME up to speed with market developments. Two policy objectives underpinned the consultation: (i) HMRC's stated objective of providing greater certainty and assistance to UK hedge funds by ensuring the permitted investment activities can be carried on without undue concern about UK tax risk for the funds; and (ii) ensuring the full amount of UK-generated fees are taxed in the UK.

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Overall, the new SP is a very welcome development which has greatly benefited from a refreshing openness of HMRC to listen to industry concerns and engage in constructive dialogue. One success of the new SP is that it clarifies many areas where the old SP was uncertain or provided no guidance. It also widens the IME's commercial scope by permitting investment transactions that were previously not allowed, or at best uncertain, in its coverage under the IME.

The IME comprises six tests, but only four are normally in issue for managers: the scope of permitted "investment transactions", the 20% test, the independence test, and the customary remuneration requirement. The numerous changes introduced by the new SP 1/01 exceed the scope of this article, but managers will be especially concerned with the following:

Permitted Investment Transactions

In one of the most helpful developments, the new SP clarifies that direct loan origination by funds is regarded as "the placing of money at interest", and therefore a permitted investment transaction. The permission extends to commitment, documentation and placement fees. By explicitly allowing bilateral lending, the new SP removes one major area of market uncertainty, as it was unclear under the old SP 1/01 whether funds were permitted to engage in loan origination. Further, given that hedge funds are increasingly prominent in the UK lender market, the ability for funds under the new SP 1/01 to act as syndicate managers or arrangers of syndicated loans is a welcome development, and may well entice more U.S. managers to open offices in London. Loan origination advised on by U.S. managers still causes U.S. tax concern for funds with non-U.S. taxpayers and therefore requires more complex structuring. Other newly permitted investment transactions include trading carbon emission credits (introduced by statutory instrument following, among other, endorsement by the *Stern Review on the Economics of Climate Change*) and physically settled CDSs.

The new SP also addresses the question of "proportionality": on a strict interpretation of the legislation, a single non-permitted trading transaction would lead to the IME being failed altogether and, accordingly, to the imposition of UK tax on the fund's profits. The new SP provides that isolated or inadvertent breaches of the IME will not lead to a failure of the IME, provided any profits from offending transactions are taxed in the UK.

Independent Test

Despite introducing a "hierarchy of tests", the independence test remains largely unchanged in substance – funds need to be widely held, or account for less than 70% of a UK manager's business to continue qualifying as "independent" under the new SP 1/01. While the "listing" safe harbour has been abolished – HMRC viewed it as particularly prone to abuse – the abolition should not greatly concern the industry: listed funds that are genuinely traded will normally be widely held, and so satisfy that independence test (now embedded as the first hierarchy test).

Further, HMRC have helpfully introduced an 18-month period for start-up managers to meet the "widely held" test, allowing managers to establish a track record before marketing the fund more widely. The new SP1/01 also sets out better guidance on the interpretation of "active marketing", which in itself may lead to satisfying the independence test where sufficient investor diversification is not achieved during the 18-month period.

20% Test

The 20% test saw relatively few changes. Importantly for global fund management groups with both UK and U.S. managers, performance fees paid to U.S. managers (typically structured for U.S. tax reasons as "incentive allocations" to the general partner of U.S. partnership funds) are now formally excluded from the 20% calculation. A technical drafting issue in the original SP 1/01 had caused concern that U.S. incentive allocations, although commercially identical in function to performance fees, could not be deducted from the 20% threshold.

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Customary Renumeration Test

This was arguably the consultation process's most controversial area, partly as fee arrangements represented the area where HMRC had encountered most abuse, but partly also as there had been no legislative or Revenue guidance on the interpretation of "customary". In practice, the industry had treated the requirement to pay the UK manager "customary remuneration" as a "gross" fee test, which was satisfied by ensuring the full management and performance fees were first paid into the UK before making payments to third parties, such as connected offshore management entities. Any dispute with HMRC about the amount of fees subject to UK tax was then simply a question of transfer pricing, not of satisfying the IME. With the first draft of the new SP 1/01 last October, HMRC introduced two changes – OECD transfer pricing guidelines as yardstick for determining the amount of "customary", and secondly, a "net" fee test, which looked at the net fee amount left in the UK after all fee payments by the UK manager to connected and unrelated parties had been made.

The introduction of OECD transfer pricing guidelines for interpreting "customary" provides a familiar and therefore helpful formula to the industry and its advisers, particularly for innovative or unusual investment structures, where departures from customary market practice (sometimes in the nature of the new structure) had often caused concern about meeting the "customary" requirement. Furthermore, HMRC's clarification on a number of common fee arrangements such as fee rebates or zero fees on management shares, and their acceptance as "customary" where the arrangements are at arm's length, is reassuring.

The introducing of the "net" fee test was more controversial, as it potentially removed the certainty that the fund would not be subject to UK tax which had been achieved under a "gross" test by ensuring the full fees were first paid into the UK. Ultimately, HMRC prevailed in applying a "net" test, but the significantly watered-down version of the final revised SP 1/01 (following much discussion on the subject) goes a long way towards reintroducing the certainty that had been available under a "gross" fee test. Yet it does so by introducing a greater compliance burden for fund managers, as certainty of meeting the IME now requires significantly more transfer pricing documentation and a full functional analysis. Provided these are in place, any dispute between HMRC and the manager, including where the matter is litigated and the manager loses, will not endanger the IME. The new SP also states that even in the absence of appropriate documentation, HMRC would normally seek to allow managers to make fee and UK tax adjustments before challenging the IME. Which is where the two policy objectives stated in the opening paragraph of the new SP 1/01 come full circle: HMRC really do not wish to tax the funds and are only interested in getting the right amount of fees taxed in the UK.

This article appeared in the August 2007 issue of *Hedge Funds Review*.

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NEWS ALERT

UK Treasury Committee Publishes Interim Report on Private Equity

On July 30, the Treasury Committee of the House of Commons published its interim report on private equity. Although the report contains no detailed recommendations, given the aggressive line the Committee took when questioning representatives of the private equity industry during its public hearings, the measured tones in which the report is expressed came as a pleasant surprise for supporters of private equity. The Committee recognises that many aspects of the private equity industry are highly complex. Its conclusions and recommendations at this stage are therefore cautious. However, the Committee does highlight a number of 'areas of concern' which, in its opinion, deserve continuing attention from policymakers. These include:

- the fact that major corporate investors have different requirements when investing in private equity, as opposed to public equity;
- the need for greater transparency;
- the lack of competition as regards the percentage fee paid by funds to general partners in the larger private equity firms; the amount of the fee has declined only to a small extent, despite the massive increase in the size of some funds;
- the tax treatment of carried interest: this is currently taxed as a capital gain on which taper relief is available, which can reduce the tax payable to 10%, as opposed to the 40% tax that would be payable if carried interest were taxed as income; and
- possible abuses of the use of non-domicile status by individuals to avoid paying UK tax.

The Committee returns to the subject in the autumn, and its further report will follow later this year or in early 2008. As private equity shows no signs of ceasing to be a hot topic, the Committee's second report will be eagerly awaited - not least to see whether it can be persuaded to take a tougher line on what the unions and some others regard as the 'excesses' of the industry.

SEC Adopts New Antifraud Rule for Investment Advisers

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The Securities and Exchange Commission (the "SEC") has adopted Rule 206(4)-8 under the Investment Advisers Act of 1940 (the "Advisers Act"), prohibiting investment advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled investment vehicles.

The SEC has adopted this rule in response to the opinion of the Court of Appeals in Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) ("Goldstein"). The Goldstein case created uncertainty regarding the application of Sections 206(1) and 206(2) of the Advisers Act in situations where investors in a pool are defrauded by an investment adviser to that pool. Prior to the Goldstein decision, the SEC had brought enforcement actions against advisers alleging false and misleading statements to investors under Sections 206(1) and (2) of the Advisers Act. However, the Court of Appeals in the Goldstein decision expressed the view that, for purposes of Sections 206(1) and (2), the "client" of an investment adviser to a fund is the fund itself, not an investor in the fund. As a result, it became unclear whether the SEC would be able to continue to rely on Sections 206(1) and (2) to bring such enforcement actions in the future.

Rule 206(4)-8 makes it a fraudulent, deceptive or manipulative act, practice or course of business for any investment adviser to a pooled investment vehicle either: (1) to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) to otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative, with respect to any investor or prospective investor in the pooled investment vehicle. A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider that fact as having significantly altered the total mix of information available. Importantly, the rule applies to both registered and unregistered investment advisers.

The rule defines "pooled investment vehicle" as any investment company within the meaning of Section 3(a) of the Investment Company Act of 1940 (the "Company Act"), or any company that would be an investment company but for the exclusions provided by Section 3(c)(1) or 3(c)(7) of the Company Act. As a result, the rule covers advisers to hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities. The rule prohibits false or misleading statements made, for example, to existing investors in account statements as well as to prospective investors in private placement memoranda, offering circulars, or responses to "requests for proposals," electronic solicitations, and personal meetings arranged through capital introduction services.

Most importantly, the new rule prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors or prospective

Most importantly, the new rule prohibits advisers to pooled investment vehicles from making any materially false or misleading statements to investors or prospective investors in the pool regardless of whether the pool is offering, selling or redeeming securities.

investors in the pool regardless of whether the pool is offering, selling or redeeming securities. Examples of prohibited conduct include making materially false or misleading statements regarding investment strategies the pooled investment vehicle will pursue, the experience and credentials of the adviser (or its associated persons), the risks associated with an investment in the pool, the performance of the pool or other funds advised by the adviser, the valuation of the pool or investor accounts in it, and practices the adviser follows in the operation of its advisery business, such as how the adviser allocates investment opportunities.

The potential breadth of the rule in application is considerable. The SEC takes the position that the new rule is designed to broaden the definition of deceptive conduct to include both statements and nonverbal conduct by advisers. In addition, this rule will permit the SEC to bring enforcement action against an investment adviser that violates a fiduciary duty imposed by other law (such as state partnership law) if the violation of such law or obligation also constitutes an act, practice, or course of business that is fraudulent, deceptive or manipulative within the meaning of the rule and Section 206(4) of the Advisers Act. Importantly, unlike the violations of Rule 10b-5 under the Securities Exchange Act of 1934, Rule 206(4)-8 does not require scienter.

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FSA Issues Policy Statement on Confirming Industry Guidance

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The fact that the FSA has set up the confirmation procedure indicates that, in some circumstances at least, the FSA recognises that firms could usefully have more assistance in working out what its rules mean than the FSA Handbook currently provides.

On 4 September 2007 the FSA published Policy Statement 07/16, "FSA Confirmation of Industry Guidance" ("PS07/16"). PS07/16 provides feedback on Discussion Paper 06/5 ("DP06/5"), published in November 2006, which sets out FSA's proposals for recognising guidance generated by the industry itself. The final policy, which takes effect immediately, is very similar to the policy examined in DP06/5.

Fund managers and advisers will find the FSA's new policy particularly relevant should their trade associations seek to produce guidance for members in the future, as the question of FSA confirmation of that guidance will inevitably arise. More immediately, however, as we shall see, one consequence of the FSA's policy is that firms now face uncertainty over the status of existing industry guidance which has been prepared following discussion with the FSA.

Industry Guidance and the Confirmation Process

"Industry Guidance" is defined by the FSA 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."

The definition is intentionally broad so as to include case studies, lists of questions and answers, and factsheets.

In order to receive FSA confirmation, Industry Guidance must meet the following criteria:

- **It should explain how the guidance relates to a relevant FSA rule and/or principle.**

- **Where it directly affects consumers, the guidance must consider consumer interests and views.**

- **It must not claim to limit or affect the rights of third parties.**

- **It must be optional and not the only way to comply with regulatory obligations.**

- **It must be publicly available and free.**

- **It must detail the audience for which it is intended.**

- **It must not be anti-competitive**.

In addition, guidance producers must satisfy the FSA that they have considered any impact the guidance may have on other sectors of the market, and may be required to seek the views of other parties before confirmation is granted.

The FSA's Stance on Industry Guidance

The FSA has indicated that it will not object to confirming more than one piece of Industry Guidance on the same topic, provided that the different pieces of guidance do not contradict each other. The FSA has also indicated that it will limit the endorsement of Industry Guidance to FSA confirmation only. This appears to mean that not only will the FSA not provide any public statement indicating that it agrees with the guidance it has confirmed, but also that the FSA will not comment publicly on the usefulness of guidance for which confirmation has not been sought.

This last point marks a change in policy from DP06/5, and whilst one can understand why such an approach might be adopted (to avoid dilution of the Industry Guidance "brand"), it nonetheless seems unnecessarily inflexible. Furthermore, the only "retrospective confirmation" that the FSA has given is to the three pieces of MiFID Connect guidance on outsourcing, suitability and appropriateness, and investment research. As a result, this new policy casts doubt as to whether firms can continue to rely on other guidance which the FSA has previously indicated would be taken into account when considering whether regulatory requirements have been satisfied. Such guidance includes the note on side letters produced by the Alternative Investment Management Association in September/October 2006.

Confirmed Industry Guidance will have a three-year "shelf life". In the absence of a change of content in the period, therefore, FSA confirmation will be revoked three years from the date of confirmation, unless the guidance provider requests that the guidance be renewed. This is designed to ensure that, as is intended, guidance providers keep their guidance up-to-date. But one wonders whether this provision (an addition to the policy consulted on in DP06/5) will have the unintended consequence that guidance providers will "fit and forget" their guidance until the end of the three year period approaches.

The confirmation wording states that the FSA "will take [the confirmed Industry Guidance] into account" when exercising its regulatory functions. This leaves it unclear on the face of the confirmed guidance whether compliance with the guidance creates a "safe harbour" for firms. In contrast, the FSA's Decision Procedure and Penalties Manual (DEPP) 6.2.1(4)G makes the position plain: "The FSA will not take action against a person for behaviour that it considers to be in line with ... FSA-confirmed Industry Guidance which [was] current at the time of the behaviour in question". It is surprising that this explanatory text does not appear on the face of the confirmed guidance, given that it is both short and puts the matter beyond doubt.

The FSA states in its press release that Industry Guidance "is not a move to strip the Handbook of necessary guidance", and that "the FSA will continue to produce guidance where required". This is designed to counter the charge that the process of confirming Industry Guidance is intended to plug the gaps in the FSA Handbook which the FSA has deliberately created for its own reasons (political need to reduce the size of the Handbook, regulatory undesirability of expanding on what EU - particularly MiFID - requirements might mean in practice). But the statements made by the FSA seem to protest too much. If FSA is producing guidance "where required", why should the FSA create a process whereby Industry Guidance that is "not required" can nonetheless be confirmed? The fact that the FSA has set up the confirmation procedure indicates that, in some circumstances at least, the FSA recognises that firms could usefully have more assistance in working out what its rules mean than the FSA Handbook currently provides. Indeed, prime examples of this are the three pieces of Industry Guidance from MiFID Connect, mentioned above, that the FSA has retrospectively confirmed.

It will be interesting to see to what extent providers of guidance seek FSA confirmation. The FSA view is that guidance providers will be selective about when confirmation is sought, and this may well be right. Already one of the guidelines MiFID Connect had originally planned to have confirmed by the FSA, on conflicts of interest, has been issued instead as an information memorandum. This suggests that even when substantial changes are being made to the FSA Handbook, guidance providers may, for a variety of reasons, choose to avoid the path of FSA confirmation. If that is correct, then it is likely that the FSA will have plenty to think about regarding the effectiveness of this tool when it comes to review the Industry Guidance process in the first quarter of 2010.

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