The Prudential Regulation Authority’s independence is ending, but what does this mean for firms?
Welcome to the November edition of the CISI’s Change magazine. Here is a seasonal poem in place of the normal editorial. This edition is up to date to 22 October 2015.

The Nightmare

The compliance officer sits and stares; the empty screen glows back; all around the office quietens. Alone with his worries – to report suspicious trading? Or not to do so? His responsibility alone. His heart races, his headache throbs, hot with worry, cold with fear, the plastic coffee cools.

Such a strange order - no precedent, no explanation. 500 cracker options - catalytic crackers equals oil derivatives? An unauthorised position in an unknown product? A transaction report? To whom? Could it move the market - how large was it? Where was the market? No one to ask – just an empty trading desk.

A crushing day – no time to think – traders’ constant queries, managers’ imperious demands - all wanting instant answers; a meeting when nobody listened, but did just what they had wanted, the urgent planned work never started, and now - this monitoring report.

The phone breaks his reverie, ‘You’re late for carols – they start at eight’, and then that light-bulb moment – bang! ‘500 cracker options’? - to be pulled at the office party!

Happy Christmas

Christopher Bond, Chartered MCSI, Senior Adviser, CISI

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Senior management information dashboard

This dashboard is intended for senior management to see quickly the most important recent and coming regulatory changes

All financial sectors

• The softer tone towards firms from the FCA from Tracey McDermott following Martin Wheatley’s resignation
• How financial services feature in the UK’s negotiations on reforming the EU
• The extension of personal accountability under the Senior Managers and Certification Regime (SMCR) to all firms in 2018 and the end of the Approved Persons Regime
• The detailed ESMA changes under MiFID II on firms’ conduct of business and on markets from January 2017
• How the FCA is using competition considerations in its market studies and firm supervision
• Changes to the FCA’s categorisation of firms for supervision purposes
• New information on how the FCA supervisors decide when to refer to enforcement
• The big drop in new attestations by the FCA
• Changes to firms’ whistleblowing policies and procedures
• The Government’s review of ‘tick box’ money laundering rules
• The lack of cases against firms for not taking reasonable steps against bribery
• The threat to exporting personal data to the US
• The re-emergence of the Eurozone Financial Transaction Tax
• The start of the Common Reporting Standard for tax data from 1 January 2016

Private wealth management/Retail

• The launch of the Treasury’s Financial Advice Market Review (FAMR) to address the ‘advice gap’ and its big impact on all retail advisory firms
• The regulatory status and obligations of ‘robo-advice’
• The application of MiFID II to best execution and conflicts of interest in retail firms
• The discussions over the content (including performance figures) and format of the Key Investor Document under PRIIPs
• The European Commission’s Discussion Paper on retail financial services
• The end of platforms paying trail commission from April 2016
• The regulatory uncertainty of how to deal with ‘insistent’ clients contrary to advice
• The FCA’s proposed changes to the Initial Disclosure Document
• The review of FSCS levies paid by IFAs
• Pensions regulation – responsibility for advice on transfers, suitability assessments and exit charges on withdrawal

Wholesale/Capital markets

• The FEMR developments in new market codes and individual accountability
• More detail from the Commission on the Capital Markets Union (CMU) and the trend towards rolling back regulatory reforms
• Softening regulations on banks’ securitisations
• The structural changes made by MiFID II to equity and bond markets including pre- and post-price transparency
• Recent regulatory enforcement action for benchmark manipulation and good practice for contributors
• The start of some swaps and derivatives mandatory clearing under EMIR in April 2016
• The confusion over central counterparty buy-in rules for failed settlements under the CSDR
• Extra capital requirements for larger asset managers
• New rules for the design and documents for product providers under PRIIPs
• The detailed rules for managers’ employees remuneration under the AIFMD and UCITS
• ESMA’s approach to equivalence for private equity marketing by non-EU managers and funds
• The EU develops detailed rules for high-frequency traders
• The authorisation requirement for very active commodity derivatives investors
• FCA warnings to corporate finance on records

Commercial and retail banks

• How banks are preparing for the SMCR
• Concessions in the detailed rules to retail banks are preparing for ring-fencing
• The impact on banks from the PRA becoming part of the Bank of England
• The extension of the full Remuneration Code including deferral to smaller banks
• Small banks challenge the Chancellor’s new bank tax
• Recommendations on customer due diligence in correspondent banking for high-risk countries
• Developments in liquidity rules and reports under the Liquidity Coverage Ratio and the Net Stable Funding Ratio
• The many other prudential changes on capital, credit risk, market risk, stress testing and supervisory reporting
• The regulator’s focus on consumer credit staff incentives
• The big changes in second charge regulation by the FCA from March 2016
News from the CISI’s Compliance Professional Forum

One of the challenges we have as a forum is how to cover the mix of attendees, both in terms of role, and the variety of firms they represent. This was certainly the case when we decided to cover the Individual Accountability Regime and more specifically the Senior Managers Regime. We did this with the view that at some point the Financial Conduct Authority/Prudential Regulation Authority would want to ensure consistency across the whole of the financial services sector. Well that change has now been announced and will mean that by 2018 all firms will have to operate under this new regime.

This is also a very good example of the ever-changing regulatory world we are living in and how compliance teams across the whole of our sector will continue to be impacted by a constant flow of change. The Forum Committee needs to try to anticipate some of this change as well as trying to get our timing right when looking at subjects for events.

MiFID is going to impact all of our firms in some shape or form and has already been the subject of events held by the European Regulation Forum. Due to the need to look into the detail this will continue to be the case and in fact other forums are planning events during 2016. We felt that the starting point for the Compliance Forum was to run in January 2016 a forum under the title ‘MiFID for Compliance Officers’ to give everyone a starting point from which they can then dip into the more detailed events being held elsewhere.

Our work with the FCA Practitioner Panel continues and we have recently raised points regarding Approved Persons applications, the new FCA website and the impacts of the Senior Managers Regime. The contact with them is now very well established so please do let us know if there are topics you think we should be raising.

The same principle works for forum events. If you feel there are particular topics you would like us to cover. Please contact christian.scott@cisi.org

David Moland, Chartered FCSI, Chairman, CISI Compliance Professional Forum

News from the CISI’s European Regulation Professional Forum

With current and future regulatory change largely ceded to the EU, it will probably come as no surprise that the range of subjects, topics and material for the ERPF to discuss is abundant and, subject to a Brexit, is heading towards the immeasurable and endless! This embarrassment of riches is both welcome and confusing. Perhaps the best place to start is by asking yourself, “What do you really know about EU financial rules?”

This was the topic of the ERPF event held at Travers Smith on 29 September. Nicholas Herbert-Young of the FCA took things back to basics and provided an interesting and interactive background to the workings of European regulation. Audience members were presented with a series of questions on various topics such as where to find the Single Rulebook, and used wireless electronic voting to select from the multiple-choice answers provided. Judging by the anonymised answers displayed on the screen, there was a good deal of knowledge enhancement going on during the session. What was clear was that firms, and anyone dealing with European regulation, need to know this stuff to be effective.

Putting European regulation into practice was the subject of the meeting held on 3 November. Aidan Paddick of ABN AMRO and Nicholas Herbert-Young were answering the question: how do you implement changes in your firm arising from EU rule changes?

The audience listened with fascination to Aidan’s extensive ‘war stories’ on how to put an effective project team together and who should be part of it, and voted for different approaches.

Turning back to topics for the Forum, we are here to serve our members and prospective members, providing information and resources that are useful and practical. We will endeavour to make informed decisions on your behalf but please let us know if there is anything specific you would like to be covered and we will do the rest.

Mark de Ste Croix, Committee Member, CISI’s European Regulation Professional Forum

A senior practitioner comments

My role within the Compliance Department is to provide advice to the business on compliance issues except for financial crime, which is separate. My desk is located in the front office, giving the business easy access, with most enquiries coming from the corporate and research departments. It also enables me to be more aware of the activities undertaken by sales, trading and market-making teams.

When not advising or otherwise interacting with the business, one of my key responsibilities is keeping senior management up to date with future regulatory developments. MiFID II is top of my agenda. The proposed implementation date in January 2017 draws ever closer representing, in my view at least, as big a regulatory challenge as the first MiFID.

Firms have not been helped by delays to the publication of MiFID documentation by ESMA, with the expected publication date of the draft Regulatory Technical Standards (RTS) having slipped from May to September.

While most key draft technical and implementing standards were published on 28 September, we still await the delegated acts. The outstanding ones include an RTS on inducements and commissions sharing, a particular concern for smaller investment banks – hopefully these papers will be published in November (after the closing date for this edition). So the timetable for the next year and a quarter is set in stone: further work on MiFID II, with papers for senior management on specific areas most impacting the business, gap analysis, remediation and training.

Then there are the other regulatory changes in the pipeline including MAD II and MAR, and the rolling implementation of the CSDR. To paraphrase a Chinese proverb: We live in interesting times!

Chris Moore, Deputy Head of Compliance at Cantor Fitzgerald Europe and Chairman of the Securities Industry Rules Group
The Prudential Regulation Authority’s independence is ending, but what does this mean for firms?

The Prudential Regulation Authority (PRA) will cease to exist shortly; it will become a committee of the Bank of England. Is this the end of its independence? Did it ever have any? And how will it affect the firms it supervises?

The Bank of England and Financial Services Bill is before Parliament. One key part abolishes the PRA and transforms it into a committee of the Bank. It will report to the Governor and to the court of the Bank. This is the final step in the Bank taking over direct supervision of banks from the Financial Services Authority (FSA). From the outside this certainly looks like a takeover that will reduce the ability of the PRA to pursue different policies from the Bank, affecting all firms regulated by it; but is this right?

BIG CHANGES POSSIBLE

The Chief Executive of the PRA, Andrew Bailey, is a Deputy Governor of the Bank already, reporting to the Governor – but as Chief Executive he is also accountable to Parliament – as the Commons Treasury Select Committee insists. This will change so that it is the Governor who is answerable. Otherwise the PRA has strongly developed a different approach to supervision from the Financial Conduct Authority (FCA) – with quarterly informal meetings with many firms and supervisory statements in place of FCA detailed rules and its many consultations. Some will remember the old bank supervision model before the Barings crisis and the establishment of the FSA – now it has much more weight behind its reviews and guidance.

So if not much changes in practice under the Bill, why replace the legal structure that the present Chancellor put in place only three years ago? One possible answer is the change of Governor. Lord King was famously reluctant to be responsible for directly supervising banks – but the Chancellor in Opposition had clearly stated that the FSA was a failed and conflicted regulator that must be replaced – so the semi-detached PRA was born.

What will change for firms as a result? Perhaps not much so long as Mark Carney and Andrew Bailey are in charge; but the Governor has only two full years to go and indicated on appointment that he may only stay for one five-year term; history shows us that the period of senior regulators has often been as short. After that there will be a new team, and then the fact that the PRA is now only a committee of the Bank will increase the new Governor’s influence and could lead to big changes in its still developing style of supervision for firms – so it would be easy to change it. Dual-regulated firms should take note.

A CLEARER PICTURE

Of equal and immediate importance is the reform of corporate governance at the Bank. The number of court members reduces and it becomes a unitary body with the non-executives having more power and responsibility to hold the executive to account. The previous Governor would not have been happy. As interesting is the formal requirement for the Treasury and the Bank to identify and manage the risk to public funds in financial crisis planning for the recovery and resolution of systemically important firms. This includes developing resolution strategies, active contingency planning and formulating of resolution policies. The lessons from the ‘troika’ of Treasury, Bank and FSA’s handling of the crisis continue to resonate. The Bank’s supervisory mandate has a new clarity.
Part one – All financial sectors

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Part one – All financial sectors

SUPERVISION

1. THE FCA REVIEWS ITS COMMUNICATIONS STRATEGY

The Financial Conduct Authority (FCA) is reviewing how it communicates with firms, consumers and generally. It is developing a ‘year three’ strategy to take account of the recommendations of the Davis Inquiry Report on external communications, with contributions from the Practitioner, Market and Consumer Panels. To date this policy has not been published. Davis recommended that the FCA put in place procedures to check FCA briefings and announcements before release, to reconsider its approach of pre-issue media briefings (Martin Wheatley, then Chief Executive, FCA, defended this policy in evidence to Davis: “So if 50 million people in this country want to know what’s going on, they won’t get it from reading our website, they will get it from the stories that exist in the media. So my answer is the media is a very powerful tool, of course it is, and that is what we use.”), to monitor the impact on the market of its announcements and media briefings and to take swift action if there were problems. Among other changes, the FCA plans to record media briefings to provide an accurate record.

Action – It is also interesting to compare the FCA’s communications strategy with the response the FCA made in June to the Treasury Select Committee on the Davis Inquiry Report. This explains how the FCA has revised its information classification system with a focus on price sensitive information. It will stop the practice of exclusive briefings ahead of the formal announcement even though this may result in less coverage.

“...To raise awareness on a given issue through a speech, then to evidence action by the FCA through thematic work and, finally, to demonstrate success with a consumer outcome or enforcement action”

FCA

The Davis Inquiry Report went beyond the narrow issue of press briefings, and looked at how it communicated with firms and consumers more generally. And this is important because it explains the structure behind communications. The example given to Davis was first “to raise awareness on a given issue through a speech, then to evidence action by the FCA through thematic work and, finally, to demonstrate success with a consumer outcome or enforcement action”. As interesting as the light thrown on the three steps in communicating with firms is the implication in the last step that sample enforcement actions are taken to send the message to and persuade other firms with the same practices to take action. Luck can play its part; however, being selected for a thematic review or market study may increase a firm’s chances of such action.

2. THE REGULATORY PENDULUM SWINGS AWAY FROM FIRMS?

In an important speech by Tracey McDermott, Acting Chief Executive, FCA, at Mansion House on 22 October, she changed the mood music of FCA regulation in the UK. She said: “I do not think I will get much argument in this room when I say that the intensity and volume of regulatory activity over recent years is not sustainable – for regulators or for the industry”, and went on to say that she appreciated that the fact that boards of many firms spent the majority of their time on regulatory matters, was bad – crowding out initiative and creativity. She was less specific about what detailed FCA policies would be affected by this change in tone from the top, although she mentioned the focus on culture and behaviour of firms’ staff (does this mean less supervisory focus on conduct risk?), and removing some standard risk warnings; she also specifically praised behavioural economics for consumers (the US is interested in this). Interestingly, she backed away from describing the FCA as...
the consumers’ champion, and described its role as more that of a referee between firms and consumers.

Comment – It is clear that the current FCA leadership (see next article to read about its future) considers that the trend towards assuming that firms will act badly (unless controlled by large compliance departments and the FCA’s continuing supervisory focus on managing staff to prevent bad behaviour) is changing. What is less clear is how this change will be shown in the FCA’s many management layers (it has talked about the ‘permafrost layer’ of management in firms for cultural change). Will the FCA have the same problem with its 3,000 staff? Will they be retrained or re-orientated?

3. ALL CHANGE AT THE FCA

Media attention has focused on Martin Wheatley who has now left the FCA (see Change, Aug 2015, All financial sectors section, ‘A new phase of regulation starts’, p. 9), with Tracey McDermott now Acting Chief Executive. As significant for the future is the change in structure at the FCA following the Davis Inquiry Report, the promotion of some executives and the appointment of new senior ones. Key appointments are McDermott as head of the new combined Supervision and Authorisations Division, Christopher Woolard as Director of Strategy and Competition, Mark Seward (new) as Director of Enforcement and Market Oversight and Andrew Whyte (new) as Director of Communications. This means that Wheatley’s successor will inherit both a new structure and a mix of old and new appointments. He or she may find it easier to make his or her mark with distance from the past.

The FCA also said it will commission an external review of the effectiveness of the Board every two years, and that it will apply the same core principles of responsibilities maps to its own senior managers.

Comment – The change in policy and style is unlikely to be as great as the switch from the Financial Services Authority (FSA) to the FCA. However, it will be much more than the change of chief executive. In addition, three non-executive board members of the FCA are leaving shortly as their three-year terms finish, including the Senior Independent Director, Sir Brian Pomeroy, who is overseeing the FCA’s response to the long-awaited report on the failure of HBOS and the FSA’s supervision of it. The new board members are expected to join at about the same time as the permanent chief executive. In its response to the Treasury Select Committee on the Davis Inquiry Report, the FCA also said that it will commission an external review of the effectiveness of the Board every two years, and that it will apply the same core principles of responsibilities maps to its own senior managers – the chairman, the chief executive and directors who are members of the Executive Committee. The FCA will publish the responsibilities map, its governance structure and senior managers’ statements of responsibility.

4. INDIVIDUAL RESPONSIBILITY TO THE REGULATORS UNDER SMCR

As deposit-taking banks and large investment banks prepare for the new Senior Manager and Certification Regime (SMCR) regime, there are some common questions that need to be answered by each firm. Here are some general ones:

• How individual responsibility fits with the firm’s hierarchical or matrix decision-making structure
• How individual responsibility fits with group strategy (on both this and the previous point see Change, Aug 2015, All financial sectors section, ‘What is the presumption of responsibility for Senior Management function holders?’, p. 11)
• Willingness of managers to accept individual responsibilities (separate legal advice/indemnity?)
• Deciding if there are any individuals outside the UK who should be senior managers (the issue is all about control of business and strategy)
• The application of the regimes to UK branches of European Economic Area (EEA) and non-EEA firms (see the August FCA feedback statement 15/3 on this, noting the big distinction between EEA and non-EEA firms)
• How far firms should encourage individuals to make a ‘root and branch’ review of their area of responsibility on start of regime or appointment? Managers may otherwise be responsible for ‘legacy’ problems.

On a more practical level:

• Difficulties in identifying function holders for managers’ statements of responsibility
• Applying the extended definition of certified individuals to wholesale staff including those dealing with eligible counterparties and corporate finance contacts (under the FCA’s Policy Statement and final rules)
• How long should individual statements of responsibility be? (The Prudential Regulation Authority (PRA) wants to keep them short; the FCA is more flexible)
• Need for senior managers to monitor delegated tasks (a key element of showing reasonable steps taken)
• The role and responsibility of the ‘whistleblowing champion’ (establishing and checking that these processes are effective)
• The procedure for notifying regulators of problems with senior managers in seven days (has to be done immediately to the PRA, perhaps before enough information is available)
• Training of managers and certified staff in their new responsibilities (including the Conduct Rules)
• Considering the apparent removal of the 30-day-a-year exemption for overseas-based individuals (who would be affected?).

5. THE SMCR IS EXTENDED TO ALL TYPES OF FIRMS

The Treasury has published a policy paper on extending the SMCR to all individuals authorised under the Financial Services Markets Act 2000 (FSMA) such as asset managers, investment firms, insurance and mortgage brokers and consumer credit firms, replacing the Approved Persons Regime.

‘Reverse burden of proof’ for senior managers in their area of responsibility will be replaced by a duty to take reasonable steps to prevent regulatory breaches in their area.

The main features of the existing bank SMCR will apply, except that the approval regime will be focused on senior managers – firms must deliver robust documents on the scope of their responsibility, and the ‘reverse burden of proof’ for senior managers in their area of responsibility will be replaced by a duty to take reasonable steps to prevent regulatory breaches in their area,
the Conduct Rules will be extended to all non-executive directors (not just those who are senior managers), and the requirement to report breaches of the Conduct Rules will not apply (it was disproportionate as so many persons would have been affected). The new regime starts in 2018. The insurance sector will have its version of the SMCR – the Senior Insurance Managers Regime (SIMR). This is based on the SMCR but with differences. It starts in 2016.

Comment – The announcement that the SMCR would replace the Approved Persons Regime for authorised persons was expected to happen, but many were surprised that it was made now. The Fair and Effective Markets Review (FEMR) had recommended that it be extended to the Fixed Income, Currency and Commodities (FICC) markets and clearly there are difficulties in defining what is FICC. More practically, there would be four regimes running in parallel, with individuals coming under one of them by chance of which sector their employer was in (SMCR, SIMR, FICC and Approved Persons Regime). There is substantial detail on the new non-bank regime contained in the latest version of the Bank of England and Financial Services Bill.

6. UK AND EU REGULATORS LOOK AT REGULATORY SUITABILITY ASSESSMENTS OF SENIOR MANAGERS

The PRA and the FCA have issued a joint consultation (closing 7 December) on regulatory references for senior managers under the Senior Managers Regime, significant harm functions under the certification regime, PRA senior insurance management functions under the SIMR, FCA insurance-controlled functions, notified non-executive director roles and key function holders in insurers. The regulators plan to publish the final rules in Q1 2016. The main proposals are:

- Requiring firms to request regulatory references from former employers of candidates applying for senior management functions and certification functions going back six years
- Modifying certain prescribed responsibilities for senior managers to ensure compliance with the regulatory reference rules
- Mandating the inclusion in a reference of concluded breaches of PRA Conduct Cules or Conduct Standards and Statements of Principle and Code of Practice for approved persons going back six years
- Requiring disclosures in a standard format, including the need to confirm where there is no relevant information to disclose
- Requiring relevant firms to update previous references given in the past six years, where they become aware of matters that would cause them to draft that reference differently if they were doing it now
- Requiring firms not to make any commitment that would restrict them from meeting these obligations, eg, under settlement agreements
- Ensuring appropriate record keeping when doing all these things.

Comment – This is an important piece of the SMCR and SIMR. The original proposal was that the new employer should obtain references from all employers for the past five years, and that they would be much more detailed than the present skeletal ones. This proposal has been softened under industry protests.

The European Banking Authority (EBA) has published a review of the implementation of its guidelines on how supervisors assess the suitability of senior managers and key function holders under the Capital Requirements Directive IV (CRD IV). It concludes that while many of the 31 countries are largely compliant, the review “highlighted significant differences remaining between NCAs’ [National Competent Authorities]’ supervisory approaches. The EBA concluded that the existing EBA guidelines have not led to sufficient convergence in supervisory practices and proposed the incorporation in the forthcoming review of a number of best practices observed”. These practices include the use of interviews for key positions, the use of the proportionality principle and set criteria for assessing suitability.

Comment – The very different approaches of the PRA and of the FCA illustrate these differences. Some overriding guidance throughout the European Union (EU) would be welcome – not least for its transparency. In parallel the FCA appears to have toughened its approach to approving senior management becoming non-executive board members at banks on retirement. The FCA appears to think that former senior managers may lack the ability to exercise the real oversight and challenge required to become non-executive directors (NEDs) at these or other banks. It is surprising for it to take this approach given that the PRA is the regular supervisor of banks, that industry knowledge is now a pre-condition for approval and that the FCA normally focuses on consumer treatment and markets.

7. THE EXPANSION OF THE REMUNERATION RULES

The European Commission (EC) and the EBA’s approach to extending the application of the EBA Draft Guidelines on their remuneration under CRD IV is causing substantial concern to CRD IV firms across the EU; in particular, extending the period for deferral of bonuses and for them to be paid in shares or similar securities, to smaller (in the UK tier 3) firms, is unpopular.
by July 2016, and this may include due to publish its review of CRD IV payment for smaller firms, the EC is In terms of the deferral of bonus fixed remuneration, may be shown in the EU, and increase in the proportion of shrinkage of investment banking in the limit of once (twice with shareholders’ approval) fixed remuneration in the EU, non-CRD IV firms, such as hedge funds, are not normally subject to the EBA guidelines, and so can offer higher and more immediate rewards for talent. Equally, other financial centres, such as Singapore or the Gulf, are unrestricted. This has to be balanced against concerns that individuals remunerated by short-term bonuses may behave irresponsibly.

In terms of amount and the bonus cap, the limit of once (twice with shareholders’ approval) fixed remuneration in the EU, shrinkage of investment banking in the EU, and increase in the proportion of fixed remuneration, may be shown in the EBA’s annual review of bonuses for 2014.

In terms of the deferral of bonus payment for smaller firms, the EC is due to publish its review of CRD IV by July 2016, and this may include proportionality requirements in line with the European Securities and Markets Authority’s (ESMA’s) approach under the Alternative Investment Fund Managers Directive (AIFMD) and Undertakings for Collective Investments in Transferable Securities (UCITS) remuneration (which would benefit smaller firms) after the new EBA guidelines come into force.

Outside the financial sector, UK bonuses rose, and the average FTSE chief executive now earns 183 times the average salary of a UK worker. The UK Government is considering making disclosure of this or other ratios by listed companies mandatory (as the US Securities and Exchange Commission (SEC) is now planning to do). Shareholder votes on pay in public companies have generally approved the company’s remuneration proposals (at 80% of companies there has been 90% approval). The votes may have also led to simplifying and reducing the number of multiple long-term incentive plans.

8. NEW REGULATORY RULEBOOKS
The new FCA Handbook and PRA Rulebook were launched on 29 August 2015. This is part of the updating of the websites, and is not a change of substance – except that the PRA continues to consult on its proposals to redraft some of the rules it inherited from the FSA, such as the cross sector and third-country parts of the General Prudential sourcebook (GENPRU), the rules on group risk systems and requirements in Systems and Controls (SYSC) and the general reporting and compliance reporting parts of supervision (SUP) (comments by 13 November).

Comment – The FCA in particular is reacting to comments upon and ideas for changing access to the rulebooks which were made when the PRA and FCA launched three years ago. This was an improvement on their structure in the old FSA website, but there are grounds for criticism in ease of access and in finding information (for example in finding the 30-day ‘fly-in’ rule). However, an important driver has been the rapidly increasing differences between PRA and FCA rules, which started as a split of the old FSA Rulebook. The different individual FCA rules are now grouped differently, and perhaps more logically. There are benefits – for example in finding related forms to the rules. There is also a parallel Reader’s Guide which explains the new structure generally, and perhaps more clearly. Users have mostly approved the changes although some glitches remain, eg, some of the forms buttons do not work currently.

This is a big improvement on the previous Register. It contains more names, more information about them and is more flexible.

At the same time the PRA and the FCA produced a new combined Financial Services Register. There is one search field to help you find a firm, individual or collective investment scheme by looking at its name, reference number or postcode. Filters are available which show, for example, whether it is covered by the Financial Ombudsman Service (FOS) or the Financial Services Compensation Scheme (FSCS). Interim authorised consumer credit firms are included as example, whether it is covered by the Financial Ombudsman Service (FOS) or the Financial Services Compensation Scheme (FSCS). Interim authorised consumer credit firms are included as businesses doing regulated business without proper authorisation – a scam warning.

9. THE LATEST FCA TRANSPARENCY FIGURES ON AUTHORISATIONS, VARIATIONS OF PERMISSIONS AND WAIVERS
The FCA has published its figures for Q2 2015 on the time it took to process authorisation applications, variations of permission and waivers. On new firm
authorisations, these show that overall the time taken has increased from 13 to 17 weeks due to increased volume (particularly in wholesale), increased complexity of cases and diversion of staff to other projects. Other comments include Alternative Investment Fund Managers (AIFM) applications being treated as business as usual, complete applications being given priority over incomplete ones, and recovery and resolution plans being required of CRD IV €730k firms after application, rather than as part of it. There is also a continuing trend of refusals and withdrawals to increase. Average time taken for variations of permission is constant at 13 weeks (retail) and 22 weeks (wholesale). Time for waivers is constant at 12 months.

Comment – These figures are helpful in preparing management expectations. They do, however, show that the FCA is taking a slightly harder line on applications, and reducing the number of staff handling them, producing more waiting time before applications are even looked at.

10. THE FCA LOOKS AT REGULATORY BARRIERS TO NEW TECHNOLOGY, AND EXPANDS PROJECT INNOVATE

The FCA has updated its webpage on its Project Innovate initiative. It has also made a ‘call for input’ on barriers that exist to innovation in developing digital and mobile solutions for financial services which can “improve the lives of consumers”. It also said: “We are interested in learning if there are any regulatory barriers, either in the UK or at EU level, preventing the development of digital solutions.” In the first seven months, the FCA has assisted 34 businesses – and turned away another 137 which did not meet these criteria. Project Innovate has been sufficiently successful to encourage the FCA to make giving informal advice to fintech businesses on authorisation procedure a permanent feature. Indeed the FCA is proposing to expand it to go beyond this to cover engaging large industry firms that have not approached the FCA to date, creating a potential ‘sandbox’ for firms to experiment with new products, developing themed weeks addressing key areas of interest and helping with technical solutions.

Comment – Project Innovate may have been politically motivated, but it has had modest success. Clearly there is a culture gap between regulation and technology to be bridged, particularly in the authorisation process. It is unclear how far the FCA will go in helping wholesale developments without any direct consumer benefit, and in balancing encouraging innovative products that carry regulatory risks.

We are interested in learning if there are any regulatory barriers, either in the UK or at EU level, preventing the development of digital solutions.

FCA

COMPETITION

11. COMPETITION DEVELOPMENTS

The three financial services competition regulators (the Competition and Markets Authority, the FCA and the Payments Authority, the FCA and the Payments Regulator) have been active in the last three months. Here are some of the developments:

• Christopher Woolard, Head of Competition and Strategy, FCA, has said that the FCA has opened inquiries into several cases of suspected anti-competitive practices by financial firms. He also said that “there is a significant number of potential cases that we are looking at”. He also drew attention to the Fair and Effective Markets Review Final Report which, in an annex, commented upon the role that competition law could play in overseeing the reformed fixed income, currency and commodities markets.

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• The FCA is reviewing the mortgage market to address competition concerns (currently six providers cover 80% of the mortgage market). If it goes ahead, the market study will consider whether the tougher criteria under the Mortgage Market Review (MMR) had “put an unnecessary constraint on competition” on the market. Woolard also saw a possible move away from a 25-year mortgage.

• A subset of the mortgage review described earlier will look at equity release. Woolard accepted that equity release products had become unpopular. He saw a role for them with an ageing population, low pensions and high property values. He said: “We believe that there is a debate to be had about what products and markets could exist and whether more entrants, more innovation in this space, might benefit consumers with more products and choice.” He also made the interesting suggestion that the FCA could use regulation to encourage growth in this area.

• The law was changed in October under the Consumer Rights Act 2015, enabling class actions in England if competition law has been broken. There are differences from the US model – no punitive damages, and for the losing party to pay the winners’ legal costs. There could be an early example if the EC decides that forex manipulation breached EU competition rules, although funding a claim may be awkward – perhaps by third-party litigation financing providers.

MIFID II AND PRIIPS

12. ESMA APPLIES FOR DELAY IN START OF MIFID II

It is strongly rumoured that ESMA is considering a formal request to the EC to postpone the start date of some, or even all, of the Markets in Financial Instruments Directive (MiFID II) requirements for one year – that is from 3 January 2017 to 3 January 2018. There is no official confirmation of this, and even if ESMA makes the application, the EC may refuse it.

Comment – As delays in producing final regulatory standards have increased from the original June date to September (with five delegated acts not due till December), and the extent of change to markets and firms has become apparent, industry pressure has built up for a delay. The red line used to go through the date for transaction reporting to start, but even that has become more fluid in regulatory language. Firms are in a dilemma – should they continue their preparations assuming a 2017 start date, or should they slow down to see the final detail from ESMA and the FCA? The next few weeks will be important to the answer.

13. OTHER MIFID DEVELOPMENTS

In September, ESMA published its long-awaited final report on the second MiFID II and Regulation (MiFIR), with draft regulatory technical standards for most of its mandates for the EC to approve – only five delegated acts remain (including the important one on research/commission sharing). These are expected in
November. They cover a wide area – here are some highlights which the draft standards cover:

**INVESTOR PROTECTION**
- How the best execution regime will change
- The cost disclosure regime for product providers.

**CHANGES TO MARKETS**
- How to define the very active financial firms’ speculative investment activities to be regulated
- How to implement the commodity derivatives position limits regime
- To describe the organisational requirements on investment firms and trading venues for high frequency trading
- The duty to give and the conditions for non-discriminatory access to central counterparties, trading venues and benchmarks, for competition purposes
- What is the requirement for trading venues to offer data on reasonable terms?

**TRANSPARENCY**
- How to calculate the thresholds for pre- and post-trade transparency regimes for bonds, derivatives, structured finance products and emission allowances
- What is the new liquidity assessment for non-equity instruments?
- How the new trading obligation for shares and certain derivatives to be traded only on regulated platforms will work (for shares, systematic internalisers), rather than over the counter (OTC)
- How the double volume cap mechanism to limit dark trading on multilateral trading facilities (MTFs) and organised trading facilities (OTFs) will work, and new conditions for waivers for shares and equity-like instruments from pre-and post-price transparency
- Are the newly introduced reporting regime for commodity derivatives.

Many specific implementation questions will be covered in this edition in the relevant sections, such as Private wealth management/Retail and Wholesale/Capital markets.

Generally, the FCA has been able to give some steers:
- On authorisation of firms resulting from MiFID changes, eg, forex firms and commercial firms, the normal process and timetable will apply except for operating an OTF and emission allowances
- It will consider providing information on the need to provide Legal Entity Identifiers for various MiFID purposes, eg, transaction reporting
- There is likely to be a significant amount of Level 3 harmonisation guidance made by ESMA. However, it is too early to say which areas will be covered
- It will hold further industry association briefings and firm conferences in Q3 this year.

Firms’ concerns, such as how issues covered in EU delegated acts and standards will be resolved, include the technical preparations needed.

**Comment – Firms have a number of general concerns. These include how the issues covered in the EU-delegated acts and technical standards, and FCA discussion paper on implementation will be resolved; how to make technical preparations needed, eg, for transaction reporting, position reporting, best execution disclosures, costs and charges for disclosures, and inducement restrictions on research; the need to know how the third-country equivalence judgments will be made; what the quoting obligation under the non-equity systematic internaliser regime will be; the boundaries between OTFs and MTFs, more about how to decide the ‘target market’ for products; and, of course, the suitability regime.**

14. AND OF PRIIPs

The responses to ESMA’s June 2015 consultation have now been published. Many trade associations representing both manufacturers and distributors have done so from many EU countries. Some interesting points:

- Manufacturers want probable transaction costs to be shown separately from predictable ongoing charges
- Much discussion on whether to combine credit risk and market risk warnings
- Some manufacturers argue against showing restrictions on exit restrictions or charges as covered in the prospectus
- Arguments for exempting vanilla retail bonds from packaged retail investment and insurance-based investment products (PRIIPs)
- The underlying tension throughout between standardisation and accuracy.

EU regulators have been warned about the extreme dangers of forcing EU individual investors to rely upon shaky future performance scenarios.

One of the key points of controversy is whether past performance data should be used in the Key Information Document (KID) as now, or only future projections – which is clearer to the investor? The European Parliament, the Council and the Commission favour the second approach, and the Investment Association endorses this approach: “This would achieve the aim of presenting an indication of possible future performance … based on actual data that academic research has shown to be at least as good a starting point as anything else.” Others, however, have criticised the EU’s approach: the industry Inter-institutional Monitoring Group for securities markets (which advises ESMA) has warned the EU regulators about “the extreme dangers of forcing EU individual investors to rely upon shaky future performance scenarios while depriving them of the only performance data that do not lie.”

Comment – Given the Level 1 agreement on PRIIPs by the European Parliament, the Council and the Commission, it appears likely that the future performance approach will proceed. There is, however, nothing to prevent fund houses publishing historical data on their websites in addition to the KID.

15. RISK CONTROLS

The recent example of a junior forex trader in a bank keying in the wrong amount, leading to a $6 billion mistaken payment to a client, emphasises once more the risks of manual processing. The ‘four eyes’ principle
should have prevented it, but failed. It is one more example showing the reduced risks of straight-through processing, and encouraging traders of vanilla products to be replaced by programmed trading.

CHANGES IN SUPERVISION

16. IMPORTANT CHANGES AT THE BANK OF ENGLAND AND THE PRA

The Treasury has published the draft Bank of England and Financial Services Bill, radically changing the structure of the Bank and of the PRA. There are important changes in:

• The legal structure of the PRA will cease to be a subsidiary of the Bank – instead it will be legally integrated into the Bank. The subsidiary structure will be replaced by a new Prudential Regulation Committee (PRC) which will have operational responsibility for prudential regulation and will be independent in making rules, policies and supervisory decisions. Its statutory objectives will remain unchanged. Like the Monetary Policy Committee (MPC), the Chancellor will write an annual letter to the PRC highlighting which government economic policies the Committee should take into account in exercising its responsibilities.

Comment – This is a big change legally, but operationally less so. For example, the Chief Executive of the PRA, Andrew Bailey, is Deputy Governor of the Bank. It can be seen as a key part of the structural and governance changes at the Bank following several reviews, the appointment of a new governor and pressure from the Commons Treasury Committee for the Bank to be accountable for its own and the PRA’s actions.

• Describing how the Treasury and the Bank will identify and manage the risk to public funds in financial crisis planning in the recovery and resolution of systemically important firms, including developing resolution strategies, active contingency planning and formulating of resolution policies.

Comment – This is an important and fascinating area. The Conservative Party heavily criticised the ‘troika’ system at the time of the financial crisis. It wants the Treasury and the Bank to work together better in the future. What is equally interesting is the implicit acknowledgement that public funds could be required in a crisis.

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• Changing the governance of, and increasing the efficiency of, the Bank’s Court of Directors. This includes reducing the number of members and making it a unitary board.

Comment – The Commons Treasury Committee has heavily criticised the current governance, role, accountability and size of the court of directors following the LIBOR, forex and quantitative easing problems it has had (see Change, May 2015. All financial sectors section, ‘The Bank of England is investigated – three times’, p. 17). The general criticism was that the executive (particularly the Governor) had too much power (and the non-executive court members too little), and that the Bank’s senior management did not know in enough detail what their staff were doing. The overall plan is to make the court more like a normal board, with the NEDs holding the executive to account.

• Changing the reporting structure of the Financial Policy Committee (FPC) from a sub-committee of the court to a committee of the Bank itself. The FPC also takes over the responsibility for setting the Bank’s financial stability structure.

Comment – This is interesting. On the one hand the court’s role is reduced and the FPC’s distance from the Bank executive removed. On the other hand it is being given greater powers to set policy. Clearly, three years on, its role is clearer. Perhaps this simplifies its power to give the PRA (now the PRC) recommendations/instructions. Finally, however, it does reduce its independence from the Bank since it now reports to it.

• The National Audit Office (NAO) will be empowered to carry out its ‘value for money’ audit of parts of the Bank, particularly its operations and assets portfolio (now estimated to have reached £300 billion under quantitative easing).

Comment – The Bank is uncomfortable with this. It considers it as weakening its independence. The Chairman of the court of the Bank, Anthony Habgood, has said that one is “the potential threat to the carefully constructed independence of the policy functions of the Bank, and they are carved out, but that’s quite a limited carve-out”. (The PRA is already audited by the NAO, but, after its structural change, its policy decisions may be exempt.) Consequently the exemption in the Bill has been widened to cover any issue “concerned with the merits of the Bank’s general policy in pursuing the Bank’s objectives”. The auditors would also need to consult the Bank’s court before making any studies into the effective
Separately, the Commons Treasury Committee has written to the Bank requesting a review of the Code of Conduct applying to members of the MPC. This follows the controversy about the hedge fund interests of a new member (Dr Gertjan Vlieghe). The letter says: “It is essential that those appointed to the MPC have no conflicts of interest, nor perception of them.” Dr Vlieghe sold his stake in the hedge fund when the question arose.

Looking into the possible future, the new Shadow Chancellor, John McDonnell, has announced a review by Lord Kerslake, the former Head of the Civil Service, of the way the Treasury operates, and while confirming its independence, launched a debate about changing the mandate of the Bank of England: “We will launch a debate on expanding that mandate to include new objectives for its monetary policy, including growth, employment and earnings.”

BANK OF ENGLAND

Comment – While not specifically named, the PRA, as the banks’ prudential regulator, would be affected as part of the Bank. It could encourage bank lending to the small and medium-sized enterprises sector.

The Bank’s actions in arranging the emergency auctions of liquidity in the financial crisis in 2008 continue to be investigated. The Serious Fraud Office (SFO) is looking at whether banks were told to bid at particular rates by Bank officials to ensure even distribution of funding and the success of the auctions. However, the SFO is also reported to be considering whether it is in the public interest to pursue the case.

Comment – This is the fourth external investigation into the corporate governance or market supervision issues in the Bank. It is hardly surprising that changes are being made. The only comfort the Bank may have is that the Federal Reserve and US regulators are equally under review.

17. THE BANK COMMENTS ON THE CHancellor’s ‘NEW SETTLEMENT’ FOR FINANCIAL SERVICES REGULATION

After the Chancellor’s encouraging comments in his Mansion House speech, the Bank has perhaps been more cautious. For example, Sir Jon Cunliffe, Deputy Governor, Financial Stability, has noted that although some change may be necessary, it is important that financial stability is not compromised: “The implementation of the reforms will inevitably throw up unforeseen effects in particular places and where it is justified, we will revisit issues; but we should be careful about turning back the regulatory dial or trying to trade off the risk of financial stability for short-term growth.”

Comment – The Bank has said that it will examine how the various regulatory reforms fit together at UK, EU and global level – and any unintended consequences. However, it appears that prudential regulation and systemic risks may not be among them. There are other signs that the Government is listening to the industry more, e.g. in softening some of the ring-fencing requirements – see Commercial and retail banks section, ‘Banks prepare for and regulator consults on bank separation’, p. 61 of this edition.

18. THE FCA CHANGES ITS SUPERVISORY MODEL

The FCA’s September Regulatory round-up describes changes to its supervisory approach towards the firms it regulates. It is moving away from the current C1 to C4 supervisory conduct categorisation and approach. Instead it will split firms into two supervisory categories – either fixed portfolio (Pillar 1) which will continue to have a programme of firm or group-specific supervision), or flexible portfolio firms (which will be subject to event-driven reactive supervision (Pillar 2) and thematic or product supervision (Pillar 3). There will also be some pro-active supervision through a mix of market-based thematic reviews, communication, engagement, and education activity based upon the FCA’s policy for the relevant sector. Only fixed portfolio firms will have a named supervisor; flexible portfolio firms need to use the Contact Centre. Initially only a small number of C1 and C2 firms are likely to become flexible portfolio firms. The FCA will contact them.
Comment – This is simply an acceleration of the trend for directly supervised firms to move to the Contact Centre as there are evermore firms to be supervised by a limited number of FCA staff. Initially the change is not likely to be large – the FCA’s supervisory expectations of firms remain the same – but individual firms which are reclassified will find the difference. There is no change to the FCA’s prudential or P categorisation.

19. A MIXED REPORT CARD FOR THE FCA FROM THE COMPLAINTS COMMISSIONER

The Complaints Commissioner for Financial Services Annual Report for the year ended 31 March 2015 shows that it received 61 complaints against the FCA. The Commissioner held in favour of the FCA in all these cases. However he did make a number of criticisms of the FCA enquiries into some of the complaints and made some recommendations in respect of them. He commented generally about complaints against the FCA and other regulators: “In particular, there is a danger that complaints may be rejected on the grounds that the regulator was simply exercising its discretion, without sufficiently testing that the exercise of the discretion was within the limits of reasonableness.”

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THE COMPLAINTS COMMISSIONER FOR FINANCIAL SERVICES

Comment – It is always difficult to challenge a regulator given its wide subjective discretion, but it is perhaps a little surprising that none of the procedural concerns of the FCA were sufficiently serious to affect the decision.

20. A TORRID TIME FOR THE MONEY ADVICE SERVICE AND PENSION WISE

The Treasury has announced another review and consultation (closing 22 December) on the Money Advice Service (MAS), The Pensions Advisory Service and Pension Wise. One of the reasons for the review and consultation is to see what role these services can play in filling advice gaps to consumers, including pensioners. This is separately under review by the FCA as part of the Financial Advice Market Review (see Private wealth management/Retail banking section, ‘Financial Advice Market Review (FAMR)’, p. 25 of this edition). In more detail, the Treasury is reviewing debt advice (including co-ordination between different agencies), overlapping pensions guidance provided by the three entities and whether any of them should provide individual financial guidance, and money guidance and financial capability where the Treasury asks whether there should be any change to the statutory objectives of the MAS.

Comment – The MAS has found it difficult to carve out a role in providing consumer services. Under its consumer financial education and support objective, it has met opposition from advisers who complain that they are funding it to compete against their own services, since it provides them at no cost to consumers. So providing advice to those who cannot afford their services, or where it is uneconomic because of the small size of their investment, may be a solution. The second criticism (made by the House of Commons’ Treasury Committee) was that the MAS was inefficient. An independent review made recommendations on this recently, which include providing grants to those filling advice gaps. The MAS has since changed its focus to debt advice and launching the Retirement Adviser Directory.

Separately there is a clear need for pensions advice after the pension liberalisation in April, and there is concern that the two bodies’ services overlap and underlap the area. One approach under consideration is for at least one of them to provide advice which is more tailored to the individual. This is controversial with advisers for the same reasons as are described in the previous paragraph.

21. INTERNATIONAL REGULATORS REVIEW CROSS-BORDER REGULATION

The International Organization of Securities Commissions (IOSCO) has published its final report on the important subject of cross-border regulation and supervision. This follows the comments received from its November 2014 consultation. Its general conclusion is that cross-border regulation is “moving towards more engagement via different forms of recognition to solve regulatory overlaps, gaps and inconsistencies. While the increased engagement is mostly bilateral at this stage, multilateral engagement is likely to develop further as markets continue to grow and emerge around the world and with the greater use of supervisory memoranda of understandings”. Its recommendations include regulators considering the three broad types of cross-border regulatory options (including how and when they could be used), the approach for assessing another country’s regime, and more consultation before a country decides on new initiatives, co-operation through the G20 and the Financial Stability Board and more “deference” to other countries’ regimes. Changes should take into account the impact of changes on different sectors such as markets, intermediaries, investment schemes and financial market infrastructures.

Comment – This is a crucial ‘hot topic’. Different interpretations of the 2009 G20 Pittsburgh Summit commitments have led to turf wars, particularly between the US and the EU, resulting in serious problems for entities operating in both areas, for example in delaying the start of OTC derivatives clearing in the EU under European Market Infrastructure Regulation (EMIR). IOSCO is well placed to knock heads together.

ENFORCEMENT

22. THE FCA ENCOURAGES WHISTLEBLOWING

The FCA has published its long-awaited rules on whistleblowing. The new key rules require all firms to:

- Appoint a Senior Manager as its whistleblowers’ champion
- Put in place internal whistleblowing arrangements to handle all types of disclosure from all types of person
- Put text in settlement agreements explaining that employees have a legal right to blow the whistle
- Tell UK-based employees about the FCA and PRA whistleblowing services
- Make a report on whistleblowing to the firm’s board (at least annually)
- Inform the FCA if it loses an employment tribunal with a whistleblower
- Require any appointed representatives and tied agents to tell their UK-based employees about the FCA’s whistleblowing service.

Comment – Andrew Hall, Head of Professional Standards at the
CISI, said: “This is clearly a step in the right direction. However, it leaves unanswered questions as to how far the FCA encourages employees to ‘speak up’ if they have ethical concerns to the firm’s senior management or board or to the regulator – and whether it will protect them if the firm does not listen to the concerns or takes action against the whistleblower. The employment history of whistleblowers is often not a happy one. We believe both senior management and staff need to be trained to make good and constructive use of disclosed concerns.”

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ANDREW HALL
HEAD OF PROFESSIONAL STANDARDS, CISI

The FCA’s Annual Report for the year ended 31 March 2015 gives a useful description of what is happening currently. Here are some points from it:

• The total number of reports the FCA received increased by 28% to 1,340
• Most reports concerned financial advisers, consumer credit and retail banking. However, a number did concern wholesale markets and firms
• The largest concern was in fitness and propriety, culture, and consumer detriment; competition and market activity were considerably less important
• Of the reports received by the FCA, the majority were of little significance to the regulator. However, about a third either directly contributed to enforcement activity or the protection of consumers or were of interest to the FCA but are not currently actionable.

Comment – These figures show why the FCA is keen on encouraging whistleblowing (apart from the political pressure to do so). It is not, however, planning to offer financial incentives to whistleblowers (as in the US under the Dodd-Frank Act – see Change, May 2015, All financial sectors, ‘Lessons from the US SEC’s approach to whistleblowing’, p. 16).

23. ENFORCEMENT DEVELOPMENTS

SPEED READ

There have been many of these in the past three months. The most interesting general ones are the new FCA enforcement referral criteria (mainly clarifying these criteria) and the drop in the recent use of attestations. Other interesting cases concern the delay in publishing the HBOS review and another case where consumer reimbursement was chosen in preference to financial penalties.

ARTICLE

Here are the standout events:

• The publication by the FCA of its new enforcement referral criteria. The three main criteria are:
  (a) Is the enforcement investigation likely to further the FCA’s aims and statutory objectives?
  (b) What is the strength of the evidence and is an investigation likely to be proportionate?
  (c) What purpose or goal would be served if the FCA were to take enforcement action in this case?

These new criteria apply where the FCA might fine, publicly censure or impose a suspension or restriction on a firm or individual, or make a prohibition order.

Comment – This clarification was one of the recommendations in the Treasury’s review of FCA enforcement in December last year. It helps to some extent, but of course, the firm or individual does not have the opportunity to argue using them since it is an internal FCA decision. See also Martin Wheatley’s comment to the Davis Inquiry (see the All financial sectors section, ‘The FCA reviews its communications strategy’, p. 7 of this edition).

The use of these attestations by the FCA has dropped considerably. In the first three months of 2015 they were used seven times compared with 38 in Q1 2014. The seven firms concerned were in retail finance (three), wholesale (three) and general insurance (one).

Comment – Before firms breathe more easily, it should be noted that the seven in Q1 2015 were up against tough comparatives in Q1 2014; also that attestations are only one of an increased number of supervisory tools available to the FCA, for example the remediation programme which many forex firms are currently undergoing.

• The PRA has written a letter to the Commons’ Treasury Committee on the delay in publishing the review into HBOS, and the regulatory response. The review started in 2012. There was a great deal of preparation in preparing the draft 500-page report. This is in the throes of ‘re-Maxwellisation’ – the process under which the 35 individuals named in the report are given an opportunity to comment upon any increased criticism of them since they last saw the report (as in the Chilcot Inquiry report on Iraq). Then confidential pieces need to be identified and either removed or cleared for publication. The PRA does not give any date for publication.

Comment – The Commons Treasury Committee is not happy with the delay. Its Chairman, Andrew Tyrie, said: “It is now almost seven years since the collapse of HBOS. We have been waiting a long time. The review should be published as soon as possible.” It is likely that the ‘re-Maxwellisation’ procedure will be changed because of these two examples.

• The use of attestations by the FCA has caused firms much heartache. Following the FCA Board’s discussion of their use, and the Treasury’s review of FCA enforcement, the use of these attestations by the FCA has dropped considerably. In the first three months of 2015 they were used seven times compared with 38 in Q1 2014.

• The FCA has agreed a consumer redress scheme with Ariste Holdings, trading as Cash Genie. The £20 million is payable to 92,000 customers because of the unfair trading practices in lending short-term...
In more detail, the firm will write off or refund fees and charges and interest which should not have been paid; refund payments taken without customer authorisation; and write off or refund charges made after the customer’s annual statement.

Comment – The case is interesting because of the FCA’s choice of customer compensation before fines. This may have been prompted by using available funds for customers, and because the firm self-reported the problems. However, these existed for five years.

• The Bittar case has reached the Tribunal. At issue is the right of the FCA to publish final notices against banks which indirectly identify an individual bank employee. However, because he or she is not named, they have no right to argue against the wording in the notice. Identification is easier where there are parallel settlement notices issued in the US, eg, of Manager B (FCA) and Trader 5 in the US (SEC). If Mr Bittar succeeds at the Tribunal, the FCA will need to explain its wording and the individual can argue against it.

• Investigations into that heavily discounted Barclays Bank fund raising rights issue refuse to go away. The SFO has gone to court to access some external and internal investigation documents in respect of which the bank claims legal privilege.

Comment – Apart from the significance to the SFO and Barclays, this makes a Deferred Prosecution Agreement (DPA) less likely given the condition that privilege must be waived. There may also be wider consequences for refusing to disclose internal legal advice and there have been reports of internal investigations.

• The Catalyst/Andrew Wilkins case has finally finished. After the Tribunal decided that the FCA should reconsider whether to ban Mr Wilkins, a former director of Catalyst, the FCA decided not to do so. The Tribunal decided that although he had made mistakes, he was still ‘fit and proper’.

• In the year ended March 2015 the FCA spent £7.5 million on external investigators. These are disclosure officers, accredited financial investigators, lawyers and paralegals – often used in bulking out the case teams used on 82 enforcement cases.

Comment – Apart from the light thrown on the small resources of the core FCA staff, there is one other interesting statistic – of those 82 enforcement cases, only 36 resulted in the FCA taking action. This period covered some hefty investigations, eg, into forex trading, so the number of cases may fall in the future.

• Following Kweku Adoboli’s conviction for fraud relating to the $2.25 billion losses to Société Générale, the FCA has banned him from performing any function in any regulated activity. He is now challenging deportation to Ghana.

Comment – There are several puzzles about this, including the timing – three years after his conviction while a colleague was banned last year – and that he has been released from prison so early after receiving a seven-year sentence in 2012. Apparently he now wants to advise compliance teams on how traders can evade systems and controls.

There is a frustration that some of the requirements to run a globally competitive wholesale financial services centre are not always understood by all parts of the European Union.” His (and the UK industry’s concerns) are that the eurozone countries voting as a block have a majority to approve new regulations. Currently there is a ‘double majority’ structure under which non-eurozone countries must separately approve new legislation. However, this may not be sufficient to enable the UK to block unwanted new rules either if non-eurozone countries are not consulted (as in the proposed use of EU funds to lend to eurozone countries) or if the majority of non-eurozone countries vote in favour of the new rules (as in the bonus cap) – and this ‘double majority’ may become weaker if and when more EU countries join the eurozone. The Chancellor therefore wants to strengthen the ability of the UK to veto the new rule or to opt out. A simple veto or opt-out is unlikely to be politically negotiable, so he has come to the preliminary conclusion that a treaty change with non-discrimination provisions strengthened would give the UK greater ability to challenge new rules. Unfortunately such a change before 2018 appears to have been ruled out by France and Germany, although the Chancellor appears to think with the EU before the referendum to be held before the end of 2017 on whether the UK should stay in or leave the EU (Brexit).

The Catalyst, the FCA decided not to do so. The Tribunal decided that although he had made mistakes, he was still ‘fit and proper’.

His (and the UK industry’s concerns) are that the eurozone countries voting as a block have a majority to approve new regulations. Currently there is a ‘double majority’ structure under which non-eurozone countries must separately approve new legislation. However, this may not be sufficient to enable the UK to block unwanted new rules either if non-eurozone countries are not consulted (as in the proposed use of EU funds to lend to eurozone countries) or if the majority of non-eurozone countries vote in favour of the new rules (as in the bonus cap) – and this ‘double majority’ may become weaker if and when more EU countries join the eurozone. The Chancellor therefore wants to strengthen the ability of the UK to veto the new rule or to opt out. A simple veto or opt-out is unlikely to be politically negotiable, so he has come to the preliminary conclusion that a treaty change with non-discrimination provisions strengthened would give the UK greater ability to challenge new rules. Unfortunately such a change before 2018 appears to have been ruled out by France and Germany, although the Chancellor appears to think with the EU before the referendum to be held before the end of 2017 on whether the UK should stay in or leave the EU (Brexit).
that a treaty change negotiated before, but not effective until after the UK referendum, could happen. Strengthening the ‘double majority’ structure is another possibility, as is negotiating a compromise on individual issues. However, he said that this “does not give confidence you can do it in every situation”.

The most recent suggestions of the Chancellor’s position are that he will ask for agreement on a set of principles to protect non-eurozone members from majority eurozone decisions: in particular that non-eurozone members can delay decisions giving more time for consultations – but falling short of a veto. Another principle would prevent discrimination against financial companies based in the non-eurozone (again less than a full opt-out for the City on financial services legislation). It is thought that these principles may not need treaty change.

Separately, the Bank of England has published its analysis of the likely impact of a Brexit on the UK, including financial services.

FINANCIAL CRIME

25. WHAT’S HAPPENING IN MARKET ABUSE?

There have been three interesting developments in market abuse which are described below. However, the most important is the start of the new and expanded regime under Market Abuse Regulation (see Change, May 2015, Wholesale/Capital markets Section B, ‘Preparing for the new Market Abuse Regulation (MAR II)’, p52) in July 2016 which all firms should be preparing for.

• Navinder Singh Sarao is charged with market manipulation, commodities fraud and wire fraud over recent years – and, significantly, contributing to the ‘flash crash’ in the US municipal bond market on 6 May 2010. The US authorities have applied for his extradition – where the maximum penalty is over 300 years if found guilty. He was released on bail of £50,000 (reduced from £5 million) in August after freezing orders had been made against his worldwide assets – which exceed £30 million made from proprietary trading. He denies the charges: “I’ve not done anything wrong apart from being good at my job. How is this allowed to go on, man? I’ve done nothing wrong.”

Comment – This is the first time that the FCA has used its new powers to apply for a permanent injunction, and it will be heartened by its success. Firms providing direct market access to clients should note that while Goldman Sachs escaped as the market member, its client which gave “three unknown individuals from a foreign country direct authority to commit it to market transactions in DVI’s [Da Vinci Invest] own name and using its credit and its own funds” did not. The firm has said it will appeal the judgment.

26. MONEY LAUNDERING DEVELOPMENTS

SPEED READ

The most interesting developments are the UK Government’s announcement on a Department for Business, Innovation and Skills (BIS) webpage to review the money laundering regulations. Admirable as this is, these regulations are largely determined by EU money laundering laws – and these will change again under the fourth Money Laundering Directive (MLD4) – see Change, May 2015, All financial sectors, ‘The progress of the new EU Anti-Money Laundering Directive (MLD4) and the Wire Transfer Regulation (WTR)’, p. 20. Other developments are the renewed focus on professionals who may unwittingly (or with knowledge) help money launderers, such as solicitors and estate agents, and, globally, on the use of gold for money laundering and terrorist financing; the first annual review of money laundering in the UK by the Treasury and the Home Office, which pulls few punches; the possible end of the ‘consent’ suspicious activity reporting system; and there is the curious case of Guernsey and Sark appearing and disappearing from the Financial Action Task Force’s (FATF) anti-money laundering (AML) blacklist.
The Treasury has released its first national risk assessment (NRA) on the domestic risks of money laundering and terrorist financing within the regulated sector. This includes the risks associated with new payment methods and UK legal entities and arrangements. It also covers the international risks to the UK from money flowing into and out of the country. The objective of the NRA is to better understand the risks involved, inform the efficient allocation of resources and mitigate those risks.

Key findings include:

- UK law enforcement agencies have the most knowledge about cash-based money laundering, but intelligence of other money laundering patterns is patchy.
- The size and complexity of the UK financial sector means it is more exposed to criminality than those in many other countries.
- The effectiveness of the supervisory regime in the UK is inconsistent.
- The law enforcement response to money laundering has been weak for an extended period of time.

Last year more than 350,000 suspicious activity reports were filed with the UK Financial Intelligence Unit (UKFIU), the vast majority of those being submitted by the financial sector.

- Last year more than 350,000 suspicious activity reports (SARs) were filed with the UK Financial Intelligence Unit (UKFIU), the vast majority of those being submitted by the financial sector.

The next steps for the action plan are to:

- Plug intelligence gaps, particularly those associated with ‘high-end’ money laundering through the financial and professional services sectors.
- Enhance law enforcement responses to the most serious threats.
- Reform the SARs regime and upgrade the capabilities of UKFIU.
- Address the inconsistencies in the supervisory regime that have been identified through the NRA.

Comment – This is an interesting report that has stirred controversy because it says that “known professional enablers” in the UK have facilitated money laundering of corrupt payments. The solicitors and accountants’ professional bodies challenge this. The report also focuses on the vulnerability of the high-end property market to ‘cleanse’ corrupt payments (indeed some other commentators suggest that it is a factor in the rise of London property prices).

The BIS and the Treasury have announced a review of the effectiveness of UK money laundering and terrorist financing rules. This is part of the Government’s Red Tape Challenge programme. The review wanted evidence on whether the current guidance meets the needs of business, and the effectiveness and proportionality to the risks of supervisors’ approach to supervision and enforcement. It also wanted examples of good practice that could help businesses meet their obligations which already exist elsewhere.

Comment – Much as business would like to reduce the rigidity of the present AML and Counter-Terrorism Financing (CTF) regulations, it is difficult to imagine that there can be much change in the UK without change at the EU law level. Would it not have been better to have made the review part of MLD4 implementation? The other interpretation is that the review heralds a tougher supervisory approach to intermediaries in acknowledged areas of vulnerability given the FATF review of the AML and CTF laws in the UK.

The Prime Minister, David Cameron, also made a speech in Singapore in August in which he committed to ‘crack down’ on criminals using London to launder their money. He referred to James Ibori, a former Governor of Nigeria, an oil-rich country, who was jailed for 13 years for fraud and money laundering of at least £50 million. Professional advisers and intermediaries are the focus. The head of the National Crime Agency (NCA) has called money laundering, particularly in real estate, a “strategic threat to the UK economy”; the Solicitors Regulation Authority reviewed 375 law firms; and Cameron has also said that he will increase transparency to prevent officials registering ‘off-the-shelf’ companies without due diligence and for their controllers to be named. However, there is no move to extend this to the Land Registry and overseas companies. The latest figures for SARs show a significant reduction in the number of reports made by accountants, solicitors and estate agents.

The UK Government has decided not to proceed with criminalising the offence of failing to prevent an economic crime. In doing so the Government has said that the principle of corporate criminal liability applies already in the UK.

The NCA has criticised some financial services companies and professionals for misusing the SAR online system, through notifying cases where they want the NCA to carry out the extensive checks needed as part of the consent procedure. In doing so they receive protection from prosecution themselves. It says that 14,000 out of the 350,000 SARs come into this category: “The number of ‘consent’ SARs is moving up, we are then forced, if you like, to put quite a lot of resources into that … and that does provide a due diligence function for some institutions”. As a consequence, the NCA is considering ending the consent procedure. Transparency International has suggested that the problem is caused by the tight seven-day deadline for the NCA to block the payment, which results in many corrupt payment transactions proceeding.
identify and report suspicions.

• The EC placed Guernsey on its ‘blacklist’ of ‘non-co-operative jurisdictions’ in June. (All those on it appeared on nine of these national lists, and that it had no responsibility for Sark, which was the tenth. The Organisation for Economic Co-operation and Development (OECD) criticised the blacklist as not taking tax transparency into account. Guernsey has been removed from the list.

Comment – Guernsey is on a journey from being an offshore haven to EU standards of transparency and exchange of information. The position of Sark (and its relationship with Guernsey) is more uncertain. The blacklist is a warning to business that enhanced due diligence and monitoring are advisable.

• In a further development of banks’ cutting-off of money transfer services to clients in high-risk jurisdictions, the Court of Justice of the European Union (CJEU) is considering an application for a ruling (Advocate General Sharpston’s Opinion: Safe Interventions) on whether a member state can authorise a credit institution to apply customer due diligence measures to a payment institution if that credit institution is itself authorised under the third Money EU Money Laundering Directive (MLD3).

27. BRIBERY AND CORRUPTION

The SFO has invited at least four companies to enter into negotiations to do a deferred prosecution agreement (DPA). This is an agreement approved by the court under which a company admits wrongdoing over bribery or corruption, pays a fine and agrees to take remedial action, eg, paying compensation or overhauling its preventative measures. For doing this, the SFO agrees to suspend charges over a fixed period. This avoids a conviction where the risk of shareholder actions for remediation is high. The decision makes it harder for the SFO to take the initiative. However, it does not, itself, agree to a corporate prosecution. It appears the SFO is keen to see if they work in practice.

The Ministry of Justice has stated that there have been no prosecutions for offences under Section 7 of the Bribery Act 2010 (for a commercial organisation to fail to take reasonable steps to prevent bribery by an employee or agent). However, the FCA has issued strong warnings about firms’ failures to do so and has fined some insurance brokers for this.

Comment – DPAs enable companies to be prosecuted for wrongdoing without causing them to collapse. However, this recent US import is still controversial there. For example, Jed Rakoff, a US District Judge, has criticised their use as “technically and morally suspect”, preferring a straight corporate prosecution. It appears the SFO is keen to see if they work in practice.

The Ministry of Justice has stated that there have been no prosecutions for offences under Section 7 of the Bribery Act 2010 (for a commercial organisation to fail to take reasonable steps to prevent bribery by an employee or agent).

28. REGULATORS WORRY ABOUT CYBER ATTACKS ON FIRMS AND INSTITUTIONS

The recent cyber attack on Sony Pictures, which deleted important files and copied internal corporate emails, has led to a rethink in the largest US financial institutions (which have suffered 300% more attacks than non-financial ones). The malware used serially searched for vulnerabilities so that anything less than 100% opened the system to the hacker. Insurance company Lloyd’s estimates that cyber attacks across all sectors cost $400 billion each year, and JPMorgan lost personal data on 76 million customers despite spending $250 million a year on cyber security. Regulators see it as a systemic risk and are continually asking financial institutions what they are doing to prevent it. Some go further – for example, the Bank of England’s ‘Operation Waking Shark’ – see Change, Feb 2015, All financial sectors section, ‘Alarm over cyber attacks‘, p. 19. Prevention is made difficult by larger firms often using multiple legacy systems from past mergers, and smaller ones not having the funds to take preventative measures.

Action – Some suggestions for best practice include training employees to spot spoof emails (since most attacks start with one containing the malware), banning the use of employees’ USB sticks, and regular ‘cleansing’ operations. There are also forums for exchanging information about attacks, such as one run by the British Bankers’ Association (BBA). Regulators take a dim view of firms that have not taken reasonable steps to protect themselves from attacks.

In the US, one of the five SEC Commissioners, Kara Stein (speaking for herself), has proposed that it widens the scope of its technology rules (Regulation SCI) to cover broker-dealers including ‘dark pools’. The regulation requires markets and other financial market intermediaries to take active steps to prevent cyber crime – which is becoming an important concern to regulators after alleged Chinese cyber attacks. Stein said: “We basically left out over 4,000 broker-dealers [and] alternative trading venues”.

29. AND FINALLY, SANCTIONS

The recent re-election of Alexander Lukashenko as President of Belarus, and the release of political prisoners, has led the EU to temporarily suspend sanctions against about 100 individuals, including Lukashenko.

The phased lifting of UN sanctions against Iranian entities will provoke many discussions on the status of individual clients and groups. The penalties of getting it wrong can be seen in the continued investigations in the US as to whether Standard Chartered did cut its links with known Iranian connected clients after its $667 million settlement in 2012.

Another bank (Crédit Agricole) has settled charges in the US that it broke sanctions on Iran, Sudan, Myanmar and Cuba – at a cost of $787 million. The bank admitted wrongdoing and the criminal charge is expected to be dropped after three years. The settlement follows those of a number of other non-US banks, including BNP Paribas which paid $9 billion.

CORPORATE GOVERNANCE

30. A RADICAL REVIEW OF COMPANY LAW AND THE UK CORPORATE GOVERNANCE CODE?

Andy Haldane, Chief Economist at the Bank of England, made a speech in Edinburgh in May which was only published in August. In it, he challenged the
'shareholder-centric company model'. He called for a fundamental review of company law, which could include different classes of shares (as in the US) or more votes for long-term holders (as in France). The Confederation of British Industry (CBI) was quick to respond. Matthew Fell, Interim Chief Policy Director, CBI, said: “Moving from a one share one vote approach has previously been considered and shown to have lots of unintended consequences, like making companies less open to challenge and less agile in takeovers. The key is to have more engaged shareholders, not just long-term shareholders.”

The key is to have more engaged shareholders, not just long-term shareholders

MATTHEW FELL CHIEF POLICY DIRECTOR, CBI

Comment – This discussion again puts the focus on passive shareholders, such as exchange-traded funds (ETFs). See Change, Aug 2015, Wholesale/Capital markets – section B, ‘Should passive shareholders have stewardship obligations?’, p. 45.

Regulations have now been made under which the Registrar of Companies has the discretion to omit a director's date of birth from the public register. See Change, May 2015, All financial sectors section, ‘The progress of the new EU Anti-Money Laundering Directive (MLD4) and the Wire Transfer Regulation (WTR)’, p. 20 for the Government’s proposals for a register for the name(s) of the ultimate owners of English companies.

31. THE FRC STUDIES CORPORATE CULTURE AND THE ROLE OF BOARDS
The Financial Reporting Council (FRC) has launched a project to study these matters to find best practice. It has asked all interested to join with it on four workstreams: the role of an effective board; people issues such as culture, values, HR practices and performance reward; shareholder issues such as relationship between culture and business models, community and environment; and embedding, measuring and monitoring culture.

32. A NEW TARGET FOR WOMEN UNDER THE DAVIES REVIEW?
The good news is that the target set by the original Davies Review in 2011 for FTSE companies to have 25% female members was reached in July this year. The bad news is that a third of FTSE 350 companies will not achieve this by 2018, and nearly two-thirds had no plans to do so. The more underlying problem is in executives below board level. A further review was set to be published in Q4.

33. IMPORTANT AUDIT AND ACCOUNTING DEVELOPMENTS

SPEED READ
There are no outstanding developments in this period. However, it is worth noting that the US is increasingly concerned about auditors providing non-audit services to clients (questioning their development into professional services firms). There is also the dispute between barristers on whether there is an overriding ‘true and fair view’ requirement for accounts under the Companies Act, the PRA’s consultation on implementing audit committee requirements under the Statutory Audit Directive and – looking into the future – the ESMA consultation on the European Single Electronic Format (ESEF) for accounts.

ARTICLE
The increasing range of non-audit services provided by the big four professional services firms is being watched carefully by the regulators. The Public Company Accounting Oversight Board (PCAOB) in the US, which was set up under the Sarbanes-Oxley Act, said: “Audit independence and audit quality could be threatened by the growth of the advisory and consulting services at the largest audit firms.”

The European Commission wanted to drastically limit non-audit services provided by auditors: it was persuaded to go for ‘mandatory rotation’ of company audit mandates instead. This was in part due to the fact that only the large audit firms are equipped to audit the largest multinationals.

“Audit independence and audit quality could be threatened by the growth of the advisory and consulting services at the largest audit firms”

PCAOB

There is a dispute between two leading barristers (Martin Moore QC for the FRC and George Bompas QC for the Local Authority Pension Fund Forum (LAPFF)) on whether the true and fair view principle could conflict with some international accounting standards. Bompas considers that the international standards use the ‘useful’ objective rather than the true and fair one. This particularly applies to calculating the amounts that may be used to pay dividends.

Comment – This dispute arises out of the introduction of IFRS 9 Financial Instruments, which the LAPFF wants the EU Parliament to refuse to endorse.

The Statutory Audit Directive requires, among other things, that all Public Interest Entities (PIEs) should have audit...
committees that are sub-committees of the board, made up only of independent directors for larger entities. PIEs include listed companies, credit institutions and Solvency II insurance companies. The PRA consultation (closing on 18 December) also describes the functions of the audit committee, such as monitoring the effectiveness of its risk management systems. The new requirements will apply to financial years starting on or after 17 June 2016.

ESMA has published a consultation on the draft technical standards on the ESEF. These are to be used for annual financial reports under the Transparency Directive. It is proposing both a structured and a non-structured data format appropriate to different parts of these reports. Structured data is machine readable with embedded coding and published in XBRL or iXBRL. ESMA proposes a taxonomy to classify financial information but notes that this may cause problems for narrative reporting. Therefore the entire report should be provided in PDF format, with the exception of consolidated accounts prepared under International Accounting Standards regulation, and annual accounts of issuers if permitted or required by national laws.

The FRC has published draft guidance for consultation (closing 15 January 2016) on a going concern basis and on accounting and reporting on solvency and liquidity risks for companies that do not apply the UK Corporate Governance Code. This includes factors for consideration, the assessment periods, reporting requirements, and guidance for companies that have half-yearly accounts or make preliminary announcements.

34. TAX DEVELOPMENTS
There have been some major developments over the last three months. Here are some of them:

FINANCIAL TRANSACTION TAX (FTT)
The German Finance Minister, Wolfgang Schäuble, has joined France and the European Commission in resurrecting the FTT for bond and stock transactions. There are currently 11 countries wanting to proceed. At a recent meeting Pierre Moscovici, European Commissioner for Economic and Financial Affairs, said: “We made important if not decisive progress [on the FTT]. This deal is possible, and more than possible, if we go on working with ambition.” Britain has protested that non-participating EU countries will need to collect the tax on behalf of the ones which are participating. The question therefore is whether the 11 countries who want it can agree on how it will work and, if so, whether the others are willing to let them do so.

“We made important if not decisive progress [on the FTT]. This deal is possible, and more than possible, if we go on working with ambition.”
Pierre Moscovici
European Commissioner for Economic and Financial Affairs

THE UK ‘NON-DOMICILED’ RULES (NON-DOMS)
The Chancellor announced the abolition of permanent non-dom status in his post-General Election Budget. The Treasury has now published a consultation on these rules. While the consultation follows the core proposals, some of the detailed rules are less onerous than expected, for example that when offshore trusts have been set up before the non-dom has lived in the UK for 16 years when he or she would become domiciled here, the income or gains from the trust would remain outside the worldwide tax basis unless a family member benefited.

CORPORATE TAX REFORMS
The OECD, grouping the finance ministers of more than 60 countries, has agreed to crack down on businesses using the gaps in double taxation treaties to shelter profits in low-tax jurisdictions. The new rules, called ‘Base Erosion and Profit Shifting’, are designed to close loopholes and restrict the use of tax havens (the OECD estimates that $100 to $240 billion could become subject to normal taxation as a result). There will be changes to the ‘permanent establishment’ rules under double tax treaties and the ‘transfer pricing’ rules will be tightened, so that more profits will be taxed in the country where the relevant sales are generated, businesses will disclose sales in each country, and profits attributed to ‘paper’ offices and perhaps some intellectual property will no longer be deductible. The OECD will revise its model double tax treaty to avoid many bilateral negotiations.

Comment – The OECD has described the agreement between the finance ministers as a ‘sea change’. Affected cross-border businesses are already considering how to restructure. This includes financial services companies which may operate a single global booking centre for particular business lines. Some EU trade bodies (the European Fund and Asset Management Association and the Alternative Investment Management Association) have warned the European Commission in response to its consultation that requiring higher standards of corporate tax transparency could encourage firms to go elsewhere, and may contain confidential information.

• Common Reporting Standard regulations. Both the OECD and the UK’s HM Revenue & Customs have issued guidelines on these, which will be important for relevant firms
• Global Legal Entity Identifiers (LEIs). The regulatory Oversight Committee of the Global LEI System (GLEIS) has issued a consultation (closed) on collecting data on the direct and ultimate parent of legal entities in the GLEIS. It recommends that an LEI should report its “ultimate accounting consolidated parent”, which is defined as the highest-level legal entity preparing consolidated financial statements in addition to its “direct accounting consolidated parent”. This information should be available both to regulators and to market participants. The reporting is to Local Operating Units (LOUS) of the GLEIS which will be responsible for verifying the relationship information based on public documents if available.

Comment – LEIs are essential under the Foreign Account Tax Compliance Act and in future under transaction reporting. The separate requirement that governments maintain registers of the ultimate owner of companies in their country will assist the LOUs.

35. THAT EU DATA PROTECTION COURT JUDGMENT
The recent CJEU decision that the US-EU Safe Harbour agreement did not automatically enable data to be transferred to the US from the EU has caused dismay and some alarm among firms who do this directly, or who use outsourcers who do so. Under the judgment, it is up to each national data protection authority to decide if the recipient gives equivalent protection to EU law. The fear is that the data will be available for US security agencies following the Edward Snowden revelations. It is now up to the relevant national agency to decide if Ireland’s Data Protection Commissioner must investigate Max Schrems’ case fully and whether to suspend data transfers. All eyes are on Ireland.
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Part two – Private wealth management/Retail

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SECTION A – PRIVATE WEALTH MANAGEMENT

1. FINANCIAL ADVICE MARKET REVIEW (FAMR)

The FAMR, a joint review between the Financial Conduct Authority (FCA) and Treasury, was announced at the beginning of August. Subsequent to this, the Expert Advisory Panel has been appointed, chaired by Nick Prettejohn, Chairman of Scottish Widows Group. It has representatives from asset managers, independent financial advisers (IFAs) and consumers. The Wealth Management Association has criticised it for the lack of traditional wealth manager representation.

The Treasury has published its Terms of Reference, which include objectives and scope which are necessarily broad in their coverage. Objectives include an examination of the ‘advice gap’, and regulatory and other barriers firms face in giving advice, and how to give firms the regulatory certainty and right environment to grow and innovate. Also covered are opportunities and challenges presented by new technologies and how to encourage a healthy demand for financial advice.

Its scope includes consideration of the current regulatory and legal framework governing the provision of financial advice and guidance to consumers. The Financial Ombudsman Service (FOS) and Financial Services Compensation Scheme (FSCS) are also covered, and the role and interplay between these and the overall regulatory framework are included. There is also specific mention of the investment, pension (including annuities), mortgage and general insurance markets.

The expected output is a package of reforms to empower and equip all UK consumers to make effective decisions about their finances, facilitate the establishment of a broad-based market for the provision of financial advice to all consumers, and create a regulatory environment which gives firms the clarity needed to compete and innovate to fill the ‘advice gap’. In addition, the proposed outputs also cover the regulatory perimeter, regulatory carve-outs such as ‘safe harbours’ and the proportionality of rules and their impact on affordability.

The FCA’s call for input (see this section, p. 26) specifically asks for views on certain measures to address the ‘advice gap’. These are limiting certain liabilities through introducing safe harbours such as longstop limits on long-term advice – so after that date the FOS could not consider complaints; and on the regulatory environment for automated advice (including consumer issues) that can provide low-cost services (see Robo-advice, p. 26 of this edition).

Association of Professional Financial Advisers (APFA) research suggests that, on average, an adviser firm spends 12% of its revenue on regulation – 3% on direct fees and 9% on indirect costs. The sector is estimated to pay £460 million on regulation, with the average client paying £170 towards the cost of the FCA. This has led a group of MPs to present an early day motion to the Commons asking for the FCA to freeze its fees for advisers for two years.
Such changes may have a commercial as well as regulatory impact on firms, and this review should be seen in its wider context and not just as a compliance issue.

**Action** – This is a significant review that has the potential to produce wide-ranging and radical change. Such changes may have a commercial as well as regulatory impact on firms, and this review should be seen in its wider context and not just as a compliance issue. Firms wishing to send comments for consideration must do so by 22 December. The FCA has published a call for input on issues which will be considered under the FAMR giving firms and trade bodies the opportunity to make their points informally.

2. ROBO-ADVICE

There has been a significant, and increasing, amount of press around robo-advice, and the regulator has also made various statements as well. Interestingly, there is no single or even general consensus view on what robo-advice actually is. Perhaps the best description is “a technology driven process that enables a client to receive regulated advice without the intervention of a human adviser”. While firms grapple with how this can be done from a regulatory and technical point of view, there are a few key questions that need to be addressed and answered before this becomes a mainstream activity. The FCA says the definition of advice remains the same regardless of how it is delivered. In January this year the FCA published FG 15/1 to clarify the boundaries of what advice means – which ran to more than 40 pages. Understanding and translating this into a useable and efficient process without exceeding those boundaries may prove to be the biggest challenge.

The FCA says the definition of advice remains the same regardless of how it is delivered.

**Comment** – The FCA has indicated that it would like to help facilitate innovation in this area, but previous actions and subsequent guidance and comments may present some inherent conflicts and potential unfairness. Largely following on from FG 11/5 ‘Assessing suitability’, firms have invested a lot of money, time and energy in updating their client take-on processes, reviewing client files and training staff in the face-to-face arena. If concessions are made to allow simpler processes in the robo-advice arena, more traditional firms may be left wondering why they bothered. Higher standards being expected of face-to-face advisers would also create a two-tier system of advice and have commercial consequences for firms invested more directly in clients.

Reconciling previous statements with robo-advice is also a challenge, as seen in comments from the FCA such as “don’t have any template objectives in suitability reports” and, in respect of risk-rating tools: “The tools are tools. If they gave the right answer they would be called machines.” Further, an FCA commentator has said that the ‘black box’ approach of inputting client information into a tool and relying on an answer coming out the other end is “fraught with risk”. Squaring this circle with robo-advice is not going to be easy. Perhaps the rules need some radical updating for the new reality of the digital age.

**Action** – Firms looking at robo-advice or the implications for their own business need to look closely at a wide range of issues. While there are clear compliance and risk implications, the issues go much further and there needs to be a broader, business-wide view taken.

3. THE FCA LOOKS AT THE FSCS LEVY ON IFAs

The FCA is reviewing the method of allocation of FSCS levies between the different industry categories. The Chairman of the FCA, John Griffith-Jones, said to the Commons Treasury Committee: “Since the financial crisis, talk about the FSCS has been dominated by bailing out banks, but in normal times we don’t expect it to bail out the banks. So when we do our review, we will have to concentrate much more on fairness to IFAs than when the FSCS was reviewed last time.” Tracey MacDermott, Acting Chief Executive, FCA, said: “One of the biggest problems of the FSCS levy is that it is lumpy and unpredictable… The good guys are funding the problems caused by the bad guys.”

**Comment** – The FCA has indicated that it would like to help facilitate innovation in this area, but previous actions and subsequent guidance and comments may present some inherent conflicts and potential unfairness. Largely following on from FG 11/5 ‘Assessing suitability’, firms have invested a lot of money, time and energy in updating their client take-on processes, reviewing client files and training staff in the face-to-face arena. If concessions are made to allow simpler processes in the robo-advice arena, more traditional firms may be left wondering why they bothered. Higher standards being expected of face-to-face advisers would also create a two-tier system of advice and have commercial consequences for firms invested more directly in clients.

When we do our review we will have to concentrate much more on fairness to IFAs than when the FSCS was reviewed last time

JOHN GRIFFITH-JONES
CHAIRMAN, FCA

4. APRIL 2016 ‘SUNSET CLAUSE’ FOR PLATFORMS

FCA rules on how platforms are paid come into force on 6 April 2016, but they will also have knock-on effects for advisers, managers and clients. From 6 April, platforms will not be allowed to retain rebate revenue from fund companies which must all be passed to clients in the form of (taxable) unit rebates. This means that in most instances, platforms will be unable to pass ‘commission’ or ‘trail’ to firms because this was paid from the rebate. Clients may also be affected to the extent that they will now be paying platform charges as well as being left in trail-paying funds, without receiving any direct or indirect benefit from being in trail-paying classes producing taxable income.

**Comment** – For many advisory firms, the changes will see the end of trail commission they receive via platforms, and the resulting drop in revenue may affect the viability of those firms that have not acted to make new arrangements with their clients. Some commentators have suggested that this will have a greater impact on adviser numbers than the Retail Distribution Review (RDR). (Nucleus estimates that advisory firms could see their profits drop by half.)

For many advisory firms, the changes will see the end of trail commission they receive via platforms, and the resulting drop in revenue may affect the viability of those firms that have not acted to make new arrangements.

**Action** – Firms, including platforms where appropriate, should review the position of their clients and ensure that they are not disadvantaged by the changes. In many cases this will involve moving the clients...
generally – both for firms that give advice or manage portfolios and for those that do not.”

David Greale
Director of Policy, FCA

Comment – Firms planning for and implementing the MiFID II requirements are also hampered by a lack of detail in certain areas. The requirements on distributors with respect to product governance and costs and charges disclosure would benefit from further guidance and clarification, so that firms can make progress with processes and IT systems development in particular. The timeline for the publishing of detailed rules will leave firms, particularly small and medium-sized ones with fewer resources and with little time to make the final changes required.

Action – It is early days with regard to establishing a trend on how the Ombudsman will assess these cases. What is important is that firms have a clear and consistent view on how they expect their advisers to approach these cases.

Some networks are willing to accept these insistent clients in certain circumstances, whereas others will not accept them at all.

7. FG 15/10 – RISKS TO CUSTOMERS FROM PERFORMANCE MANAGEMENT AT FIRMS

This guidance, published by the FCA at the end of July, follows the March consultation looking at how performance management practices in sales areas within firms dealing with retail clients operate and how this may affect behaviour. While not identifying widespread issues, the FCA has identified instances of poor practice that could lead to client detriment. It noted that poorly executed performance management can encourage or drive misleading behaviour because of pressure to meet targets and/or corporate objectives. Interestingly, the FCA identified middle managers as being most likely to have to

The FOS has always taken the line that any outcome would depend on the facts of the particular case and perhaps these cases are evidence of this. The decision on the rejected complaint made several references to the words used, which appear to provide strong evidence that the client is insisting in the face of a clear statement of contrary advice and the consequences.

Comment – It is interesting to note that some networks have been willing to publicly state their stance on insistent clients. Some networks are willing to accept these insistent clients in certain circumstances, whereas others will not accept them at all. In itself, this is a strong indication that the current rules and guidance are not clear, and regulatory bodies may wish to consider this and the effect it may have on clients. Indeed a member of the Commons Treasury Select Committee (Mark Garnier) has asked the FCA to clarify its position on insistent clients, in particular the distinction between guidance and advice.

Some networks are willing to accept these insistent clients in certain circumstances, whereas others will not accept them at all.

The timeline for the publishing of detailed rules will leave firms, particularly small and medium-sized ones with fewer resources and with little time to make the final changes required.

Action – Firms should have a reasonable plan in place to deal with the changes required by MiFID II. This will need to identify what work can be done now, eg, in relation to inducement policies and procedures, and build in flexibly wherever possible to take account of detailed requirements as they become available. Regulators are likely to take a more favourable view of firms that have acted reasonably and on a ‘best endeavours’ basis than not at all.

6. INSISTENT CLIENTS

Recent decisions from the FOS have provided mixed evidence of how these types of cases will be dealt with and decided.

In a case involving Lighthouse Advisory Services (the advice was given in 2006), the Ombudsman rejected a complaint where guaranteed pension benefits were transferred but the adviser had made clear this was against advice; on the other hand, the complaint was upheld in another case involving a self-invested personal pension (SIPP) and a low-risk client investing in a high-risk investment within this, despite the IFA claiming that the client had already decided where they were investing. Based on what it saw, the Ombudsman decided that the client was “neither a sophisticated investor nor an insistent client”.

Equally as important is the fact that MiFID II will refocus our attention on inducements more generally – both for firms that give advice or manage portfolios and for those that do not.”

David Greale
Director of Policy, FCA

Comment – For independent advisers, these new inducement rules are toughened in inducements. Under MiFID II level 1, the inducement rules are toughened generally – both for firms that give advice or manage portfolios and for those that do not.”

David Greale
Director of Policy, FCA

Comment – Firms planning for and implementing the MiFID II requirements are also hampered by a lack of detail in certain areas. The requirements on distributors with respect to product governance and costs and charges disclosure would benefit from further guidance and clarification, so that firms can make progress with processes and IT systems development in particular. The timeline for the publishing of detailed rules will leave firms, particularly small and medium-sized ones with fewer resources and with little time to make the final changes required.

Action – Firms should have a reasonable plan in place to deal with the changes required by MiFID II. This will need to identify what work can be done now, eg, in relation to inducement policies and procedures, and build in flexibly wherever possible to take account of detailed requirements as they become available. Regulators are likely to take a more favourable view of firms that have acted reasonably and on a ‘best endeavours’ basis than not at all.

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Action – It is early days with regard to establishing a trend on how the Ombudsman will assess these cases. What is important is that firms have a clear and consistent view on how they expect their advisers to approach these cases.

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manage conflicts of interest, eg, where they have to balance sales results against other objectives such as sales practices.

The FCA identified middle managers as being most likely to have to manage conflicts of interest, eg, where they have to balance sales results against other objectives such as sales practices.

**Action** – Firms should be clear about how their overall sales practices, and specific requirements within these, may potentially influence and drive inappropriate behaviour. There should be evidence that this has been considered and action taken where necessary to control or eliminate poor outcomes for clients.

8. **FSCS CLAIMS RELATING TO TAX ADVICE**

The FSCS has obtained legal advice on the complex issues surrounding advice on tax-related claims. It would appear that the question was whether the FSCS could cover such schemes. While the primary purpose of the advice may be tax mitigation, where this involves the use of an investment such as film partnerships, the answer appears to be ‘yes’. Having taken some considerable time to resolve the complex issues surrounding this, the FSCS will now start to consider claims.

**Comment** – Firms should be very much aware of the risks and obligations involved when giving advice on tax mitigation that involves investments. Many investments will be unregulated, but FSCS coverage will apply whether they are regulated or not. If other professionals are involved in giving tax advice, firms may wish to consider how they manage liability and clearly document the split between the parties involved.

9. **ALL CHANGE IN THE INITIAL DISCLOSURE DOCUMENT**

The FCA has published a consultation on the Initial Disclosure Document. It is concerned that the template leads to information being duplicated and has too much of a ‘tick box’ approach, discouraging firms from considering how their disclosures of services and costs can best be made. The template is therefore to be removed. However, firms can continue to use it if they wish – but without the ‘keyfacts’ logo.

**Comment** – The FCA has given somewhat mixed messages about client disclosures – on the one hand saying that they should be simpler, and on the other that they must be appropriate. This consultation could be seen as a development of the second approach.

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10. **THE NAO STUDIES FINANCIAL SERVICES MISSELLING**

The National Audit Office (NAO) has announced a study into misselling. It will consider how well the FCA, the FOS and the FSCS work together to detect problems in misselling and consumer redress; examine how the FCA regulates firms to prevent or reduce this; and analyse whether the regulatory regime provides the right incentives to prevent misselling, and how it identifies and responds to these risks. The NAO plans to publish its report in Q2 2016.

11. **FCA BANS AND FINES ADVISER FOR SIPP AND CONFLICTS OF INTEREST FAILINGS**

The FCA has fined a third director of Tailormade Independent, Robert Shaw, for failing to ensure suitability of investments for its clients and for not identifying and managing the conflicts of interest. Shaw was also banned from holding senior positions in financial services.

Tailormade advised clients to invest in a number of unregulated investments including green oil, biofuels, farmland and overseas property. Many were not permitted by the client’s SIPP provider. Shaw also benefited financially by being a director and shareholder of Tailormade Alternative Investments, an unregulated introducer referring clients to Tailormade. He also failed to act on advice from external compliance consultants about the conflicts involved.

**Action** – Alternative investments have some inherent risks that all firms should acknowledge and address. Firms should actively obtain and address all conflicts of interest their advisers may have, both internally and with clients. MiFID II will increase the requirements of dealing with conflicts. Lastly, firms may wish to take account of the risks presented by the regulatory interest that surrounds alternative investments and conflicts.

12. **HIGH COURT OF IRELAND CASE, DEIRDRE EARLS V FINANCIAL SERVICES OMBUDSMAN**

In this case the FSO had found against the client, Deirdre Earls, with respect to a policy of insurance on her home insurance policy. The case revolved around failure to disclose. What is interesting is the general findings of the judge in this case, who found in favour of the client and considered the FSO to have erred in law on five grounds.

What is clear is that the court expected the FSO to take account of established case law and highlighted where it had failed to...
do so. Where it did do so, it applied a very narrow interpretation that did not look at the wider issues. Lastly, it would appear that where a legal issue was interpreted, in this case ‘utmost good faith’, it was not balanced and considered that the requirement works both ways.

The judge also made an interesting comment about the role of the FSO: “Because it falls to the court to review decisions of the Financial Services Ombudsman and because the court sometimes finds fault with those decisions, there is perhaps a risk that Ombudsman and court may sometimes be perceived as being opponents. The truth is very different. Both are engaged in the late and justice ‘business’, and certainly this court freely acknowledges the public good served by the office of the Financial Services Ombudsman in ensuring that financial services law and regulation is observed.”

Comment – While not directly related to wealth management, firms may take some comfort from the way that the judge has viewed the duties of the FOS in this case.

13. FCA FINES AND BANS KEYDATA’S FORMER FINANCE DIRECTOR
On 22 September the FCA fined former Keydata Finance Director Craig McNeil £350,000 and banned him from performing any significant influence function in relation to any regulated activity. He was judged to have failed to comply with Statements of Principle 4 and 6 of the FCA’s Code of Practice for Approved Persons. Keydata products, sold mainly through IFAs, were underpinned by investments in bonds issued by Luxembourg-based Special Purpose Vehicles (SPVs), which in turn invested in life settlement policies. One of the SPVs, SLS Capital SA, failed to make payments to Keydata, which used its funds to make income payments to investors, thus masking problems with SLS and performance of the investment portfolios. The failure of Keydata led to large levies by the FSCS on firms to cover compensation paid to its clients.

Comment – Notwithstanding the personal failings, funds with complex internal structures, and with reduced transparency, may present risks that it is difficult for advisers and investment managers to quantify and track. While the actions of the individuals involved fell short in this instance, the question of whether this was as likely to happen in a less complex and more straightforward structure or mainstream fund is not something compliance officers or investment professionals can or should ignore when assessing the risk of investing.

14. WORTHING & ANOR V LLOYDS BANK
This High Court case, decided on 8 October 2015, involves clients claiming negligence, breach of contract and breach of statutory duty (specifically Conduct of Business Sourcebook (COBS)) against Lloyds Bank for losses on bad advice on an investment. It is interesting for a number of reasons: firstly, it confirms that these types of claim are time-barred by statute (in this case the clients relied on subsequent advice because the original advice was given more than six years before the start of proceedings); secondly, the judge took great care to examine all aspects of what happened between the two parties, including fact-finding documents, internal notes, terms of business and warning statements, both at the time of original advice and subsequently; thirdly, the judge took the time to look at various COB and COBS rules, not just suitability, including COB 2.1.3R (client communication), COB 5.2.5R (sufficient information about clients), COB 5.4.3R (client understanding of risk), COBS 2.1.1R (client’s best interests) and COBS 2.2.1R (provision of appropriate information).

The judge found in favour of Lloyds based on the facts of what he saw. Despite the client’s claims to the contrary, the judge said: “They understood that it was a medium-risk investment, they knew what that meant and they knew what they were getting.”

Action – This case is a welcome reminder that good quality documentation and a robust process will stand up to scrutiny and protect firms and clients alike.

15. SNIPPETS/IN BRIEF
- The Small Business, Enterprise and Employment Act 2015 (Commencement No 2 and Transitional Provisions) Regulations 2015 (SI 2015/1689), consequentially amends section 87 of the Financial Services Act 2015 relating to complaints schemes of the FCA and the Prudential Regulation Authority (PRA) (for complaints against the regulators themselves). The amendment requires the Office of the Complaints Commissioner to produce and publish an annual report, including any recommendations for how the regulators’ complaints-handling procedures could be improved.
- On 7 September the EC published a ‘roadmap’ on its forthcoming green paper on retail financial services and insurance. The aim of the paper is to consult with stakeholders on the obstacles that providers and consumers face when offering or purchasing financial services across the European Union (EU). Concerns cover fragmentation of the market and lack of cross-border activity.
- There is a debate taking place in the US with government departments pushing for a fiduciary duty to be imposed on retirement advisers which would effectively ban commission. Current rules require advice to be suitable, but this does not prevent commission being received or more suitable products being recommended. The application of a fiduciary standard would effectively require advisers to put their clients’ interests first and provide independent and impartial advice. It is being strongly opposed by firms and advisers who claim that it will increase costs and disenfranchise lower-value clients. Sound familiar?
- The FCA has finalised its new rules on dealing with complaints. From 26 October 2015 the cost of calls for clients making a complaint is limited to the basic rate. From 30 June 2016 the ‘next business day’ rule for complaint resolution is extended to three days to allow firms to deal with complaints less formally. On the flip side, all
complaints, including those dealt with inside the three days, must be reported. Firms should ensure they understand, and are prepared for, the changes.

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• Social investment tax relief was introduced in last year’s Budget and provides tax breaks (eg, 30% income tax relief) to investors in projects and schemes run by charities, social enterprises and community groups that would otherwise have to use other sources of private finance. There are strict rules on how money can be paid out from the schemes and there is little in the way of track record. While these investments are attractive to philanthropically minded investors, the investment risks should not be underestimated or ignored when it comes to suitability within a client portfolio.

• On 27 August 2015 the FCA published a suggested template for firms to use to submit their individual and group recovery plans. This can be used by firms subject to the requirements in the Prudential Sourcebook for Investment Firms (IFPRU) 11.2.7R and IFPRU 11.3.9R, though it is not compulsory.

SECTION B – PENSIONS

1. PENSIONS ADVICE OVERVIEW

The big events in the last three months are the finalisation of the FCA’s rules on pension transfer advice, particularly where clients must take advice before moving their money to use the new pension freedoms made by the Chancellor in spring’s Budget (see next article) – the first evidence of how pensioners are using their new freedoms; and the potential next big step in the pensions revolution – this time focusing on contributions and how they are taxed. All these important developments and others are discussed in more detail in the following paragraphs.

There is a mixed picture on pensioners cashing in their pension funds under the new freedoms. First estimates suggest that more than £1.8 billion was withdrawn from pension funds in the first two months, of which a quarter was used on cars and holidays. However, data from some major providers suggests that the surge may be waning, with pensioners investigating a more diverse range of options – such as reinvesting in specifically designed retirement funds. Providers, however, appear to be struggling to cope with the demand – one said it had refused more than a thousand customer requests for partial withdrawals, blaming the complexity of the process and heavy pressure on staff. There are only small indications of the regulator’s attitude to delays – but it is likely they will respond to multiple complaints. Meanwhile, pension fraud has trebled after the changes. City of London Police data for reports made to them shows that losses from pension liberation jumped 235% in April to £1.4 million (victims are often not warned of significant tax charges and are sold bogus or high-risk investments).

The FCA has published a report setting out the results of its recent data collection exercise. This covers: the scale of access by consumers, the financial advice requirements firms place on consumers, and their approach to consistent customers (61% accept these in “certain circumstances” and 30% refuse to accept any transfer requests from clients that do not listen to advice); the current pension transfer process (including firms’ views on how it can be improved, for example, under the Australian example of requiring employers to submit data and payments electronically in a consistent and simplified manner); and exit charges that firms levy on consumers.

The Chancellor announced in his summer Budget that he was open to “radical change” in the taxation incentives given to pension contributors. As a start he would restrict these incentives for those paying the 45% rate of tax. He would also consider introducing a new way of saving, under which there would be no tax relief on contributions but payments out of the fund would be tax free – reversing the current structure. This is driven by the ever-growing cost of tax relief on contributions (currently about £40 billion a year) and that this is disproportionately taken up by high earners. There are at least three ideas in discussion: (a) reversing the tax on contributions – ‘pension ISA’ – described earlier (perhaps with limits on tax-free sums paid out and even Treasury support for the lowest income earners), (b) simply limiting tax incentives on contributions to a flat rate – not the individual’s marginal rate – in the interests of equality, and taxing funds and payments out of them as now (including the 25% tax-free lump sum), or (c) making no change to the current system. Next steps: it is likely that the Chancellor will either make an announcement on his decision in the Autumn Statement, or launch a white paper in the spring 2016 Budget.

He would also consider introducing a new way of saving, under which there would be no tax relief on contributions but payments out of the fund would be tax free

Comment – Some critics point to the relative ease of setting up a pension master trust, which can take transfers from the original provider or fund and then invest in the doubtful investments.

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There are some important points arising from the FCA’s June Policy Statement on transfers receiving advice before transferring funds, which is still causing industry concern. These include: the expansion of the requirement, from final salary transfers, for obtaining advice from a fully qualified pension transfer specialist where transfers are made from money purchase schemes where guaranteed benefits are being surrendered (unless the fund value, including guaranteed rights, is less than £30,000) – some providers are insisting that all transfer and cash-in

Comment – This proposal could be radical or change little – it is too early to tell. The total cost to the Government may well determine the answer, with the Government cutting the deficit. This suggests that there will be change in any event; the only question is whether it will be radical, or simply at the margins.

2. TRANSFERS – AND THE FCA’S FINAL RULES ON ADVICE

There are some important points arising from the FCA’s June Policy Statement on transfers receiving advice before transferring funds, which is still causing industry concern. These include: the expansion of the requirement, from final salary transfers, for obtaining advice from a fully qualified pension transfer specialist where transfers are made from money purchase schemes where guaranteed benefits are being surrendered (unless the fund value, including guaranteed rights, is less than £30,000) – some providers are insisting that all transfer and cash-in
requests should be on an advised basis; the ability of ‘restricted advice’ advisers to provide this advice (as well as ‘independent’ ones – though there is the qualification requirement described earlier); the need for firms to have a transfer advice permission where benefits are being crystallised; and the problem of ‘insistent’ clients (which is described in more detail earlier in this section in 'Insistent Clients', p. 27).

Case law on responsibility for delays in meeting clients’ requests for drawdowns is beginning. In one case, the Pensions Ombudsman decided that two providers (Axa and St James’s Place) should pay the client compensation because of a two-month delay in meeting its request – which they each blamed on the other.

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Comment – The essence of this statement is helpful. However, the practice (including the approach of FOS) will be all: further, the boundaries may shift under the FCA’s review of the transfer value rules (“We are keen to explore the options for reviewing the TVA [transfer value analysis] methodology in the light of pension flexibilities, and will seek input from stakeholders in this process”), and of the FAMR more generally (see article ‘Financial Advice Market Review’ earlier in this section on p. 25), later this year. In the meantime firms and advisers are faced with taking great care in providing advice and providers in making transfers.

3. THE DIFFICULT QUESTION OF PENSION ACCESS AND ITS COST

Some pension providers have either delayed or not given policyholders full access to their fund, eg, to multi-access drawdowns. The Secretary of State for Work and Pensions, Iain Duncan Smith, is not happy with this, and has said: “We will not hesitate to take action to ensure that consumers get a good deal, and if we have to, we are prepared to name and shame those companies who are putting barriers in the way of people getting access to their money. It is your pension, and it should be in your hands. I am determined that those who have saved should not remain handcuffed.” However he has some sympathy with companies with insufficient IT systems, which can expect some flexibility.

Pension providers have long dealt with policyholders being persuaded by doubtful advisers to cash in part or all of their pension pot – even before the new freedoms, these advisers focused on over 55s’ lump sum drawdowns; now those younger than 55 are better able also to do so. The fear is that the pension holders are being scammed. One provider said: “There is still a demand for both and it is the vulnerable who are targeted. They are not aware of the tax charges nor the fees. They are convinced [by the scammer] that there is a loophole in the law that will avoid massive tax charges but there is no loophole.” Industry estimates are that the annual volume of this is about £500 million. Hundreds of transfers are blocked by providers each year for this reason.

A further regulatory angle on access is the claim by consumers that they are required to pay high exit charges to providers for transfers or cashing in a pension early (now that over 5% have the right to do so) – of up to 20% of the value. The industry responds that these arise under a small minority of old pension policies – perhaps 10%. The Government is concerned about these charges, and the Chancellor has said that it will consult on them, perhaps capping them. There is controversy as to whether the FCA does not already have sufficient powers to curb any unfair practices. The Association of British Insurers said: “We agree that further clarity is needed and have been calling for it for some time. But we reject any suggestions that the industry is putting up unnecessary obstacles to hinder customers exercising their pension options.”

The claim by consumers that they are required to pay high exit charges to providers for transfers or cashing in a pension early

4. FACT-FINDING FOR PENSIONS

Comment – One consequence of the pensions revolution has been to change the basic approach to fact-finding in financial planning, and pension decisions in particular. In the past this was driven by the rules determining what pension contributions and payments were available: now by the customer’s circumstances and ambitions. So there is an extra element to the normal suitability questionnaire – to find out more about their present and future expenditure and income, and to work out with them how much money they need in order to lead the life they want. This is going to require a lot of soft skills for which training may be needed.

5. SOME SIPP OPERATORS MEET PROBLEMS

The number of complaints to FOS against SIPP operators increased by a third during Q2 of the 2015/16 year. However, they were still at a low level – from 210 to 281. Less, however, went to the Ombudsman. In March 2015 the FSCS issued a £20 million interim levy for pension and life advisers arising out of them. The increase in complaints could cause another levy.

Better news for SIPP operators is that the Pensions Ombudsman has ruled that the pension provider had no duty to verify the suitability of investments chosen by a member under either its statutory duty of care as trustee or under FCA rules. The member (Goodwin PO-7436) invested through the SIPP in an unregulated collective investment scheme that later failed. The provider had warned the member and his agent that the investment was unregulated and that he should seek professional advice. Later FCA unregulated collective investment scheme guidance could not apply since the investment had already been made.

6. IS COMMERCIAL PROPERTY A ‘STANDARD’ ASSET FOR SIPPS?

The confusion over whether SIPP operators can treat commercial property as a ‘standard’ asset has been clarified by the FCA. It will change the way that firms report quarterly valuations through them being entitled to rely on valuations provided to members rather than apply the 30-day transaction rule. The Quarterly Consultation said: “For a UK commercial property, the asset should be considered to have been realised at the point that the Land Registry is formally notified. In addition to this, we clarify that responsibilities and expectations around valuations and due diligence is in line with previous FCA guidance [which generally labelled UK commercial
they are not a product holding a single fund. Meanwhile, the Prime Minister has voiced fears that auto-enrolment could be treated as a product. She is instead focusing on the new RDR, particularly on advice to those with smaller pension pots. He said: “What time is not right to ask the pensions industry to absorb the new swathe of regulation that would be needed to make such further reforms to work effectively”.

Comment – Since the FCA’s 2014 guidance, some firms have treated it as a ‘non-standard’ asset – attracting a higher capital requirement for the SIPP operator. The application of the 30-day rule to commercial property appears to leave room for commercial judgment, which some fear could be swayed by the extra capital requirements for ‘non-standard’ assets.

7. THE ROLLOUT OF AUTO-ENROLMENT FUNDS AND MiFID CONCERNS

The number of enforcement notices of all kinds issued by The Pensions Regulator has reduced considerably since the first stages of the scheme in 2014. Small and micro businesses will be brought into the scheme towards the end of this year. Ros Altmann, Minister of State for Pensions, said: “My message to small and micro employers is to ensure you leave enough time and be clear about what you will need to do to comply. We are here to help – but we will take action if an employer is wilfully non-compliant.”

Meanwhile, the Prime Minister has voiced fears that auto-enrolment could be treated as ‘complex’ funds under MiFID II – because they are not a product holding a single fund. Categorisation as ‘complex’ would trigger the duty of appropriateness.

Comment – No doubt the FCA is talking to ESMA on this subject. Its ramifications for such schemes in other countries in the EU are wide.

In a related development, Altmann has decided against pensions change in ‘defined ambition’, ‘collective benefits’ and ‘automatic transfers’. Her spokesperson said that “the time is not right to ask the pensions industry to absorb the new wave of regulation that would be needed to make such further reforms to work effectively”. She is instead focusing on the new state pension which starts in April 2016.

8. PENSIONS FREEDOMS AND THE FAMR

A leading member of the Commons Treasury Committee, Mark Garnier MP, is asking the Treasury to review the effects of the RDR, particularly on advice to those with smaller pension pots. He said: “What is happening is that there are a lot of people out there with £10,000 or £20,000 pension pots and these are the people that really need help on this.” He cited the so-called ‘advice gap’ which the FAMR is addressing – see the article, ‘Financial Advice Market Review (FAMR)’ earlier in this section on p. 25.

9. SHOULD THERE BE A EUROPEAN PENSION PRODUCT?

As EU governments overhaul their pension regimes to absorb the aging population and introduce mandatory pension contributions, the EC and the European Insurance and Occupational Pensions Authority (EIOPA) wonder about creating a regime and a pension for long-term investments which would both be available in and portable across the EU, and provide a low-cost, diversified savings vehicle for EU citizens. The example of Undertakings for Collective Investments in Transferable Securities has encouraged them. EIOPA published a consultation paper (which ended in October) which proposes a harmonised legal framework for an internal EU market for a so-called standardised Pan-European Personal Pension Product. The idea is that this product would not require advice – it would be a direct-to-consumer one. The UK industry has given this initiative a lukewarm reception, wondering whether there is room for this as well as for national regimes. They doubt the demand, and fear complexity.

Comment – It is easy to see the barriers to this product – particularly the different national tax treatments. However, the EU has a point. In the EU there are about 32,000 mutual fund products with an average size of €222 million – this compares with the US where there are about 8,000 products with an average size of $1.6 billion. Clearly costs can be reduced and investor choice simplified if there are fewer funds and they are larger: that said, the EC is likely to struggle to gain traction with EU governments to give priority to this over their own plans. This concept has been linked with the EU’s Capital Markets Union proposal – a simple cost-effective cross-border pension plan that is easy to buy without advice and supervised by public bodies.

In parallel the Organization for Economic Cooperation and Development (OECD) has a less-ambitious project to update its Core Principles for regulation of private, personal and occupational pensions, particularly with the increase in personal pension plans. The updated principles cover such matters as adequate, transparent and coherent legal, accounting, technical, financial, managerial, and, above all, governance, requirements.

Comment – The principles are, of necessity, high level but contain enough detail in them to enable the OECD to challenge governments under them. For example, the OECD has called upon the UK to reconsider its flexible access policy.

SECTION C – RETAIL

1. OVERVIEW OF REGULATORY RETAIL BANKING CHANGES

The most important trend during this period is the debate over how traditional banks should meet the challenge of the digital age we are entering. A recent KPMG report said: “Banks must adapt or die. Mobile banking is clearly supplanting all other channels as the main portal between the bank and the customer.” There are many aspects to this, including: the closure of bank branches; the impact on the digitally excluded; the breaking of human contact between bank and customer; the likely increasing portability of bank accounts; the rise of credit and debit cards leading to cash being used less and the separation of payment systems from banks. From a regulatory perspective, there is political pressure on banks to maintain branch networks, regulatory pressure to invest in reliable technology (to prevent the problems RBS and HSBC customers have suffered in accessing cash) and protect private data, and prudential regulatory pressure to be profitable. All in all, it is a difficult time for them.

“Banks must adapt or die. Mobile banking is clearly supplanting all other channels as the main portal between the bank and the customer.”

KPMG

The less important regulatory changes are described in the articles below. Other changes in banking regulation generally are covered in the Commercial Banks section of this edition.

2. WHERE NOW FOR THE FCA’S INTEREST RATE HEDGING PRODUCT REDRESS SCHEME?

At the FCA’s Annual Public Meeting in July, Martin Wheatley, Chief Executive at that time, said that there were now a number
of cases before the courts against the FCA or the banks which sold the products. He agreed that the courts were therefore now the correct place for deciding on the FCA’s scheme. He also confirmed that the FCA had not taken any enforcement action against the banks or individuals, although this was possible in the future. In April, Wheatley said to the Commons Treasury Committee that the scheme has delivered “fair and reasonable redress for the vast majority of customers”. The High Court has granted an application for the judicial review of the scheme because it is a matter of strong public interest.

3. SHOULD CHALLENGER BANKS BE HELPPED BY REGULATORS?

The Chancellor certainly wants to encourage newcomers to create more competition for the incumbent banks, which hold 80% of retail and small and medium-sized enterprise bank accounts. Jayne-Anne Gadhia, Chief Executive of Virgin Money – a challenger bank – has been appointed to advise the Government on strategy, and the competition regulators are examining the retail banking market. She speaks of innovation in banking. The big issues for challenger banks are free current accounts, direct access to the payments system and the bank profits tax (which will apply to both established and challenger banks). She has said: “Many customers who think they have free banking often do not. Many suffer penalty charges for breaching terms and conditions. Most carry credit balances that are not paid a fair rate of interest.”

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Many customers who think they have free banking often do not. Many suffer penalty charges for breaching terms and conditions. Most carry credit balances that are not paid a fair rate of interest.
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Jayne-Anne Gadhia
Chief Executive, Virgin Money

Comment – There is also concern about barriers – real and imagined – to switching banks. Paul Pester, Chief Executive, TSB has suggested that “customer data should be put into a credit passport, which can be passed to the new bank”. The chairman of the Commons Treasury Committee has written to the PRA calling upon it to assess whether an 8% surcharge on bank profits above £25 million would hinder competition and reduce lending at retail banks. He also encouraged the PRA to allow smaller banks to have lesser capital buffers.

4. CASH SAVINGS QUESTIONS AND REMEDIES

The FCA’s July Discussion & Consultation paper (consultation now closed) on the cash savings market has opened up a subject of considerable importance to banks and customers – particularly in an era of very low interest rates. The FCA intends to consult on firm disclosure remedies (key information in a product summary box for comparison purposes; guidance on the prominent display of interest rates; changes to notifications) and switching (a prompt and efficient service to enable a customer to switch to another account offered by the same (or another) firm). The Authority will also trial publishing information on the lowest interest rates firms pay on open and closed easy access savings accounts for a limited period. Separately the FCA is working with the industry on delivering seven-day switching for cash ISA accounts from January 2017.

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Comment – The bigger picture is the Competition and Markets Authority’s report on retail banking, which is expected before the year end. This could recommend more radical steps such as limiting the market share of the big retail banks.
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5. THE CAPPING OF CREDIT AND DEBIT CARD INTERCHANGE FEES

The Treasury has launched a consultation on implementing the EU regulation on interchange fees charged to business customers. The regulation permits national governments to set caps below 0.3% and 0.2% for domestic credit and debit card transactions respectively (the UK plans to use these percentages – currently 0.6% to 1.9% in the UK). The Chancellor said: “I expect businesses to pass on these savings to consumers in the form of lower prices.” Some are doubtful this will happen. The comparison site uSwitch said: “This EU cap, due to come into effect from December, was welcomed as great news for credit card users – if savings were to be passed on to consumers.”

Following the consultation, the Treasury published its consultation response on the regulation. This confirms that the fees banks can charge will be capped at 0.3% for credit card transactions and at an average of 0.2% for domestic debit card transactions.

6. PACKAGED CURRENT ACCOUNTS IN TROUBLE

The FOS is receiving a growing number of complaints about packaged current accounts. It is currently running at about a 1,000 new complaints a week, many more than in 2014. Customers normally pay between £5 and £25 a month. The complaints range from the rigid nature of the accounts to the inclusion of benefits
that are not in fact available (eg, travel insurance for older people) or not wanted.

7. REGULATOR REVIEWS ‘UNAUTHORISED’ TRANSACTIONS TREATMENT
The FCA has published a report with the results of its thematic review into the fair treatment of customers who suffer unauthorised transactions. It found that firms generally meet their legal obligation to make good on the customer and they are making efforts to ensure their fair treatment. In particular the review did not find that any firms refused to do so because the customer had not complied with complex security protocols; some account terms and the lack of clear procedures for complex cases were criticised; customers had problems in remembering multiple PINs and/or passwords; and customers much appreciated the provider immediately adopting and maintaining a supportive approach, as well as quick action.

8. THE PRA UPDATES ITS RULES ON DEPOSITOR AND DORMANT ACCOUNT PROTECTION
After the confusion surrounding the change in protected amount from £85,000 to £75,000 (caused by the relative reduction in value of the euro against sterling), the PRA has updated its Supervisory Statement to reflect this. It is also encouraging firms to talk to their supervisors if they have difficulties in meeting the requirements, particularly in notifying their customers of this before 1 January 2016.

The PRA proposed in its July consultation to make further changes to these rules on how firms satisfy the disclosure requirements, the form of the depositor acknowledgement and how it applies to telephone and online banking.

9. WHAT LEGAL DUTIES DO FIRMS OWE TO THEIR CUSTOMERS IN FCA PAST BUSINESS REVIEWS OR REDRESS SCHEME?
The High Court decided in the recent case of Suremime v Barclays Bank that it is arguable that a firm owes a duty of care in tort to customers under such a review or scheme if the firm does not follow the terms of the review or scheme. This case arose out of the FCA’s interest rate hedging products scheme (see article ‘Where now for the FCA’s interest rate hedging product redress scheme?’, p. 32 in this section), under which the customer considered the payment offered inadequate. The agreement between the bank and the FCA specifically excluded giving third parties rights under the Contracts (Rights of Third Parties) Act. However, the judge said the FCA agreement meant that the customer could be owed a legal duty to compensate adequately under the general law of tort. It was only a preliminary judgment.

10. GLOBAL FINANCIAL INCLUSION INCREASES
A report (by the Brookings Institution) on this subject has found that there has recently been good progress in financial inclusion: “Financial inclusion is really taking off. I think we have reached the tipping point.” Around 700 million people have opened accounts. The main reason is the growth of mobile phone-based payment platforms. This development is most pronounced in Africa, particularly Kenya, eg, the M-Pesa service. In some of these countries the government has loosened the regulations on non-bank payment services.

“Financial inclusion is really taking off. I think we have reached the tipping point”

BROOKINGS INSTITUTION

11. OVERVIEW OF CONSUMER CREDIT REGULATION
The most interesting development in this period is the FCA’s thematic review of how consumer credit firms pay and incentivise their staff. Other changes include amending the Consumer Credit Sourcebook (known as CONC) to take account of second charge mortgages before they move to the Mortgages Conduct of Business (MCOB) Sourcebook when the Mortgage Credit Directive (MCD) comes into force next year, and the many guides that the FCA has issued for firms on the firm application form for authorisation (clearly there are significant practical difficulties in completing these).

12. REGULATOR LOOKS AT STAFF INCENTIVE REWARDS
The FCA has started a thematic review into how consumer credit firms reward their employees and manage the risks of producing poor consumer outcomes. It had previously carried out work between 2012 and 2014 and found that a number of firms including banks and insurers had schemes that were likely to drive misselling – few firms had properly considered the risks that these produced, and some schemes were so complex that even the staff did not appear to understand them. The review covers a wide range of sectors and also firms where consumer credit is a secondary activity. It will be in two stages – the first is a desk-based review; the second covers on-site visits and more detail on some of those firms.

13. THE REGULATOR CHANGES CONC
In February this year, the FCA published its consultation paper on changing CONC in a number of important areas such as credit broking, guarantor lending, high-cost short-term lending, financial promotions and mortgages. In July it issued a Policy Statement making final rules necessary to implement the MCD in line with its proposals in the consultation. However this is only a staging post because in March 2016 the regulation of virtually all first and second charge mortgages will move from CONC to MCOB. Meanwhile it will feed back on and make final rules in respect of the other changes it has consulted upon; it has also issued a consultation on loans within the MCD, which are not secured on land.

14. THE REGULATOR ISSUES MANY GUIDES FOR FIRMS
The FCA has published 11 guides for firms on consumer credit. These cover everything on the firm application form for authorisation from disclosure of significant events through the owners and influencers section to the supporting documents that are needed.

15. MORTGAGE REGULATION OVERVIEW
There have been many changes in the regulation of first and second mortgages during the last three months. Standout ones include responses to the FCA’s report of its communications paper, the regulatory regime for second charges and very different views on the future regulation of the UK mortgage market spurred on by the FCA’s competition study.

16. THE FCA’S CUSTOMER COMMUNICATIONS PAPER PROVOKES INDUSTRY RESPONSE
The Council of Mortgage Lenders (CML) has criticised the FCA’s approach in its June communications paper. The CML approves of the approach of “writing for the consumer first and then ensuring that communications are compliant, rather than the other way round”. However it criticised the comment that the consumers’ ability to make informed decisions is often hindered by information.
overload. The CML said: “Whisper it quietly – there is also the possibility that as a large organisation with multiple strands, the FCA’s own culture may not be entirely aligned to the message – we will sometimes hear some lenders telling us that their supervisors have a tendency to adopt a ‘tick box first, think creatively second’ approach.” The CML praised the CML/Which? initiative to improve information and understanding on fees and charges.

“We will sometimes hear some lenders telling us that their supervisors have a tendency to adopt a ‘tick box first, think creatively second’ approach.”

CML

17. THE MCD WILL SOON START
The MCD introduces an affordability assessment for second charges under some circumstances from 21 March 2016. Switching a loan without borrowing new funds will not require an affordability assessment; conversely borrowing more will do so, and the assessment should take account of the impact of increased interest rates on the first charge. The FCA has dropped the requirement for the borrower to find out the interest rate on prior charges since the new lender can contact a credit reference agency, and take account of the Financial Policy Committee’s appropriate interest rate expectations. Second charge lenders will also need to have specific FCA authorisation since the charges will move from the consumer credit to the mortgage regime.

18. CHANGES TO THE TREATMENT OF SOME FIRST CHARGE MORTGAGES
The regulatory treatment of a small number of first charge mortgages made before 2004 will change under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2015. This clarifies that the exemption from regulation by the FCA as regulated credit agreements only applies if the activity was already regulated by the FCA; that this extends to the authorised activity of administering of regulated mortgage contracts and to contracts for loans for the purchase of land.

19. THE DEBATE ON FUTURE REGULATION OF MORTGAGES
The debate follows the FCA’s reflections on the impact of the Mortgage Market Review (MMR). Christopher Woolard, Director of Strategy and Competition at the FCA, noted in a speech that mortgage approvals were higher now than before it started (43% now compared with 41% before). He said: “We do, however, have to remain sensitive to the impact of these reforms over the longer run. And we certainly need to keep focused on outcomes and whether the market is working well. Even if we believe our rules are proportionate, we need to remain alert to how firms are interpreting them and the effect on consumers.” He went on to say that this is the reason for the FCA to start a study of barriers to competition in the mortgage sector in early 2016. It will take into account the impact of the MMR (six lenders have 80% of the mortgage market).

“The challenge for lenders is how do you assess income into retirement without giving investment advice.”

CHARLES HARESNAPE
CHAIRMAN, IMLA

In another FCA speech, Lynda Blackwell, Mortgage Sector Manager, has blamed the “industrialised” lending process for some borrowers having difficulty in finding a suitable mortgage. “One of the things we are seeing in this market is the march to industrialisation by the bigger lenders who have a factory-style one-size-fits-all approach. She focused on lending into retirement.

“We need to think more widely in terms of innovation so we are not just thinking in terms of borrowing and debt.” She mentioned as an example rent to buy. Charles Haresnape, Chairman of the Intermediary Mortgage Lenders Association (IMLA), said: “I worry about people who are lending into retirement. The challenge for lenders is how do you assess income into retirement without giving investment advice. It puts a heavy responsibility on the lender to figure out what affordability looks like in retirement.” Nigel Waterson, Chairman of the Equity Release Council, said: “People and advisers do not think about equity release. It is a product of last resort rather than part of retirement planning.”

The background to all of these statements is the FCA’s study of competition among mortgage providers. It has concerns about the dominance of a few lenders, the lack of variety of their product offerings and the apparent uniformity in fee increases. So the FCA has issued a Call for Inputs on the mortgage market from everyone interested, such as lenders, brokers, consumer groups, builders, estate agents and academics. There is an accompanying document that guides on its concerns – unsuitable mortgages, misunderstanding the type of loan, complexity of products (repayment, interest-only, discounted, fixed rate, tracker and offset), the difficulty of comparing cost particularly with low introductory rates, and lack of product choice for older asset-rich, income-poor borrowers. The FCA plans to start a full market study in 2016.

20. NO NEED FOR REGULATORY ACTION ON INTEREST-ONLY ‘TIME BOMB’?
The Citizens Advice Bureau has suggested that about one million mortgage holders may face repossession because they face problems in repaying the loan capital. Linda Woodall, the FCA’s Director of Life Insurance and Financial Advice, and its former Acting Director of Supervision, is more optimistic: “One of the messages we have given out is that if you have an interest-only mortgage and you are concerned about your ability to pay, do not stick your head in the sand; engage with your lender. Whether we would take action or not depends if we get a sense that consumers are being treated unfairly and we get the sense at present that this is not the case.” Volumes of such new mortgages have reduced dramatically from 104,100 in 2007 to 1,700 in 2014.

“One of the messages we have given out is that if you have an interest-only mortgage and you are concerned about your ability to pay, do not stick your head in the sand; engage with your lender.”

LINDA WOODALL
DIRECTOR OF LIFE INSURANCE AND FINANCIAL ADVICE, FCA

Comment – Interestingly, the FOS has noted in its latest Ombudsman News that complaints about misselling interest-only mortgages tend to increase near maturity of the loan term.
WHOLESALE/CAPITAL MARKETS

Part three – Wholesale/Capital markets

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SECTION A – CHANGES FOR UK FIRMS

1. WAITING FOR THE FAIR AND EFFECTIVE MARKETS REVIEW (FEMR) PROPOSALS

The two main strands of the FEMR – market reforms and individual responsibility in the Fixed Income, Currencies and Commodities (FICC) markets – are progressing behind the scenes. Many market and trade associations – both in the UK and outside it – are considering how to take forward the recommendations of the FEMR. For example, the Bank for International Settlements (BIS) foreign exchange working group has started work on strengthening its existing Code of Conduct. This has global reach because it covers both developed and developing countries. In support of the working group, market participants from the sell-side, buy-side and infrastructure providers have formed a parallel group. There are two workstreams – a new single global code of conduct harmonising the common elements of the many existing forex codes with new principles covering the gaps which have been exposed by recent bad behaviour, and proposals to promote and incentivise greater acceptance and compliance with them. It will take time to negotiate these international standards so the target date is appropriately conservative – May 2017.

The Bank for International Settlements foreign exchange working group has started work on strengthening its existing Code of Conduct. This has global reach because it covers both developed and developing countries.

This work is international so the BIS foreign exchange working group, chaired by Guy Debelle, Assistant Governor (Financial Markets) at the Reserve Bank of Australia, is finalising a global forex code of conduct. This will replace no fewer than six codes which are currently used, and will extend to timestamping transactions, futures contracts that are activated in the future, automatic stop-loss orders and the different capacities of acting as an agent and market making. The new code will apply widely – not only to traders but also to asset managers and trading platforms, and will also cover high-frequency trading. The standards and principles in the new code will be enforced by national regulators.

Meanwhile, the Treasury is considering how to extend the Senior Managers and Certification regime (SMCR) to firms and their employees in the FICC markets. This raises several big questions. First, how do you define FICC? It borders and overlaps many other financial activities and would potentially bring in both sell-side and buy-side – for example small asset managers that occasionally hedge their foreign currency investments, and manufacturing companies that buy metals forward to use in their processes. The Treasury will also need to decide what elements of the bank SMCR to apply to the FICC markets – the FEMR suggests there should be modifications from it, for example in omitting the presumption of individual responsibility for managers.

The Treasury’s policy statement plans to extend a modified SMCR not only to FICC but also to all other authorised firms, entirely replacing the existing Approved Persons Regime in 2018. There are variations from the bank SMCR. For much more detail on this, see All financial sectors section, ‘The SMCR is extended to all types of firms’, p. 8 of this edition.

The Bank of England is participating in the process of implementing the FEMR through its Open Forum 2015, which it held on 11 November and which brought together many interested parties.

2. WHAT LIES AHEAD FOR THE EU’s CAPITAL MARKETS UNION (CMU)?

The long-awaited CMU Action Plan from the European Commission (EC) was published at the end of September.
This contains many ideas for initiatives to improve the support for and funding of small and medium-sized enterprises (SME).

Encourage long-term infrastructure investment through revising the Capital Requirements Directive for banks and Solvency II prudential requirements for insurance companies.

Here are some of them:

- Modernise the Prospectus Directive and make it cheaper for SMEs to raise funds.
- Support venture capital and equity financing through taxation and regulation.
- Promote innovative business funding through such methods as private placements and crowdfunding while protecting investors.
- Encourage long-term infrastructure investment through revising the Capital Requirements Directive (CRD) for banks and Solvency II prudential requirements for insurance companies, and make different EU regulations more consistent.
- Reduce or remove barriers to retail investors investing across borders in the EU – a discussion paper in Q4 2015.
- Revitalise the bank securitisation and covered bonds markets with simple, standard and transparent products. This will roll back parts of CRD III and the requirement for banks to have ‘skin in the game’.
- Build cross-border investment through addressing the different national insolvency regimes and approaches to securities ownership.
- Make it easier for companies to list and raise funds (changing the listing requirements) including SME Growth Markets under the second Markets in Financial Instruments Directive (MiFID II).
- Review liquidity in the corporate bond market and considering its regulatory and market developments and voluntary standardisation of offer documents.
- Continue work on the Common Consolidated Corporate Tax Base across the EU and (more radically) considering the debt/equity tax bias.
- Conduct a comprehensive study of European markets for retail investment products, including distribution channels and investment advice, so that investors have choice and fair terms.

The EC will submit annual reports to the EU Parliament and consider in 2017 whether further measures are necessary.

Comment – This is quite an agenda. Some steps can be taken reasonably quickly such as on securitisation and prospectuses; others will need much more time such as harmonising insolvency laws and taxation bases. It is a test of the strength of will of EU members and of their cohesion as to whether this agenda can be delivered. What is clear is that there will be a significant rollback of some recent regulatory reforms, eg, prudential requirements for banks and insurance companies. It is not clear whether this will extend to MiFID II and European Markets Infrastructure Regime (EMIR), although the last bullet point may be coded wording for this.

What is clear is that there will be a significant rollback of some recent regulatory reforms, eg, prudential requirements for banks and insurance companies.

3. SECURITISATION REGULATION REBORN

One of the key steps in the CMU is to breathe life into the securitisation market so that banks are able to lend more. The EC considers securitisation to be “an important element of well-functioning capital markets”. Given the role of asset-backed securities (ABS) in the global crisis, the regulators are cautious and have imposed conditions that they should be simple, transparent and comparable – see Basel’s criteria in its July paper. Since then, the International Organization of Securities Commissions (IOSCO) has published its final report on the peer review in implementation of the incentive alignment recommendations for securitisation. This found that there was significant but variable progress: the EU (Basel III) and the US were ahead of others.

Comment – The market argues that the key to restarting the ABS market is the capital treatment under Basel III and CRD IV. For qualifying issues the EC is proposing lighter risk weights and counterparty risk requirements. The market, however, sees these as insufficient – the proposed prudential treatment is still less favourable than that for covered bonds (which stay on the banks’ books) for the unbundled underlying securities, and the requirement under CRD III for the sponsor to retain ‘skin in the game’ still applies while IOSCO is reviewing its inconsistent implementation – in a world threatened by deflation.

4. DO EXCHANGE-TRADED FUNDS (ETFs) INCREASE VOLATILITY?

Some commentators have blamed ETFs for increasing market volatility in August and September. In particular, ETFs linked to futures on the Chicago Board Options Exchange (CBOE) Volatility Index were active at the time. They also point to leveraged ETFs. BlackRock has said “these products should not use the ETF label”. The regulators will be making their own studies.

At the same time, ETF providers have called upon US exchanges to rethink the trading limits imposed on stocks following the ‘Flash Crash’. The providers complain that the volatile market meant that ETFs investing in them were prevented from pricing the ETFs, leading to significant tracking errors with their benchmarks (of the 1,278 trading pauses on one day, 500 related to ETFs). BlackRock, the owner of iShares, said: “We are concerned about the impact of this dislocation upon our clients, and are working with a broad set of market participants to identify the causes of, and remedies for, the underlying structure issues that may have caused these dislocations to occur.”

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Meanwhile the US Securities and Exchange Commission (SEC) has issued a ‘Wells’ notice to Pimco stating that it is considering taking enforcement action against it upon whether investors in its Total Return Fund received a misleading picture of its performance historically (in more detail, whether revaluing odd lot bond purchases consolidated into more liquid amounts was reasonable and disclosed – possibly a wider industry issue).

5. GLOBAL REGULATOR REVIEWS MONEY MARKET FUND (MMF) REGULATION

IOSCO has issued its final report on the peer review of MMF regulation. Overall, as at March 2015, IOSCO
Looking to the future of benchmark regulation, the Financial Conduct Authority (FCA) has published its thematic review of firms’ oversight and controls in financial benchmarks; generally it found that all firms visited had made changes but more were needed.

**ARTICLE**

The wider issue is the concern that some firms have that they may be sued for compensation by both institutional and retail customers for losses arising from forex manipulation. These have been heightened by two developments: the settlement in the US where a number of banks (including Barclays, Goldman Sachs, HSBC and RBS) paid $2 billion to thousands of investors; and the opening of class actions for breaches of competition law in the UK under the Consumer Rights Act 2015. The UK is the largest global centre for forex so logically the most exposed.

The Serious Fraud Office (SFO) has followed up its success in obtaining a criminal conviction against Tom Hayes for attempting to manipulate LIBOR (now under appeal by him) with criminal prosecutions against other traders and brokers. The FCA has separately banned a former trader at Rabobank, Lee Stewart, for lacking honesty and integrity following his criminal conviction in the US, but the FCA’s Regulatory Decisions Committee decided that no action should be taken against another former trader, Panagiotis Koutsogiannis, because the FCA had not proved its case against him. Six brokers will be prosecuted for conspiring with traders at various panel banks setting LIBOR. The prosecution claims that they “deliberately disregarded the proper basis for the submission of those rates, thereby intending to prejudice the economic interest of others”.

Recent research from Morgan Stanley shows that the fines and legal actions following the global crisis have cost the financial industry no less than $260 billion. The five largest banks in the US have paid $137 billion so far and face a further $15 billion in litigation costs, and the 20 biggest in Europe have paid $137 billion and face a further $50 billion. Morgan Stanley said: “Litigation not only takes a bite of your equity but has a much longer lasting impact on the amount of capital you need to hold.” Bank of America Merrill Lynch tops the list of charges taken at $65.6 billion, followed by JPMorgan’s $42.4 billion and Lloyds Bank’s $26.6 billion. Looking forward to prevent or reduce future problems, Bank of America Merrill Lynch is spending $15 billion a year on compliance and JPMorgan $8–$9 billion.

**Comment –** These figures are shocking, particularly because none of these figures take account of the management time absorbed, or the loss from this distraction from business.

The issue of whether the FCA identified individuals indirectly in final notices against their firms refuses to go away. In the latest twist Chris Ashton, a member of the chat room ‘Cartel’, is claiming that he was identified, but given no chance to rebut the allegations, in the final notice. His lawyer claims that the relevant settlement between the bank and the FCA was based on incomplete inquiries and the FCA misunderstanding the evidence (including its use of cockney slang). “For there to be public confidence, it is important that regulatory action is based on a sound evidential basis; here we have significant doubts that there was any proper investigation … It’s quite possible that the settlements – which have had such a disastrous effect on the reputation of the City of London – may simply have been based on a set of facts that simply did not exist.” The FCA challenges this before the Upper Tribunal.

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**SPEED READ**

The UK regulator is now well into its stride in pursuing individuals for attempting to manipulate the LIBOR and forex benchmarks. At the same time some of those dismissed by their firms for doing or assisting this are suing their firms for unfair dismissal. In the US and Switzerland there are new claims of market manipulation that are being investigated. There is no end to the bad news for banks and brokers. Looking to the future of benchmark regulation, the Financial Conduct Authority (FCA) has published its thematic review of firms’ oversight and controls in financial benchmarks; generally it found that all firms visited had made changes but more were needed.

**Comment –** This report is a useful description of the varied approaches which national regulators have taken to address the risks of MMFs being unable to repay capital invested at par, as seen in the global financial crisis. For the EU’s approach, see Change, May 2015, Wholesale/Capital markets section, ‘The EU Parliament intervenes in EU Money Market Funds (MMF) reforms’, p.38.

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**6. THE REGULATORY CONSEQUENCES OF BAD BEHAVIOUR OVER BENCHMARKS**

**SPEED READ**

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A LAWYER REPRESENTING CHRIS ASHTON

Comment – Once again this shows the potential conflict between the firm’s interest in settling with the regulator and that of individuals who may later face enforcement action, in part based upon a final notice they had no opportunity to challenge.

Another recent development has been the litigation by employees dismissed by firms for perceived involvement in, or lack of supervision of, bad behaviour. For example four former employees of Citibank are challenging their dismissal in an employment tribunal. They were dismissed for “misuse of electronic communication tools”. The ex-employees claim they were using them in accordance with the bank’s rules, and that senior staff were using them in the same way. The bank and others dismissed many senior traders during its investigation of currency trading. The result could affect other cases being brought by employees who complain that they were dismissed before the investigations and that they were unfairly singled out.

Comment – The key question is whether sharing of client information with other firms happened and, if it did, whether it was condoned by senior managers.

Firms involved in the benchmark manipulation scandals have made use of the ‘clawback’ rights for causing losses or bad conduct. The five big UK banks have taken back £844 million in deferred or unvested annual bonuses since 2011. These malus repayments increased in 2014 to £290 million compared with £100 million in 2013.

In Europe, the Swiss competition authorities are investigating whether banks colluded on the level of ‘spreads’ in precious metals trading. Banks being investigated include UBS and Julius Baer as well as five non-Swiss banks. There are similar competition investigations being conducted by the EC and US authorities.

Comment – The Consumer Rights Directive opens the door to class actions in the UK and elsewhere in the EU for breach of competition rules.

In the US, some 20 buy-side investors, including pension funds, have started legal actions against banks and brokers, claiming that they manipulated the US Treasuries market, increasing the cost of selling debt to them through these primary dealers, and taking advantage of Treasury auctions and pre-auction transactions (the ‘when issued’ market), to profit at the expense of their customers when seeking a lower price during auctions. In other words, that the auctions were rigged. The buy-side institutions may use similar arguments for compensation as used by the regulators imposing penalties over LIBOR manipulation.

7. THE FUTURE REGULATION OF FINANCIAL BENCHMARKS

The FCA has published a thematic review into the oversight and controls over these benchmark activities (contributing to, administering, consolidating, distributing or passing on or providing raw data to those who do). Overall the FCA found that the 12 firms visited had improved these. However, there was uneven progress with different benchmarks, banks were better than brokers, there were problems with identifying benchmark activity and conflicts of interest, and a trend towards withdrawing from contributing to them without understanding the consequences. In particular the FCA wants relevant firms to identify benchmark activity or activity that could have an effect; senior management should do a gap analysis; there should be more governance and oversight; and banks should identify; be aware of and manage conflicts of interest; ensure they have in place robust controls over in-house benchmarks, and when exiting benchmark activities, consider the wider impact.

Comment – One lawyer said: “The report is a clear wake-up call, and if things are not speeded up by the autumn we can expect the next round of multi-million pound fines to commence.”

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8. MANY CHANGES UNDER MiFID II/MiFIR

It is clear from a review of the final regulatory technical standards (RTS) and implementing technical standards (ITS) that the European Securities and Markets Authority (ESMA) has taken on board some stakeholder comments but, from a compliance officer’s perspective, there remain several questions, in particular as to how it will work in practice and the impact on the market – especially given the tight timescale for requisite technology changes. Some key changes are:

• Best execution: Greater information on the quality of execution, particularly the venue disclosures. Firms need to provide more accurately detailed execution policies and publish their top five execution venues. Firms need to justify who they trade with.

• Pre-trade transparency, equity, double volume caps: As part of the political compromise, the restrictions on the pre-trade transparency waivers (reference price and negotiated) remain. There will be a 4% cap of total trading per stock on any one venue and a 8% cap on total trading in that stock in any EU venue. It is unclear how this will work in practice.

• Pre-trade and post-trade transparency: Extended to bonds, derivatives, structured finance products and emission allowances. In relation to bonds – a critical product to the UK market and economy – firms need to understand the liquidity criteria and transparency waivers and put systems in place to meet the new post-trade reporting requirements. It took years for the US to get the Trade Reporting and Compliance Engine (TRACE) implemented successfully and, given that ESMA’s IT project for fixed income transparency will not be ready until December 2016, it is uncertain whether the industry will be able to meet the 3 January 2017 deadline.

• Transaction reporting: A topic close to all compliance officers’ hearts given
its importance to the regulator. Luckily the updated final Regulatory Technical Standards (RTS) is more favourable with required fields reduced to 65. There is still work to be done to make sure you get it right, especially as trader and client fields touch the topic of personal data for some firms.

- **High-frequency trading (HFT):**

  Stricter rules on high-frequency trading.

  The “delegated acts” are expected to be released in mid-November. The industry waits with anticipation to see the impact on research and commission sharing.

9. **MANY DEVELOPMENTS IN REGULATION OF MARKETS**

**SPEED READ**

The two big issues are the negotiations in the EU on some key aspects of market changes under MiFID II. (These include pre-trade transparency for non-equity instruments, waivers relating to this, access to trading venues, best execution, transaction reporting, etc. – see Wholesale/Capital markets section, ‘Many changes under MiFID II/MiFIR’, on p. 41 in this edition and the changes to FICC markets under the FEMR – see Wholesale/Capital markets section, ‘Waiting for the Fair and Effective Markets Review (FEMR) Proposals’, p. 38 in this edition.) There are other smaller developments such as regulatory concerns about algorithmic trading and the move by exchanges into the forex market.

Perhaps the most important development is the new services that exchanges are offering to the buy-side to trade large blocks of shares – avoiding the fragmentation of orders under high-speed trading seen on some exchanges.

**ARTICLE**

Negotiations continue in respect of the market reforms under Level 2 of MiFID II. In particular, the French, German and UK governments have made common cause on lobbying ESMA and the EC on changes to some key ESMA Level 2 proposals for market changes. This covers:

- **Pre-trade pricing for no-equity instruments (typically bonds and derivatives).** The battleground is over ESMA’s approach to defining a ‘liquid’ market which the three governments (particularly the UK) characterise as wanting a proportion of securities to be covered, and not applying the liquidity test objectively (“there are ready and willing buyers on a continuous basis”). ESMA would also not misclassify instruments or classes of instruments. The governments do not consider that ESMA has demonstrated this in its approach.

- A related issue is on pre- and post-trade waivers. They insist the Level 1 test “would expose liquidity providers to undue risk”. They criticise ESMA’s approach of setting the threshold at a level which captures a specified number of bond transactions: “Which would not mitigate the likely effect of introducing requirements for liquidity providers to broadcast their prices publicly (and be required to offer that price to all market participants).” Coincidentally ESMA published a new version of the waiver document for assessing pre-trade waivers. The main difference from the previous version is how different price limits apply to ‘large in scale’ orders.

- **Trading venue access to Central Counterparty Clearing Houses (CCPs) was always contentious, particularly in Germany.** Level 1 decided that trading venues had the right to non-discriminatory access to CCPs if certain conditions on collateral and netting of economically equivalent contracts were satisfied. The French, German and UK governments consider that ESMA’s approach of very general definition of equivalence is too broad and it should be required to demonstrate that “the non-discriminatory netting of economically equivalent contracts should not … endanger the smooth and orderly functioning, the validity or enforceability of the close out and other netting procedures of the CCP” because that would be inconsistent with Level 1.

*Comment – Now that ESMA has issued its final draft regulatory technical standards, it is unclear how much these governments’ potentially radical changes to its proposals will be effective – other than through the EU Parliament’s possible refusal to endorse them.*

A number of EU exchanges and multilateral trading facilities (MTFs) are developing new services to enable the buy-side to trade large blocks of shares without being hit by HFT programmes. The London Stock Exchange (LSE) started an order type that allows dark trading on its main order book in November (“What we’re actually trying to do is to give asset managers a way of re-aggregating liquidity”); Turquoise will introduce intraday auctions in February 2016; Bats Chi-X has also introduced an order book with set auction periods independent of an investor’s ability to trade in milliseconds; and Luminex is set up by asset managers to help users avoid HFT with high minimum size limits on trade sizes.

"What we’re actually trying to do is to give asset managers a way of re-aggregating liquidity"

**LSE**

Other developments include questioning whether risk parity funds (which automatically adjust their stock, bond and commodities allocations according to volatilty rather than capital weighting) have increased the swings in market prices. There is now an estimated $600 billion invested in such funds on an unleveraged basis. Will the regulators see this as a systemic risk? Meanwhile, exchanges are expanding their forex derivatives products as banks suffer from their benchmark problems (this includes Deutsche Börse and BATS Global Markets – however, there are well-established forex platforms). The LSE, with backing from six large banks, is launching a European futures market to compete with Deutsche Börse and ICE; a hedge fund (Citadel) has launched a European fixed income swaps market maker to challenge banks’ trading of government debt (it is already an important firm in this space in the US); and the Association for Financial Markets in Europe (AFME) and the Investment Association (IA) have agreed a voluntary share-dealing code for indications of interest for block trades (those that can be satisfied immediately without market impact can be labelled as ‘client neutral’; those that may involve information leakage and market impact as ‘potential’). Bloomberg will adopt
this classification. Finally, there are new LSE procedures (securities to be traded and settled) that enable US Regulation S, Category 3 securities to be traded and settled in accordance with the new electronic settlement requirements of Article 3(2) of the EU Regulation on improving securities settlement.

10. WILL NEW REGULATIONS PREVENT THIRD-COUNTRY SWAPS TRADING?
The UK is keen to establish a swaps trading marketplace for Chinese issuers and traders. However, there are concerns that the requirements to trade swaps on an EU exchange, MTF or organised trading facility (OTF) under MiFIR, and to settle trades through an EU CCP under EMIR, will prevent this. This is because ESMA may consider that China does not have equivalent regulatory standards for trading and settling swaps, particularly in netting of exposures and margining. The UK Government is taking this issue up with EU authorities, and the European Banking Authority (EBA) and ESMA have said that they are “well aware” of the issue, and “will certainly propose a solution”.

11. CHINA MOVES AGAINST SHORT SELLERS AND CREDIT RATING AGENCIES
Short selling has always been controversial. In the EU there are restrictions in place on short selling sovereign bonds. In China the Government and regulators took more severe action – by banning short selling and questioning those foreign institutions selling equities or suspected of advising others to do so. However, these steps did not prevent the Shanghai Index falling further.

Comment – Short selling bans are controversial. Some argue that short selling increases liquidity – and restricting it reduces it. Others argue that it accelerates both stock price rises and falls. The academics are divided.

In a separate development, the Hong Kong Securities & Futures Commission has imposed a fine of HK$23 million ($3 million) on Moody’s for “allegations that the firm has breached required standards of conduct, eg, poor or substandard work or management practices”. Moody’s has appealed. The dispute arises from a 2011 report that scored 61 companies for 20 ‘red flags’ covering corporate governance, opacity of business model, speed of growth, quality of earnings and financial statements. Of the top five companies with the most red flags, one has collapsed, a second is in liquidation and the shares of the other three are trading at least 50% below their 2011 level. Moody’s “disagrees that the report was misleading – or that there were any deficiencies in its procedures governing the provision of credit rating services”.

Comment – The role of credit rating agencies (CRAs) in rating sovereign debt is not an easy one. Too benign and the market disbelieves them; too robust and governments criticise them – for example prosecutors in Italy have accused five employees of Standard & Poor’s, and one from Fitch, of inflicting unjustified damage to Italy during the euro crisis. (This follows the claim for €200 billion by Italy’s state auditor that the CRAs should have taken history, art and landscape into account in its ratings.) What is unusual is that it is employees who are being prosecuted.

12. DARK POOLS IN TROUBLE AGAIN
In the EU, the policy to increase exchanges’ share of the equity market is approaching. There is a double cap on MTF and OTF share of the equity trading market – 4% of each stock by venue, and 8% of the company’s stock overall – resulting in times when no trades in that stock can be made on that venue, or perhaps at all if the overall figure is reached, given that sometimes only 50% of a company’s stock is traded on-exchange. MTFs and OTFs find the second restriction particularly difficult: “A lot of confusion is about what the rule will look like, how you categorise data and what impact it will have on trading behaviour”. There are suggestions that buy-side institutions (which recently set up their own matching platform – Luminex Trading & Analytics) will favour “large-in-scale” trading which may benefit from a pre-trade price waiver, and exchange auctions (such as the one started by the Turquoise, part of the LSE).

In the US, an agency broker, Investment Technology Group, has received a record fine ($20 million) for failing to disclose relevant information to clients which bought and sold shares on its platform.

In the US, an agency broker, ITG Investment Group Technology, has received a record fine ($20 million) for failing to disclose relevant information to clients which bought and sold shares on its platform. It is the use of the trading information in the wider group that caused the problems. The SEC has also settled claims against Pipeline and Liquidnet (also order consolidators) although the facts were different.

Comment – Regulators in the EU are determined to increase the liquidity in exchanges so that it becomes a solid indicator of price discovery; they note that the average size of dark pool transactions is now similar to those on exchanges, that dark pools use exchange prices as a reference, and that there is more opportunity for bad behaviour on dark pools because they are not transparent.
13. REGULATORS STUDY THE IMPACT OF HIGH-FREQUENCY TRADERS (HFTs)

The debate continues over whether algorithmic trading is unfair to slower retail and institutional investors. Anne Richards, Chief Investment Officer, Aberdeen Asset Management, said: “If bunch of these guys never have a down day. That’s bucking the odds by a substantial amount. It can’t be just clever machines, so there is something structural in play.”

The former head of the New York Stock Exchange (NYSE), Richard Grasso, agrees “a fast market is not necessarily a fair market. Creating an advantage to an institutional user or a particular type of trader that disadvantages the retail investor is bad for the country, bad for the markets and bad for your business.” In contrast, the head of AXA Rosenberg has said: “The market is more predatory than it was before because of all these algorithms, but we’re better off overall as the bid-offer spreads and commissions are much lower now.” Richards would like the exchanges to give a small but crucial buffer to when orders arrive at exchanges.

Comment – There is no easy resolution to this argument. The regulators are concerned about liquidity (which algos claims to increase), by market resilience (particularly after the ‘Flash Crash’) and by increasing competition. The EU under MiFID II has taken a tougher control and supervision position on this than the US regulator – see ESMA’s final draft regulatory technical standards described in the All financial sectors section, ‘Other MiFID developments’, p. 11 of this edition.

Creating an advantage to an institutional user or a particular type of trader that disadvantages the retail investor is bad for the country, bad for the markets and bad for your business.

RICHARD GRASSO FORMER HEAD OF NYSE

However, both EU and US regulators have taken action against market manipulation through HFT. A recent case is the charges against US proprietary trader, 3Red, for ‘spoofing’ – duping others in the market by quickly entering and cancelling orders. Regulators and exchanges have introduced new rules against disruptive trading, including spoofing. 3Red’s co-founder and head trader has previously settled charges from CME Group and ICE, but according to reports, plans to challenge the new rules. The US Commodity Futures Trading Commission (CFTC) claims that on at least 51 trading days between 2011 and 2014, 3Red “intentionally and repeatedly” spoofed at least five futures markets. If 3Red does take the case to court, the decision may show where the line between legitimate and manipulative trading is.

As more and more HFT firms and proprietary trading firms using algorithms enter the sovereign debt market, US and EU regulators are wondering whether or not to intervene. They are most active in the US Treasury where it is estimated they conduct 10% of cash trading in them from zero ten years ago. They are not ‘primary’ dealers but they are active in the interdealer market. They argue that they provide liquidity when the banks’ proprietary desks pull back, hedging their risks with futures and derivatives instruments. Others think that the algorithms increase volatility in disturbed markets. The wild swings in prices on 15 October are claimed by both sides to demonstrate their case.

Comment – Given the importance to governments of the secondary sovereign debt market, regulatory intervention is more likely than not.

14. CENTRAL SECURITIES DEPOSITORY REGULATION (CSDR) DEVELOPMENTS

ESMA published its final report of the draft RTS for the CSDR. This does not contain final requirements on the controversial mandatory buy-in process for failing trades or settlement discipline which are of most interest to investment firms – it is delaying on these pending further analysis following close of the consultation process for mandated buy-ins in August.

Comment – As regulation that appeared initially to be of most relevance just to securities depositories, the potential for impact on the wider markets arising from the prescriptive new mandatory buy-in processes and penalties for failed settlement highlights how even apparently unconnected regulation can have a much broader impact. All firms that enter into transactions in securities, repo and stock lending which use central securities depositories (CSDs) will need to keep an eye on the outcome of ESMA’s analysis.

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NASDAQ has launched software designed to identify manipulative behaviour in off-exchange equities trading. It is concerned that while many traders and asset managers use it for trading at the start and end of trading, much business in between flows to these (often bank-owned) trading platforms or dark pools. Ideally it is offering to take over the running of these venues.
One UK consequence of the CSDR has been the change to Alternative Investment Market (AIM) Rules under which securities admitted to AIM must be eligible for electronic settlement. The LSE sometimes waived this rule for so-called Regulation S US securities: this waiver will no longer be available so Regulation S issues must now be eligible for electronic settlement with effect from 1 September 2015.

15. THE EU/US RECOGNITION OF CCPs

The Financial Markets Law Committee and the Committee on Capital Markets Regulation have published a joint paper on problems flowing from the lack of mutual recognition of CCPs between the EU and the US. The main points are that although the margin requirements for futures are different, the result is broadly the same (therefore this should not prevent mutual recognition); the US CFTC should describe clearly its approach to substituted compliance for foreign CCPs, while the EU has such a regime under EMIR (equivalence decisions should have conditions addressing specific issues); and there should be a template for appropriate levels of host participation in supervisory colleges established by the home supervisor (the committees consider that this should avoid conflict and duplication of supervision).

Comment – Different implementation by the EU/US of the G20 recommendation to require liquid over the counter (OTC) derivative transactions to be cleared through a CCP has caused big problems in mutual recognition. The joint paper suggests a way forward.

The EU has also corrected an error in the EMIR implementing regulation. For existing CCPs established in third countries that have already applied for recognition, the recognition process was ongoing at the time of publication of the implementing regulation but would not be completed by 15 June 2015.

16. WHO IS RESPONSIBLE FOR BAILING OUT CCPs IN TROUBLE?

Big banks, asset managers and the Federal Reserve have expressed concerns about CCP members not being able to bail out a CCP if a member fails; or even if they do, the risk of interconnectedness with other CCPs with the same (weakened) members. They suggest that CCPs should hold more capital. The CCPs do not want to do this, and suggest that requiring members to put up original margin and variation margin against the value of contracts or ‘variation margin gains haircutting’ will manage any losses; and if not, insuring against the risk through issuing ‘tail risk’ derivatives to help them in case of need.

Comment – It seems unlikely that regulators would let any such derivative holders gain at the expense of the CCP members. Concrete international plans covering the world’s major international currencies and contracts for CCP bailout are clearly necessary. At present this still seems to depend upon government bailout – the European Central Bank (ECB) has published a report favouring CCPs’ access to government funding, and the Committee on Payments and Market Infrastructures (CPMI) and IOSCO recognised that many financial market infrastructures are government-owned, and have issued a report on how the principles of financial market infrastructures apply to them.

The Financial Stability Board (FSB), the CPMI and IOSCO have developed a workplan to address CCPs’ resilience, recovery planning and resolvability – a key focus for 2015. The workplan covers stress testing (there may be new guidance shortly); the Level 3 assessment of the implementation of the principles for financial market infrastructures started in July this year (report expected mid-2016); a separate group will study interdependencies between CCPs and major clearing members (report by end 2016); and a further report on all CCP resilience and recovery issues should be published for consultation in mid-2016.

The message is clear. Resolvability is a big issue for CCPs and the governments that may be called upon to bail them out.

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17. OTHER REGULATORY DEVELOPMENTS FOR FINANCIAL MARKET INFRASTRUCTURE (FMI) PROVIDERS

The International Securities Services Association (ISSA) has developed a guide to its financial crime compliance principles for securities custody and settlement. This explains the rationale, expected costs, benefits and – importantly – the practical measures that entities should take. The principles and the guide are aimed at global custodians, sub-custodians, trustee/depositary banks, fund distributors, brokers (including prime brokers) and CSDs that operate cross-border.

Comment – Clearly, the allocation of responsibilities between them for due diligence and monitoring is difficult but important.

The Bank of England has updated its webpage on CHAPS and CREST to announce the implementation date of 20 June 2016 for extending the settlement day on both systems.

18. CAN YOU IDENTIFY A FIRM OF GLOBAL SYSTEMIC IMPORTANCE, AND WHAT NEXT FOR INSURANCE COMPANIES?

The EBA has published its standards and guidelines on the key information to be disclosed on size, interconnectedness, substitutability, complexity and cross-jurisdictional activity of the global systemically important banks (G-SIBs) identified by Basel and the FSB under their framework. The EBA package for EU-based G-SIBs goes beyond the FSB/Basel standards in respect of the detailed information to be disclosed, and the group-wide scope of the information.

The package goes beyond the FSB/Basel standards in respect of the information to be disclosed.

The saga of whether insurance companies or re-insurance companies are systemically risky continues. Nine primary insurers are named on the list and, the FSB proposes, should hold an average 10% capital cushion against losses. They are unhappy about this, particularly because there are no reinsurers on the list. Non-traditional and non-insurance activities carry the highest requirement. They start in 2019. Some insurers predict that these proposals will never happen.
What’s your story?

No matter how big or small the impact, we all help shape the financial services industry and the world in which we live.

We’re proud of you, our members, and we want to share your stories. We want to tell the wider community about what we do and the value we add; the contribution financial services makes to economic growth and development, the support and advice we provide to individuals and businesses to help them to achieve their goals…

Why is the industry important to you?
What’s your proudest accomplishment at work?
What opportunities does the industry offer?
How have you provided support to colleagues, clients, associates?

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SECTION B – SPECIFIC SECTORS

ASSET MANAGEMENT

1. REGULATOR CONSULTS ON UCITS REMUNERATION GUIDELINES

ESMA has published a consultation paper (now closed) on the draft guidelines on remuneration under the Collective Investment of Transferable Securities (UCITS) V Directive. These have been developed with the EBA. The consultation paper describes ESMA’s proposed approach to some important questions, including governance, requirements of risk alignment, and disclosure. Proportionality is one of the important issues. ESMA disagrees with the EBA’s guidelines for bank remuneration, basing its case in part on different risks, and on aligning its guidelines with those under the Alternative Investment Fund Managers Directive (AIFMD); how the payment of 50% of the variable remuneration in units of the relevant UCITS would work; and reconciling asset managers who come under multiple remuneration principles, eg, the EBA ones for banks, the UCITS V ones for UCITS managers, and the Alternative Investment Fund (AIF) ones for AIFs (ESMA is considering that firms should either opt for a pro rata approach based upon time spent or choose whichever code is “discouraging excessive risk taking and aligning the interest of the relevant individuals with those of the investors in the funds they manage”. However, there are restrictions on this choice). ESMA proposes to finalise the guidelines in Q4 2015 and for them to start at the same time as UCITS V on 18 March 2016.

ESMA disagrees with the EBA’s guidelines for bank remuneration, basing its case in part on different risks, and on aligning its guidelines with those under the Alternative Investment Fund Managers Directive.

Comment – Given that the FCA believes that the principle of proportionality is a “cornerstone of the UCITS Directive”, this should give some comfort to asset managers. Asset managers who have both UCITS and AIFMD funds (Annex 8.1 contains a useful comparison table on the remuneration approaches) will clearly have to wait for the final guidelines due at the end of 2015. In September 2015, the FCA published CP 15/27 (UCITS V implementation and other changes to the Handbook affecting investment funds), and in Part 1 consults on the requirements applicable to management companies, including remuneration principles and transparency obligations towards investors (comments due by 9 November 2015).

2. RECONCILING THE PACKAGED RETAIL INVESTMENT AND INSURANCE-BASED INVESTMENT PRODUCTS (PRIIPs) DISCLOSURE DOCUMENT WITH MIFID II DISCLOSURES

Currently UCITS has a three-year grace requirement from the mandatory use of the PRIIPs disclosure document (see All financial sectors section, ‘And of PRIIPs’, p. 12 of this edition). While this is very welcome to providers and managers, this delay has made the Financial Services Consumer Panel unhappy: “It is likely the prescribed approach will result in some regulatory arbitrage, as manufacturers of UCITS will face less strict requirements in presenting their products to retail investors.” The second concern they raise is that intermediaries will need to provide extensive costs disclosure information to clients when MiFID II comes into force in January 2017 – the exemption “is at the root of potential problems in the disclosure of transaction costs by intermediaries under MiFID II”.

Comment – This is a difficult question. Requiring providers to convert the documentation for many thousands of funds in the next 12 months is an enormous task – and the form of the PRIIPS document may need to be customised to UCITS anyway; on the other hand consumers may well be confused by different documents for UCITS from the other retail investments. And intermediaries will need to make up their own to comply with MiFID II. Perhaps requiring some conformity for UCITS sales in the three-year period would help. Technical advice modifies Article 31 of MiFID such that investment firms are required to inform clients about the functions and performance of financial instruments in different markets (including positive and negative conditions). Any mandatory requirement to provide illustrations for retail clients with limited real knowledge of financial services products is a real challenge under PRIIPS and/or MiFID II, and must be a real challenge for asset managers to deliver when exemptions are not available.

See also the next article on current disclosures for costs.

3. CURRENT COST DISCLOSURE DOCUMENTS ADOPT DIFFERENT APPROACHES

The fund management industry appreciates the need to disclose more information about the costs the fund investor will have, given the limitations of the annual management charge (AMC) and ongoing charges figure (OCF). Unfortunately there is no agreement on how this should be done. There are variations from the IA’s approach (see Change, Aug 2015, Wholesale/Capital markets section, ‘The Investment Association sets out principles for investment managers’, p. 44). Some favour the total expense ratio (TER); others the OCF (encouraged by the regulators under UCITS IV – which is less comprehensive than TER); finally, there are the bespoke approaches – for example a mix of AMC and OCF. There is no UK regulatory standard here – only the general principle of fair costs disclosure. Paul Myners’ Financial Times article “Active funds underperform the inertia index – never mind the market” also illustrates the issue of an underperforming active fund management industry. Following a similar theme, Chris Flood’s The Times article “High fees hurt European pension funds” also illustrates cost disclosure across the asset management industry. It is likely to be very challenging, and could impact future investments going forwards.

Comment – The different approaches are well intentioned, but threaten to confuse both consumers and their advisers. Comparison becomes increasingly difficult. The Key Investor Information Document (KIID) helps but is not sufficient – only the PRIIPs is likely to do that – see Wholesale section, ‘Reconciling the packaged retail and insurance-based products disclosure document (PRIIPs) with MiFID II disclosures’, earlier on this page.

Very few of them have an understanding of what disclosures actually mean.
WILL REGULATORS CHALLENGE ‘CLOSET TRACKERS’?

A number of regulators in the EU have said they are investigating actively managed funds which replicate the benchmark or wider market (broadly ‘closet tracking’). The FCA has said “we will review whether UK authorised investment funds and segregated mandates are operated in line with investors’ expectations as set by the marketing material, disclosure material and investment mandates”, expected to be completed by April 2016. ESMA has said: “The issue of closet indices is a complex one due to the technical nature of the matter and the size of the fund market in Europe. ESMA is working actively on the matter, in close co-operation with [national] authorities. If and when we have something to report, we will do so.” Some national authorities have indeed acted already – the Danish regulator has discovered that almost a third of domestic equity funds could be categorised as closet trackers; Sweden has launched a formal enquiry; and Norway has ordered one large fund manager to reduce its charges or “bring it into line with the characteristics of active management”.

Comment – The jury is out as to whether regulators will take action against such fund managers. However, the financial media could make it a ‘cause célèbre’.

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ARE INVESTMENT TRUSTS ‘COMPLEX’ INSTRUMENTS?

Currently investment trusts are classified as ‘non-complex’ so there is no requirement for advice or any appropriateness duty under the MiFID I. However this may change under MiFID II and ESMA’s making of the standards under it. The problem is that these trusts are funds which take the form of shares (not UCITS units) often with different net asset value (NAV) from the price. Understandably trusts and their managers are unhappy with this possible change – and the restrictions on their sale. They have made the argument to the FCA that they should not be restricted, rather treated like UCITS. JPMorgan has said that there would be “a lack of investor clarity” and “a potentially adverse impact on investor perception. This could in turn potentially limit the liquidity of investment trusts to the detriment of existing retail investors.”

“This could in turn potentially limit the liquidity of investment trusts to the detriment of existing retail investors”

JPMORGAN

Comment – It is interesting that the FCA is the regulator being lobbied rather than ESMA or the EC: the FCA will have limited room to interpret MiFID II without a waiver. There are various alternatives to the ‘complex’ label and its consequences such as a simple one-time appropriateness test (“When an investor opens a trading account or tries to buy an investment trust for the first time, they could do it. But then they shouldn’t have to do it again. It’s not like they will lose their knowledge that these are ‘complex instruments’” – Associated Investment Companies) or making a distinction between complex trusts and simple ones. There are other types of investment that could become ‘complex’ such as non-UCITS ETFs and real estate investment trusts (REITs). In an FT Adviser article, Liz Field, Chief Executive of the Wealth Management Association, said that it could lead to greater detriment due to insufficient discrimination between products. Also she felt that the complex label would deter retail investors, and also firms, as they would need to complete an appropriateness test every time a client wishes to purchase one on a non-advised basis.

SHOULD MANAGERS BE ABLE TO ‘SOFT CLOSE’ A FUND?

This question arises in the context of the FCA’s consultation (closing 7 December) on the implementation of UCITS V in the UK. Currently asset managers must normally obtain the FCA’s approval to limit the issue of new units in a fund without affecting the ability of investors to sell their units (a temporary restriction). Fund trade associations and funds have asked the FCA to limit the issue of new funds at short notice. The FCA can see both advantages and disadvantages from allowing this: the advantage is prompt liquidity management (and protection of
existing investors from oversupply): the disadvantage, says the FCA, is that “closure to new investment at short notice could create problems, given that many investors use both financial advisers and intermediaries (such as platform service providers), who need to be aware of [the authorised fund manager’s] intentions so they, in turn, can stop accepting new investments”.

Comment – Given the FCA’s principle to treat customers fairly, it will depend on the circumstances of each case whether a soft close is appropriate. For example, if too much money is flowing into a fund, there may be limits of efficient investment (especially if there is poor liquidity). Asset managers who have a reasonable rationale with a current or potential client protection in mind are likely to satisfy FCA requirements. It remains to be seen if the FCA will apply the same blanket approach given the ad hoc nature and varying way this will affect different asset managers at different times.

7. WHAT FORM SHOULD SUPERVISION OF LARGE-ASSET MANAGERS TAKE?

Now that the global regulators have accepted the arguments from large asset managers that they are not systemically risky, the question is whether there should be some form of enhanced supervision, and if so, what form this should take? BlackRock has accepted that there should be enhanced supervision in principle and has proposed “a regulatory regime focusing on activities, such as those that employ leverage or those that cause liquidity mis-match issues”. Others have suggested other areas for this special supervision such as a minimum cash holding requirement (unattractive for funds since they will not follow benchmarks used already by the Prudential Regulation Authority (PRA) and the FCA); longer redemption periods with the possibility of gates to stop mass withdrawals; regulatory stress tests to test liquidity and resources; and more disclosures, eg, on leverage through the use of derivatives.

Comment – The SEC in the US came to the same conclusion that asset managers – even very large ones – should not be treated in the same way as banks, with a predominantly prudential approach not suited to asset management. A US Economic Studies at Brookings paper in May 2014 on the systemic risk and the asset management industry is worth a read.

8. SHOULD REGULATORS LIMIT MANAGERS’ INVESTMENT INTO ‘BAIL-IN’ BANK BONDS?

As regulators and banks adjust to the new rules on bank bonds being subject to bail-in in the event of the bank coming into difficulties, the risk of loss is being transferred from the taxpayer to the clients of asset managers. The holders of Greek bank bonds have experienced this problem already; in future it is likely that more managers and investors will be affected. This is not only retail investors but also insurance companies which invest as principals. So the question is, how will the regulator balance a natural desire to control the build-up of risks in portfolios (so the desire to micro-manage managers’ and insurance companies’ portfolios) with its mandate to supervise only (and not make investment decisions)?

The EU Bank Recovery and Resolution Directive (BRRD) (2014/59/EU), Article 55 requires EU firms and other in-scope entities to include a contractual recognition of a bail-in clause in a very wide range of non-EU law governed contracts. EU member states are required to implement Article 55 into national law by 1 January 2016.

What is an in-scope entity? Article 55 applies to EU incorporated banks and qualifying investment firms, their EU incorporated holding companies, and their subsidiaries which are EU financial institutions, as well as certain affiliates. Articles 1(a) to (d) of the BRRD and associated definitions draw a wide perimeter. Non-EU incorporated firms and their EU branches are out of scope. However, firms need to consider the national implementing rules to determine which entities are in scope (see Clifford Chance’s September 2015 useful guidance).

Comment – As prudential regulators, both the PRA and the FCA have a duty to require individual firms to hold enough capital and liquid assets. The Financial Policy Committee (FPC) also has a macroeconomic responsibility (as shown in mortgage leverage): but too heavy a hand means reducing the ability of the buy-side to fund banks. Wait and see! Asset managers need to assess whether BRRD Article 55 affects them as qualifying investment firms.

9. HOW MUCH REGULATORY CAPITAL SHOULD AN ASSET MANAGER HOLD?

In many cases, the relevant prudential capital rules of the PRA or FCA or EU Directive prescribe the minimum amount, eg, under the CRD or Interim Prudential Sourcebook (IPRU). However, the regulator has the right to require that the manager holds more capital. KPMG has estimated that a manager could need an extra £54 million of capital – of the 32 surveyed, 19 had been instructed to put up an extra £30 million on average. Some of these demands are based upon the firm’s risks and their management, and the Internal Capital Adequacy Assessment Process (ICAAP) is a key document for both purposes. Nausicaa Delfas, Director of Specialist Supervision at the FCA, has said: “We have found that some firms are not assessing their ICAAPs appropriately. This can result in us requiring significant capital increases.”

Comment – New City Initiative, a group of independent smaller fund managers, has made a survey of its members’ costs of compliance with regulations. This found that more than 20% of management time was spent on regulation – as well as significant cost. This is one factor behind the reduction in the number of boutique investment fund operations from 40 in 2013 to 34 in 2014. New City’s chairman said: “It is too often the case that regulations within the financial services industry end up doing the opposite of what they are intended to do.”

CORPORATE FINANCE

1. THE TRANSPARENCY DIRECTIVE IS AMENDED

The Treasury has made the Transparency Regulations 2015. These implement the changes to the rules under the original Transparency Directive (TD). They came into force on 15 November 2015. Among other changes, they enable the FCA to apply for a court order suspending the voting rights of shares of shareholders who have breached the notification requirements for notifying major shareholdings (this does not apply to AIM for technical reasons); where the FCA considers there may be a risk to market stability from publishing sanctions it has made, the Authority may delay publication or publish it anonymously; there are also changes to the definition of ‘disregarded holdings’, to comparable instruments and to the notification conditions.

Comment – Anyone who might be affected needs to read the whole court order since the detail is important.
2. NEW TAKEOVER PANEL PRACTICE STATEMENTS
There are two new Practice Statements (numbers 29 and 30). The first gives guidance on Rule 21.1 in respect of exclusions from the prohibition on offer-related arrangements; agreements between the offeror and offeree on the conduct, implementation and terms of an offer; and on agreements under which an offeree may pay an inducement fee to an offeror. The second guides on Rule 20.2. This may be complied with where commercially sensitive information is given to lawyers or economists of the offeror on an “outside counsel only” basis for competition law purposes. Practice Statement 23 has been withdrawn because its contents are covered by number 29.

3. VINDICATION FOR THE 2011 CHANGES TO THE TAKEOVER CODE?
The controversy continues over whether the shorter time period for an offeror to make a bid under the 2011 changes continues. Named ‘PUSU’ – put up or shut up – it was blamed for the collapse of Pfizer’s bid for AstraZeneca; now, its promoters claim it has scored a signal success in enabling SABMiller to persuade AB InBev to increase its offer price to an acceptable level.

4. THE REGULATOR LOOKS AT M&As FOR POSSIBLE INSIDER DEALING
There is an interesting insight into how the FCA takes action if it thinks there could have been insider dealing in an M&A transaction. For example, the FT reported that the FCA was surprised to see a rise of 17% in the shares of Friends Life before news of the proposed merger with Aviva.

Normal practice is for the FCA to call for lists of all those on insider lists at the companies and their different advisers, and (in this case) the brokers who were separately arranging the buyback programme which Friends Life was making prior to the news becoming known. There is no information upon whether they will take action against anyone.

Comment – The FCA’s latest Annual Report shows a steadily improving trend in market cleanliness. There have been many M&As recently.

5. M&A IN FUND MANAGEMENT – AN UNINTENDED CONSEQUENCE OF NEW REGULATIONS?
The news that London’s share of global asset management decreased from 9.6% in 2006 to 6.8% in 2013 gives pause for thought. At the same time, New York’s share increased from 12.6% to 20%.

One analyst’s suggested reason for this significant decline is not the growth of Asia (which continues to lack a large financial centre to compete with the West), but rather the economies of scale in meeting the increased regulatory costs since the global crisis in 2008, and the regulatory changes since. Put simply, compliance costs decrease as the proportion of assets under management increases. A leading example is BlackRock, which was only tenth in assets among global managers in 2006; it is now first, with 50% more assets than its nearest competitor.

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Comment – Size carries prominence and focus from the competition regulators in all continents. Large asset managers may find the new focus in the UK and the EU on competition uncomfortable.

6. FORMALITY IN MANAGEMENT DOCUMENTATION IN SMALLER CORPORATE FINANCE HOUSES
Smaller M&A houses would do well to take heed of the FCA’s comments regarding commodity firms in its September issue of Market Watch.

Speaking of a recent review, the FCA said: “We found less effective governance arrangements, for example, informal committee structures and arrangements, unclear escalation procedures and no formal records of board or committee debates or decisions. These firms were also less able to demonstrate that senior management had clear sight and control of the conduct risks presented by the front office in terms of conflicts of interest or more serious issues…”

While smaller firms will always rely on their fleetness of foot and lack of bureaucracy, firms must be aware that this should not be at the expense of the documentation of routine decision-making.

Comment – Check that you have a regular routine of board meetings, and that the minutes of these detail the major issues facing the firm.

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7. THE LSE GETS TOUGH WITH NOMADs
The LSE has issued a private warning to a Nominated Adviser (Nomad) and fined another (£75,000) for breach of Rule 19 (liaison with the Exchange) and Article 23 (proper procedures). The firm had failed to make the changes which it had agreed to make following an earlier review of the Nomad. There are no public details of the particular failures.

Comment – The LSE has an inbuilt tension in both promoting AIM and disciplining firms or companies that breach its rules. The use of private censures and anonymity does seem increasingly against the trend of transparency – and giving information to clients and companies.

8. THE FCA CONSIDERS WHICH PARTS OF MiFID II SHOULD APPLY TO EXEMPT CORPORATE FINANCE FIRMS
The FCA is required to apply analogous provisions under MiFID II to Article 3 exempt firms. These are firms such as corporate finance boutiques which only provide advice or transmit orders but do not execute orders or hold client money or assets. The most relevant requirements are to record phone calls and electronic communications relating to client orders, changes to client classification, conflicts of interest and (for those firms with retail clients) adviser independence and inducements, and record keeping.

Comment – Corporate finance firms need to prepare for changes in these areas from 3 January 2017. Recording phone calls could be the largest change for order transmitters; inducements and record keeping for other corporate finance houses.

DERIVATIVES
1. FINAL RULES FOR SWAPS CLEARING IN THE EU
The EC has issued the provisional delegated regulation that it has adopted for the
mandatory clearing of certain derivatives (fixed-to-floating interest rate swaps, basis swaps, forward rate agreements and overnight index swaps in euro, sterling or yen, and some types of US dollar denominated swaps). The EC proposes that these new requirements will be phased in over three years depending on category of business, starting from April 2016 to give smaller market participants more time to prepare. However, this timetable is subject to the EU Council and Parliament accepting this timetable – which they may not because the EC adopted them during the summer recess without consultation.

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There are four categories of business under the regulation:
(a) Category 1: clearing members of any CCP for any of these instruments;
(b) Category 2: financial counterparties and AIFs which are not clearing members and which have a higher level of activity in OTC derivatives (to be measured against a quantitative threshold);
(c) Category 3: financial counterparties and AIFs which are not clearing members and which have a lower level of activity in OTC derivatives (to be measured against a quantitative threshold); and
(d) Category 4: non-financial counterparties not included in the other categories.

The start of the clearing obligation depends on which category the business is in.

The regulation recognises that firms may have problems in categorising their counterparties. The EC’s approach is to postpone the starting date of the frontloading requirement until two and five months from the entry into force of the regulation for categories 1 and 2 respectively. Such a postponement would allow counterparties to determine whether they fall into a category of counterparties subject to frontloading.

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Action – As soon as a financial counterparty knows that it falls within category 2, it has to adopt the necessary arrangements to be able to frontload contracts, including providing the appropriate representations to its counterparties and making the appropriate changes to its systems, controls and internal procedures to reflect these determinations and representations.

There are transitional arrangements for intra-group transactions – a sticking point in the negotiations with the industry – where interest rate swaps (IRS) OTC derivatives that are intra-group transactions are concluded between a counterparty established in a member state and another counterparty established in a third country which belongs to the same group and which fulfil certain conditions. These could benefit from the exemption from clearing.

Comment – It has been a long three years since the mandatory clearing obligation for these instruments was meant to start in 2012. The practicalities and negotiations with the US have meant that the EU is planning to implement this duty two years after the US and Japan. There remain serious differences in how all three have interpreted the G20 commitment – in margining, for example. Time will tell whether these are serious flaws – in the meantime cross-border firms will have to have different procedures for each region.

2. DATES DRAW CLOSER FOR MARGINING NON-CCP CLEARED TRANSACTIONS

Here are the principal dates for this:
- Variation margin requirement for major market participants – 1 September 2016 (1 March 2017 for all others)
- Initial margin requirements start – 1 September 2016 to 1 September 2020.

3. MiFID II/MiFIR

ESMA has published the technical standards on the revised MiFID.

The regulatory review, which takes the form of a Directive and a new Regulation and is commonly referred to as MiFID II, is intended to increase market transparency, efficiency and safety as a result of developments in the trading environment since MiFID’s implementation in 2007. The technical standards include areas such as transparency, microstructure issues, data publication and access, requirements applying on and to trading venues, position limits and reporting in the commodity derivatives markets, market data reporting, post-trading issues, and information relating to best execution.

The technical standards have been sent to the EC which has three months within
which to approve the standards. MiFID II will become binding on market participants in 2017.

4. COMMODITY POSITION LIMITS UNDER MiFID II
Under MiFID II, the cap on the number of contracts that can be held will range between 5% and 35% — a clear limit but better than the 10% to 40% range ESMA originally proposed. What is less well understood is the impact on customers — such as energy companies, food manufacturers and agricultural businesses that use commodity derivatives to hedge their raw materials. From January 2017, they risk being regulated under MiFID II if their speculative commodity trading exceeds the relevant threshold. Steven Maijoor, Chair of ESMA, has described this as “the most important change from earlier versions” (and the current position under MiFID I). Maijoor warned that “once you get into speculative trading you are competing with the investment banks and there should be a level playing field; you will be caught by the rules”. These rules include authorisation and the holding of prudential capital like financial firms (under MiFID II there are two threshold tests — the ratio of speculative trading to total commodities activity — broadly 10% — and their market share measured against the overall market — between 3% and 20% depending on the commodity). One key question is the meaning of ‘hedging’ for producers and manufacturers alike.

Comment — The charge against speculative investment in commodities was led by France and it is now embedded in MiFID II Level I. This is a new concept for non-financial companies. It is unclear what the role of brokers is, given that their clients may well be using a range of different intermediaries, and may be unwilling to explain details to them to see if it is genuine hedging or speculation.

5. THE ESRB REVIEWS EMIR
The EC is reviewing the operation of EMIR under the terms of the original regulation. The European Systemic Risk Board (ESRB) has published two reports on EMIR to help the EC.

In its first report on the efficiency of margining and additional intervention capacity, the ESRB looks at various aspects of margining such as stressed periods, more rigidity in haircut requirements, and CCPs’ pro-cyclicality policies, and looks ahead to a further review in 2018 focusing on the systemic implications of margin and haircut requirements.

In its second report on EMIR more generally, the ESRB recommends that the EC consider a swift process for the suspension or removal of mandatory clearing to address illiquidity of instruments, specifying that ESMA should have responsibility for conducting the evaluation of systemic risks of mandatory clearing — not the national authorities — requiring that CCPs should have ‘skin the game’ in line with their clearing operations; that CCPs should publish quantitative and qualitative requirements information; that ESMA should publish a list of CCP interoperability arrangements; and that access to trade repository data to national authorities should be widened to cover data on all subsidiaries of entities in their jurisdictions.

6. CCP CLIENT ACCOUNTS UNDER EMIR
ESMA has issued a discussion paper on the review of its technical standards in respect of these accounts (now closed for comments). Article 26 sets out the time horizons for their liquidation by CCPs. ESMA asked interested parties whether its standards should be revised to reduce the liquidation period from two days to one day except for OTC derivatives, which are margined on a gross basis. It also asked if this is sufficient for a CCP to transfer or liquidate the relevant position.

7. INDIRECT CLEARING OF EXCHANGE-TRADED DERIVATIVES UNDER EMIR
ESMA has published a letter from Steven Maijoor, its Chair, to Jonathan Hill, European Commissioner for Financial Stability, on the draft RTS on indirect clearing for OTC and exchange-traded derivatives. These specify the types of indirect contractual arrangements that do not increase counterparty risk and ensure that the assets and positions of the counterparty are protected.

8. GLOBAL REVIEW OF OTC DERIVATIVES MARKETS REFORMS
The FSB has issued its latest progress report on how standard-setting bodies, national and regional authorities and market participants are meeting the G20 commitments on OTC markets reform. The main conclusions are that most progress has been made in trade reporting and higher capital requirements for non-CCP cleared transactions; that further progress has been made in mandatory clearing with seven jurisdictions having at least a framework for this; few jurisdictions have mandated derivatives execution on exchanges for standardised contracts; there has been even less progress with requiring margining of non-CCP cleared transactions; but there is progress in the number of CCPs and trade repositories (TRs), although there remain issues around regulators’ ability to access, use and aggregate their data.

9. PROGRESS ON THE UNIQUE TRANSACTION IDENTIFIER (UTI)
The Committee on Payments and Market Infrastructures (CPMI) and IOSCO (‘the Group’) have issued a consultative report (consultation period closed) on the harmonisation of the UTI. This is primarily used for derivatives transaction reporting, but there are others used for other purposes such as supervisory or tax reporting. The objective is to produce clear guidance to prevent the proliferation of (and conflict between) different national or regional UTI protocols. The key points in the report are that OTC derivatives transactions should be assigned...
a UTI, to identify the entity responsible for generating the UTI in practice, what the structure and format of a UTI should be and how these UTIs would be kept distinct from UTIs under existing regimes such as for supervisory, prudential or taxation purposes.

The Group has issued a consultative report on technical guidance to authorities on definitions of a first batch of key OTC derivatives data elements (other than UTIs) which are needed for the aggregation of data for OTC transactions on a global basis. A consultative report on global Unique Product Identifiers (UPIs) was expected in November 2015, as well as a consultative report on a second batch of other key data elements during 2016.

Comment – All these steps are positive and helpful to firms and supervisors. The industry will be asking two basic questions: first, to have sufficiently and practical granular technical specifications in good time before the requirement starts; and second, that the supervisors do in fact aggregate and make use of the data since otherwise firms’ considerable costs and time will be wasted and the aim of managing systemic risk will have failed.

That the supervisors do in fact aggregate and make use of the data since otherwise firms’ considerable costs and time will be wasted and the aim of managing systemic risk will have failed.

10. WHAT DO REGULATORS DO WITH ALL THAT POSITION DATA?

Comment – TRs and regulators have received huge volumes of new data under Dodd-Frank (for spotting the build-up of positions or credit risk in bilateral OTC and exchange-traded derivatives in recent years in the US and EU). The question which firms ask frequently is whether the data which their huge investment in time and money produces is of any value to, or used by, the regulators. Answers to this question are beginning to emerge – and they are not encouraging because of the different requirements of national regulators (for example in the EU both parties to the transaction, while only one in the US), different reporting systems of TRs and regulators, the lack of a single mandated unique entity and reporting system, and the inability of TRs and regulators to analyse the data. For example it is suggested that initially only 3% of exchange-traded derivatives could initially be matched across different TRs; and the bank. TRs and regulators appear to have had the reports which should have identified the build-up of positions in JPMorgan’s book of credit derivatives by Bruno Iksil (‘the London whale’) but did not. Hopefully both TRs and regulators are now much more experienced.

11. INDUSTRY INITIATIVE FOR A DERIVATIVES PRODUCT IDENTIFICATION STANDARD

The International Swaps and Derivatives Association (ISDA) has published a press release announcing the launch of this standard. It aims to develop an open-source standard derivatives product identification system that can be applied consistently and comprehensively across all derivatives facilities including trading venues, clearing houses, repositories and other infrastructures. It addresses the need for a standard under MiFID II and SEC reporting rules, which require a standard means of identifying derivative products at a granular level. The first initiative is for globally standardised symbols for credit, rate and equity derivatives in 2015.

12. ESMA LOOKS AHEAD TO AN EU OTC UNION

ESMA’s Chair, Steven Maijoor, made a speech in which he reviewed the regulation and supervision of the derivatives market. Some points he made are: by the end of 2016, ESMA will have completed the post-crisis changes so that afterwards, its focus will move resources from making the single rulebook to their implementation; the right level of access of smaller counterparties to CCPs under EMIR is a focus; although trade reporting under EMIR has worked reasonably well and ESMA has used the reports, the current ESMA review has shown there are shortcomings and limitations. (There are also examples of non-compliance.) For the present, ESMA has asked national regulators to increase supervision on current reporting standards; ESMA is contributing to the EMIR review – see Wholesale/Capital markets section, ‘The ESRB reviews EMIR’, p. 52 of this edition

The ‘OTC derivatives union’ provides a model for the Capital Markets Union.

By the end of 2016, ESMA will have completed the post-crisis changes so that afterwards, its focus will move resources from making the single rulebook to their implementation.
Comment – It is doubtful whether any derivatives firm would agree that the CMU should be based on the EMIR approach – the main objective, CCP clearing of liquid derivative transactions, may finally be close to achievement, but the process of getting there has been slow and tortuous, for example in transaction reporting and equivalence negotiations. The EC’s and EU Parliament’s lack of understanding of how the different derivatives markets work has been shown, as well as the stubbornness of the derivatives sector to be reformed.

13. IMPORTANT GUIDANCE ON MARKET ABUSE FROM OFGEM

Ofgem has written an open letter to industry participants on its understanding of the market abuse rules under the EU Regulation on energy market integrity and transparency (REMIT) and its expectations of firms to prevent market abuse in the wholesale energy market. Separately Ofgem has published guidance on warning and decision notices and a statement of its policy on imposing financial penalties.

Comment – The market is still adjusting to the extension of market abuse rules to the wholesale energy market. This clarification of the regulator’s understanding is therefore important. If and when it takes action against firms, its message will become even clearer (as with the FCA). In the meantime firms, having escaped the threat of price caps and stronger regulation under a Labour Government, will do well to listen and prepare.

14. ACER APPROVES FIRST ENERGY REPORTING MECHANISMS

The Agency for the Cooperation of Energy Regulators (ACER) has published a press release explaining that it has approved the first five Registered Reporting Mechanisms (RRMs). They have successfully passed the identification, attestation and testing stages for approval. (There are currently 34 pre-registered RRM applicants.) The press release also describes how to report trades and orders. REMIT reporting started on 7 October 2015.

15. US REGULATOR RELAXES LARGE COMMODITY TRADE RULES

The US CFTC is proposing to change one important element of its long-debated new rules on commodity speculation. (These include caps on commodity positions as mandated by the Dodd-Frank Act.) The change affects the consolidation of group companies and funds under management for calculating the limit. The CFTC now appears likely to accept that a group or fund manager could calculate positions at an individual company or fund level if it attests that it has no control over it and meets certain standards.

16. HOW PUBLIC SHOULD FUTURES EXCHANGES’ VOLUME DISCOUNTS BE?

Commodity futures exchanges and platforms have long offered discounts, rebates and payments to attract big customers to trade on them, particularly for new contracts lacking liquidity. Market makers are particularly attractive. The regulators appear to accept the principle but are wary. “The main concern is that the programmes don’t lead to non-bona fide trading, where there are just people executing trading for the sole purpose of getting the incentive and not really assuming risk” – a former director of oversight at the CFTC. One trader was recently fined $750,000 for such ‘wash trades’. Another approach is to increase transparency of the incentives. “We understand that the CFTC will be issuing a new rule designed to further improve transparency, and we look forward to reviewing it and responding” – the CME.

HEDGE FUNDS AND PRIVATE EQUITY

1. DO PRIVATE EQUITY INVESTORS KNOW HOW MUCH THEY ARE PAYING?

The Institutional Limited Partners Association (ILPA) has launched a campaign to standardise the reporting of managers’ fees. It is concerned that some investors have not tracked this information fully because of their reliance on their own in-house systems. The Association aims to produce a “reporting template that details … all monies paid to the fund manager” setting out details under the principles of the Association on fees and what investors are entitled to expect. This initiative flows from the SEC’s demand that to increase and standardise these disclosures (see Change, Aug 2015, Wholesale/Capital markets, ‘US and EU regulators heighten supervision of private equity firms’, p. 51). “Investors believe that fees must be appropriate, arm’s-length, reasonable and disclosed” – ILPA.

Comment – In part this initiative also springs from the public embarrassment which a very large Californian investor has had in its own recording system not apparently covering the ‘carried interest’ or profit.
share of managers, and the background to the rebates which managers give (some) investors for fees related to portfolio companies. The discussion has further opened up the basis for private equity charging. EY’s 2015 global private equity survey showed that the biggest problem for investors in buyout funds is the current level of management fees – 30% would want a change from the ‘two and twenty’ model. Guy Hands, Chairman of Terra Firma, says that the risk to private equity managers is that their biggest investors will bypass them and invest directly.

We will continue taking action against advisers [private equity managers] that do not adequately disclose their fees and expenses. — Andrew Ceresney, Director of Enforcement, SEC

The issue of non-disclosure of fees has gained importance following the SEC’s action against Blackstone for not informing private equity fund investors of hidden fees ($39 million in compensation and fines). The SEC’s Director of Enforcement, Andrew Ceresney, said: “We will continue taking action against advisers [private equity managers] that do not adequately disclose their fees and expenses.”

Comment – Some commentators see this case as the ‘tip of the iceberg’. and estimate that these ‘hidden’ fees could be as much as $20 billion.

2. THE TREASURY CONSULTS ON THE TAX TREATMENT OF LIMITED PARTNERSHIPS

The Treasury has published a consultation paper on changes to the Limited Partnership Act 1907. These amendments are designed to update the 1907 Act and make it fit for purpose as the market standard structure for European private equity and many other types of private equity funds. Changes include: a process for designating private at the start of the new regime (the new regime will apply to other new ones); empowering the Registrar of Companies to remove inactive private fund limited partnerships (LPs); a non-exhaustive ‘white’ list of activities that a limited partner in a private fund LP can do without being considered as taking part in the management of the business, and therefore losing their limited liability; deleting the requirement for limited partners in private funds to make a capital contribution (and of liability for capital contributions that have been withdrawn); abolishing the need to obtain a court order to appoint a partner to wind up the LP; simplifying the LP private fund registration process, and of the need to advertise some changes in the London Gazette; and removing the requirement of limited partners to produce accounts and information to other partners and to account for profits made in a competing business. Looking further ahead, the Government has committed itself to exploring LPs having their own separate legal personality (as in some other jurisdictions).

It will help make the UK more competitive with other popular jurisdictions that either have specific legal frameworks for private equity, or which have already modernised their laws to adjust them to this purpose.

Comment – These changes, made in consultation with the industry, are helpful in modernising a 100-year-old law that was not designed for private equity LPs. It will help make the UK more competitive with other popular jurisdictions that either have specific legal frameworks for private equity, or which have already modernised their laws to adjust them to this purpose.

3. AIFs IN THE FORM OF LIMITED PARTNERSHIPS

The FCA has issued guidance on where an AIF in the form of an LP is established based on its understanding of the effect of the Alternative Investment Fund Manager (AIFM) regulations. It uses the definition of ‘established’ for an AIF to be ‘authorised or registered’ in a given country; or if the AIF is not authorised or registered, then having its registered office in a given country. It further states that where an AIF is not registered or authorised anywhere in the European Economic Area (EEA), then it considers the place of establishment to be the country where its registered office is located. An AIF is not authorised or registered unless it is authorised or registered as a fund; registration at, for example, Companies House does not fulfil this requirement. If there is no registered office, then the determination of the place of establishment is based on the location of the head office of the AIF. The FCA guidance includes two specific examples involving Guernsey.

Comment – Guernsey and Jersey have long been favourite locations for alternative fund structures and this guidance is important, as it appears to confirm that a non-EU AIF can be established in Guernsey or Jersey using a Guernsey or Jersey general partner as appropriate, even if it is using an English limited partnership for the fund, as its principal place of business is deemed to be in the Channel Islands. The benefits from a marketing perspective are that it can market in the EU using the National Private Placement Regimes (NPPRs) and reduce its AIFMD burden. Alternatively, if the AIF is not marketing in the EU it can remove itself completely from the AIFMD. This guidance may also be helpful in relation to non-EU AIF managers and their eventual compliance with AIFMD, especially as the extension of the third country passport to Guernsey and Jersey is completed. A non-EU AIF manager who manages an EU AIF and would normally be subject to substantial AIFMD regulatory requirements, even if the fund was never marketed in the EU. It can now avoid this by structuring as a non-EU AIF.

4. EXTENDING THE AIFMD PASSPORT TO NON-EU AIFMs AND AIFS

The AIFMD (along with the Foreign Account Tax Compliance Act (FATCA)) has been the principal candidate for strong controversy over recent years. Hedge funds and private equity managers have now adapted to the Directive, but as was clear during its consultation phase, it was remuneration and marketing that were the two hot topics. Marketing remains so, and depending on your viewpoint, is regarded as either complicated or a mess, mainly because the implementation of the AIFMD into national law by each EU country has resulted in an uneven implementation and lack of standard definitions, eg, marketing. For those EU funds and managers that have complied with the burden of compliance to be authorised under the legislation, even the ‘golden ticket’ of the marketing passport for funds has been less than plain sailing.
with the imposition of additional requests or requirements from the regulators in some countries a fund wishes to market in. That situation is easy when compared to the options available for non-European managers who either have to use the onerous or sometimes non-existent NPPRs, or rely on reverse solicitation. The result is that there are non-EU funds stopping or targeting their marketing in Europe, thereby depriving institutional investors in Europe of the ability to invest in overseas funds in order to seek higher performance or diversification.

The result is that there are non-EU funds stopping or targeting their marketing in Europe, thereby depriving institutional investors in Europe of the ability to invest in overseas funds in order to seek higher performance or diversification.

Even at the earlier stages of the legislative consultation, this problem became apparent and lobbying forced the EU to incorporate the concept of a marketing passport for non-EU fund managers, the so-called ‘third-country passport’. The statutory deadline for ESMA to deliver its report and recommendations to the EC was 22 July 2015. On 31 July ESMA provided its advice on the extension of the AIFMD passport to non-EU AIFMs and AIFs. It performed a substantive assessment for six jurisdictions which had provided sufficient information: Guernsey, Hong Kong, Jersey, Switzerland, Singapore and the US. It concluded “that no obstacles exist to the extension of the passport to Guernsey, Jersey, while Switzerland will remove any remaining obstacles with the enactment of pending legislation. No other definitive view has been reached on the other three jurisdictions … It aims to finalise the assessments of Hong Kong, Singapore and USA as soon as practicable.”

Steven Maijoor, Chair of ESMA, made a statement in October on the next steps with the AIFMD passport. ESMA will continue its assessment of Hong Kong, Singapore and the US; start to assess a second group of countries (Australia, Canada, Japan, the Cayman Islands, the Isle of Man and Bermuda); and develop the framework for the passport including ESMA’s role in its operation and strengthening supervisory co-operation.

Comment – While this appears to be good news for Jersey and Guernsey, which will have no doubt push for this to be implemented quickly, ESMA cautioned against the EU governing institutions rushing to extend the passport until ESMA has delivered its advice on a sufficient number of non-EU countries. Timing is not clear and the current situation regarding marketing looks set to continue.

ESMA also commented on the functioning of the current passport and NPPRs identifying a number of issues, including those commented on in the Wholeale/Capital markets section, ‘Extending the AIFMD Passport to non-EU AIFMs and AIFs’, p. 55 of this edition. Interestingly, it did not find serious problems with the current NPPR regime.

5. US REGULATOR CRITICISES HEDGE FUND COMPLIANCE PROCEDURES

The Chair of the SEC, Mary Jo White, has criticised some hedge fund managers for a range of compliance failures resulting from two years of spot checks since the SEC took over their regulation. In particular, she mentioned allocating winning trades and investment opportunities to personal accounts, failing to disclose conflicts of interest relating to managers’ proprietary funds and personal accounts, and massaging performance figures in marketing materials through using alternative funds. These are “a few of the recurring specific compliance risks our examiners have seen that each private fund adviser should be addressing every day”.

Comment – The risk for hedge funds is that these failures by some managers may lead to a broad-based enquiry as private equity is seeing in ‘hidden’ fees.

6. WILL OFFSHORE HEDGE FUNDS MOVE ONSHORE?

A poll conducted by UBS and PwC of investors in hedge funds found that they expected more offshore-based hedge funds to move onshore in the EU as a result of the AIFMD. For example, ESMA has not yet started to assess the Cayman Islands for equivalence and an AIFMD passport (see the Wholesale/Capital markets section, ‘Extending the AIFMD passport to non-EU AIFMs and AIFs’, p. 55 of this edition). Ireland (with its new Irish Collective Asset-management Vehicle (ICAV) structure which may also be tax efficient for US investors) and Luxembourg are leading the way with 81% of EU-based funds. UBS has decided to move some funds to Ireland as ICAVs.

Comment – Where this appears to be good news for Jersey and Guernsey, which will have no doubt push for this to be implemented quickly, ESMA cautioned against the EU governing institutions rushing to extend the passport until ESMA has delivered its advice on a sufficient number of non-EU countries. Timing is not clear and the current situation regarding marketing looks set to continue.

7. TRADE BODY REVISES PRIVATE EQUITY MODEL ARTICLES OF ASSOCIATION

The British Private Equity and Venture Capital Association (BVCA) has published an updated version of its model Articles of Association for early-stage venture capital investments. The changes to the existing model result from the Companies Act 2006 (Amendment of Part 18) Regulations 2015. So Article 3.4 now reads: “Subject to investor Majority Consent and the Act, the Company may purchase its own Shares to the extent permitted by the by Section 692(1ZA) of the 2006 Companies Act.”

8. ESMA GUIDES ON AIFMD TRANSPARENCY REPORTING

There is important information for AIFMD transparency reporters contained in a Q&A which ESMA has published. These look at some of the problem areas supervisors have found in firms’ reporting. The Q&As focus on problem areas such as “Should leverage be provided as a ratio or as a percentage of NAV?” to more complex ones such as “How can an AIFM verify whether it has given the correct euro FX rate and not the reciprocal by mistake?”. The Q&As also identify where AIFMs have provided inconsistent responses to connected questions and give more information on the general use and functionality of GABRIEL, (the FCA’s reporting system).

Comment – Whilst this guidance is helpful, it does not address the sometimes confusing guidance previously given by ESMA, or the inflexibility (and lack of capacity) of GABRIEL, which has broken down when many reports are made at the same time.

9. REPORTING THE VALUE OF ASSETS UNDER MANAGEMENT UNDER THE AIFMD

ESMA has issued some useful Q&As on this question. There are updated answers which are highlighted in yellow in its updated version.

10. CYBER SECURITY – SECOND US EXAMINATION

The SEC is continuing its cyber security programme and confirms its serious intent on cyber security procedures and readiness by announcing a Risk Alert regarding a second round of examinations of registered investment advisers and broker-dealers. The first took place in April 2014 and the results were released in February 2015 (see All financial sectors section, ‘Regulators
worry about cyber attacks on firms and institutions’, p. 20 in this edition). This second round will incorporate more detailed testing of procedures and controls as opposed to documentation and will focus on governance and risk assessment, prevention of data loss, IT vendor selection and control, access rights/controls, and training and data breach response procedures. The National Futures Association has issued its cyber security proposals and the Alternative Investment Management Association has published a Guide to Sound Practices for Cyber Security.

Comment – This is an important topic for all types of enterprises to understand and assess, particularly hedge funds, as the pace of change and expectation in this area increases rapidly. Investors are issuing detailed questionnaires to managers and institutions to analyse their status, compliance and risk. The previous regime of best practices in this area is now being converted into legal requirements, as evidenced by the recent SEC action against a registered investment adviser for failure to adopt suitable policies and procedures. The Risk Alert contains a sample document request and firms should review this together with those proposals from other trade associations to check for any deficiencies in their firm.

The previous regime of best practices in this area is now being converted into legal requirements.

11. COMMON REPORTING STANDARD
The Organisation for Economic Co-operation and Development’s (OECD) Automatic Exchange of Information Common Reporting Standard (CRS) will come into force on 1 January 2016 and whilst the US will not be participating but using its FATCA Intergovernmental Agreements (IGAs), jurisdictions such as the UK, Jersey, Guernsey and the Cayman Islands will be. For alternative funds this means that more information will be needed from investors and additional reporting compliance to tax authorities. While forward planning in respect of FATCA should have gathered the required additional information for CRS purposes, for those that did not, then this must be obtained and future investor documentation amended to collect compliant information. HM Revenue & Customs (HMRC) has recently released its detailed draft guidance on this topic.

INVESTMENT BANKING AND CAPITAL MARKETS

1. COULD REGULATORS HELP INCREASE BOND LIQUIDITY?
The Bank of England’s Capital Markets Division has examined bond liquidity in a blog and concluded: “We find that dealer holdings act less as a shock absorber than they did around a decade ago. Instead bond spreads rise more. We also find that greater declines in issuance follow these shocks.” Its modelling showed that dealers normally increased their holdings by 1.5 basis points when manager demand fell sharply, while post-crisis, the increase reduced to only 0.2 basis points. In contrast, bond spreads have widened more after falls in manager demand. The BIS made its own review of the impact on emerging market bonds: it found that the impact of declining liquidity resulted in investor redemptions forcing sales of bond holdings, and additional discretionary sales by fund managers: “A hundred dollars’ worth of bond sales due to investor redemptions is accompanied by roughly ten dollars’ worth of discretionary bond sales.”

Comment – So should regulators roll back the prudential requirements that are blamed for the reduction in bond dealers? Governments are concerned that those rules are at the core of making banks safe – and less likely that taxpayers’ money will be needed to bail them out. A report made by PwC and commissioned by the Global Financial Markets Association (GFMA) on behalf of international banks suggests some remedies. These include improving market data and analysis, exploring the links between liquidity and regulations, harmonising regulations here globally and rolling back policies that “may not add significantly to financial stability, but are detrimental to market liquidity”. It does not name these policies but they are likely to include prudential requirements and recovery and resolution procedures, as well as potentially MiFID II.

2. WHAT ARE BANKS’ MAIN CONCERNS ABOUT MiFID II?
Here are a handful:
• The identification of systematic...
internalisers and their quoting obligations for non-equities (bonds and derivatives)

- The need to know the current percentage of equities traded outside the exchanges, eg, on MTFs
- For commodity derivatives, the need to know the ‘size of the market’
- Whether ‘over-reporting’ would be acceptable and the increasing requirements for Legal Entity Identifiers

And more generally:

- What Level 3 Guidelines ESMA is planning (and their timing)
- The time needed for authorisation for new regulated activities
- The shrinking of the time gap between the final Level 2 regulations and delegated acts, the FCA’s papers on their implementation and the start of MiFID II in January 2017, giving little time for the technical challenges in transaction reporting, price transparency, position reporting, best execution, cost and other disclosures and commission sharing (ESMA final drafts are still not out)

3. REGULATORS CONTINUE TO PUSH AHEAD WITH SECURITISATION EASING

Basel and IOSCO have issued a joint report on the final criteria for identifying simple, transparent and comparable securitisations. There are 14 criteria which are non-exhaustive and non-binding. The main groups of these are around the underlying asset pool, transparency around the securitisation structure and governance of key parties in the process, eg, fiduciary and servicer. The criteria are to be read with but not replace investor due diligence.

Comment – These criteria result from an industry consultation. General industry reaction was favourable but some thought they were over-prescriptive and a number of technical and implementation points were made. Some of these have been included in the report and criteria. We can now expect these criteria to be considered in the EU’s consideration of securitisation, and the easing of prudential requirements in respect of securities that meet the simple and transparent tests.

4. SECURITIES LENDING DEVELOPMENTS

The next step in the Securities Financing Transactions Regulation (SFTR) is for it to be approved by the EU Parliament. This was scheduled for October, but may be postponed, even though the text has been informally agreed between the Council and the Parliament. The SFTR increases the transparency of securities transactions.

Comment – The SFTR flows from the FSB’s focus on the regulation and transparency of shadow banking.

The ECB’s Money Market Statistical Reporting Regulation requires major banks to report on their money market transactions to their central bank from April 2016. It was originally envisaged that this would cover repo transactions, but did not extend to securities borrowing or lending. However, it does now seem this is caught if the transaction is collateralised by EUR cash.

5. THE VOLCKER RULE AFFECTS COVERED FUNDS AND COLLATERALISED LOAN OBLIGATIONS (CLOs)

One impact of the Rule can be seen in the shedding by banks of covered funds and CLOs whose holding is penalised by capital charges for banks under the Rule (CLOs typically pool risky US corporate loans and high yield bonds). This has affected the liquidity of some of them in the market.

Comment – Holding/transaction in/sponsoring covered funds, including CLOs, may be prohibited for banking groups that contain a US bank (which is most of the large groups). This may also have an impact on liquidity – some issues that have been made after 2014 rely on different exemptions within the US Investment Company Act and thus do not fall within the definition of covered funds. This is, however, a difficult area for firms caught by the Volcker Rule in terms of identifying which products fall within the very broad and amorphous covered funds definition.

6. LSE FINES MEMBER FOR FAILING TO REPORT TRANSACTIONS

The LSE has unusually fined an unidentified member £225,000 for its failure to report its fixed income transactions over several years. The member’s failure had “resulted in a significant impact on market transparency, in that the non-reported volume in some instances represented a significant share of trading in certain securities”. The problem existed for some years, and when identified, it took the member five months to notify the LSE.

Comment – This is a doubly unusual step. Normally the FCA does the fining, and the LSE rarely uses its powers to do so.

The member’s failure ‘resulted in a significant impact on market transparency, in that the non-reported volume in some instances represented a significant share of trading in certain securities’

LSE

7. CHANGES TO AIM RULES

AIM has consulted on proposed changes to investing companies (raising the minimum capital raised to £6 million from £3 million) and AIM companies that make a fundamental change of business (deleting the provision that deems that the company becomes an investing company rather than a cash shell on disposing of its business so that it must complete a takeover – or reverse takeover – within six months, or have its shares suspended).

Comment – These changes follow increasing concerns that cash shells have raised money and then sat on their investors’ funds incurring management expenses for too long.

Separately the LSE has published guidance on AIM company disclosures relating to equity financing products (such as equity lines of credit, swap facilities and crowdfunding) in which an AIM company or its directors are interested. The guidance recommends that AIM companies and their Nomads should study the products carefully and consider giving more detail in announcements about them. It also notes the broad definition of ‘deal’ (including the transfer of voting rights) and that the nature of any dealing arrangements should be disclosed.

Comment – This guidance follows the recent controversy about the non-disclosure of some unusual share financing arrangements under which the lender could control the shares – see Change, Feb 2015, Wholesale/Capital markets section, ‘When is a loan a sale by a director?’; p. 66.

Finally, the AIM rule that states that every company must have a Nomad or face suspension looks likely to affect Chinese AIM shares where the Nomad has concerns about the ability of the company to meet AIM rules, eg, on timely filing of accounts.
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1. SHOULD THE TREASURY HELP CHALLENGER BANKS ON BANK PROFITS TAX?

The new 8% bank profits tax has been criticised by small banks and challenger banks. They say it will restrict their ability to serve the niche areas (including funding small and medium-sized enterprises (SMEs)) that mainstream banks may have pulled away from. In these niche areas, smaller banks may be competing against less or even unregulated non-banks such as hedge funds, as well as peer-to-peer and payday lenders (which may expand again). The smaller banks are appealing to the Treasury to set a higher threshold for the profits tax than the current £25 million. One bank said: “All of these [lighty regulated] entities are much less heavily regulated and now also have a huge tax advantage. I’d be surprised if they didn’t make use of it.” Some estimate a £6 billion reduction in SME loans as a consequence.

All of these [lighty regulated] entities are much less heavily regulated and now also have a huge tax advantage. I’d be surprised if they didn’t make use of it.

2. REGULATOR RESPONDS TO PARLIAMENT ON SME LENDING

The FCA has responded to the report and recommendations of the Commons Treasury Committee on conduct and competition in SME lending. Its response covers the competition work the FCA is carrying out in banking, the redress scheme established by the FCA for the mis-selling of swaps to SMEs, SMEs’ proposed access to the Financial Ombudsman Service (FOS) and the barriers to sharing its information about borrowers under the Financial Services Markets Act 2000 (FSMA).

Comment – With the FCA under pressure from Parliament on SME funding, it seems likely that there will be more consideration of the risk-weighted assets (RWAs) to be attached to SME loans, and more consideration given by the regulation of other providers. However, challengers only provide a small amount of SME lending.

3. THE BANK OF ENGLAND ADDRESSES NON-EU RETAIL BANK ACTIVITIES

In accordance with its policy of protecting UK depositors in the wake of the Icelandic banks saga, the Bank is requiring UK branches of non-European Union (EU) banks to establish subsidiaries that are more heavily capitalised than the branches. There are some 50 non-EU banks in this category. The Indian banks have been the first to subsidiarise. Others await the Bank’s Prudential Regulation Authority’s (PRA’s) decision as to whether they are satisfied with the standard of supervision and resolution planning of the bank’s home country.

The Bank is requiring UK branches of non-European Union banks to establish subsidiaries that are more heavily capitalised than the branches.

Comment – Some non-EU banks may pass this test, eg, Australia; others not. This approach applies to banks taking UK retail deposits. Wholesale activities may continue to be conducted through UK branches, although the position of systematically important wholesale banks is doubtful.

4. BANKS PREPARE FOR AND REGULATOR CONSULTS ON BANK SEPARATION

As the date for the start of ring-fencing comes closer (2019), banks’ preparations for such a radical restructuring are increasing – see Change, Aug 2015, Banks section, ‘UK EU and global waves for bank restructuring’, p. 58.

The PRA has issued two papers on important aspects of ring-fencing. Its first consultation (closing 6 January 2016) addresses the relationship between the ring-fenced retail bank and the rest of the group. The PRA has confirmed the separation of important activities such as independent risk management, but has relied on the payment of dividends by the retail bank to the parent company, which could recycle them to the group (including investment banking), avoiding the trapping of excess profits in it. Relevant banks have welcomed this as enabling them to compete more equally with non-UK banks. The retail bank will also be able to cross-sell products and lend to the group – but only on arm’s-length terms as if they were third parties. This again is a relief for groups wanting to use the deposits of the retail bank. The second paper concerns the resolvability of banks including retail banks and is described in the Commercial Banks section, ‘Interesting PRA and BRDD developments’, p. 64 of this edition.

The FCA has issued a consultation on what disclosures should be made to consumers by non-ring-fenced banks. A deposit-taker that is such an entity, or is exempt from ring-fenced, must provide individuals who are account holders with financial assets exceeding £250,000 with information that they are not ring-fenced and an explanation of what this means. They will also need to describe the investment and commodities trading activities that they do in the group, and of any “prohibited actions”. This requirement starts in 2019, and applies to new accounts as well.

In the US, the Governor of the New York Federal Reserve Bank, William Dudley, has taken a strong stand against the pressure from large banks to roll back the Volcker Rule elements of the Dodd-Frank Act. He said: “First, the evidence to date that liquidity has diminished markedly is, at best, mixed. Second, even if one were to interpret the evidence as indicating that liquidity has been reduced, it is not clear whether regulation is the primary driver, as other changes have played important roles as well.” However, he did agree that the ‘liquidity risk’ in not being able to sell corporate bonds in a downturn at a reasonable price existed. For example, he thought the rise of passive funds, including ETFs, might have increased liquidity risks. The banks argue that higher capital requirements have led them to reduce or shut down their market-making operations in bonds.

Like a frog in boiling water, there is a risk we end up with only US investment banks in the UK, and that will be a real disaster for the City.

A CITY COMMENTATOR

Concerns over the reduction of investment banking services by European banks under pressure from the regulators to shrink their balance sheets have led to the suggestion that several of them should join together to create a European champion to compete with the big US investment banks.
This would require political consensus as well as commercial agreement. A City commentator has said: “Like a frog in boiling water, there is a risk we end up with only US investment banks in the UK, and that will be a real disaster for the City.” Currently all eyes are on Barclays to see if its new chief executive will shrink or expand its investment bank.

5. INTERNATIONAL REPORT ON CORRESPONDENT BANKING

The reduction in the number of correspondent relationships for financial crime and other crime by some large banks is well known – as are the consequences for some emerging market countries. The Committee on Payments and Market Infrastructures (CPMI) has been studying this question and has now issued a report. This analyses and makes recommendations on some technical measures relating to ‘know your customer’ and legal entity identifiers, information sharing mechanisms and improvements in payment messages (as under the EU’s wire transfer regulation).

6. OVERVIEW OF PRUDENTIAL DEVELOPMENTS

There is no standout development to report – but a lot of important ones. These include some interesting prudential changes, the European Central Bank’s (ECB’s) review into banks’ risk models and estimates of the capital shortfall EU banks face under Capital Requirements Directive (CRD) IV when fully implemented.

JPMorgan estimates that the 35 biggest EU banks will lose as much as €137 billion of prudential capital or 1.5% of CET1 ratios by 2018 under these rules.

The ECB has spent time in its first year of supervision of 123 eurozone banks directly harmonising the method of calculating capital that national supervisors in the 19 countries have accepted. This trend is encouraged by Basel, which is developing more detailed rules to ensure similar treatment by national regulators of assets such as mortgages and trading assets. A report by JPMorgan estimates that the 35 biggest EU banks will lose as much as €137 billion of prudential capital or 1.5% of CET1 ratios by 2018 under these rules. The bank thinks that investors may demand even more capital over and above the rules. Banks with large mortgage books are likely to be particularly affected.

The ECB has increased the time it takes to make its intensive review of the 7,000 risk models of the banks it supervises from two years to four years. These reviews are comprehensive and, some say, intrusive, and are designed to reduce or even remove the apparently significant differences between different banks’ models. Some banks may need to increase prudential capital if their risk-weighted assets value is reduced. One key issue arising out of the ECB’s direct supervision is that some larger, more systematically risky banks are being required to hold more than Basel minimum capital (12% rather than 10% of their risk-weighted assets). A group of nine of the largest banks have written to the ECB, protesting that this increased requirement will reduce commercial lending and place them at a disadvantage to US and UK banks. Mario Draghi, ECB Chief Executive, said: “All efforts have been made to try to keep the supervisory action on the same ground as has been done in other jurisdictions, namely the UK.”

The PRA’s occasional paper CP29/15 covers sensitivity models under the Capital Requirements Regulation (CRR), amends the definition of ‘material risk taker’ for the Certification part of the PRA rules, emphasises that the CRR fills in definition gaps in PRA rules, and removes the administrative fee rule for late reporting (but the PRA will take this into account in its assessment of the firm’s management).

In Europe, several large countries are considering legal changes so that traditional senior debt of the largest banks can be ‘bailed in’ in a crisis, enabling it to be included in the global total loss-absorbing capital (TLAC) requirement, rather than the TLAC only comprising new capital issues. Germany has decided to do this, and France is considering it. The market is concerned by the lack of a single EU approach, particularly because the regulator may use the same approach for domestically important institutions.

7. PRUDENTIAL DEVELOPMENTS IN MORE DETAIL

CREDIT RISK

The European Commission (EC) has published its final delegated regulations on the definitions and framework for risk concentration and intra-group transactions under the Financial Conglomerates Directive (FICOD); and Basel has issued an FAQ on the standardised approach for measuring counterparty credit risk exposures. These pick up some of the questions it has been asked on its March 2014 revised standardised approach document. They are grouped into the general formula, the add-ons, specific derivatives and others. There is also an ECB report on counterparty credit risk – internal models and credit adjustments which the EBA has benchmarked with a hypothetical portfolio across nine EU banks, using the Basel benchmarking approach (see previous article ‘Overview of prudential developments’, on this page). This is part of the EBA’s approach to restoring regulators and the market’s confidence in banks’ internal models.

The PRA is asking banks what their exposures are to commodities, given their reduced prices. This covers both direct operations through trading them, and indirect exposures through lending to commodity companies.

The EBA has published an opinion on mortgage lending value – the prudent long-term value of immovable property. The EBA considers that this value can be calculated under national rules in those countries that have rigorous criteria for it; however, there should be an exception for covered bonds collateralised by immovable property.

Comment – This is another example of where the Capital Markets Union (CMU) may roll back parts of the CCR – in this case, the review of such bonds under the CMU to promote their use.

Separately, Basel plans to consult in Q4 2015 on proposals that increase the comparability of risk-weighted assets using the internal ratings-based approach. It also plans a second consultation in Q4 2015 on standardised approaches to credit risk – perhaps favouring simplification rather than complexity and reintroducing external credit ratings.

LIQUIDITY

The PRA has issued a July Supervisory Statement on and updated its webpage on Liquidity Coverage Requirement (LCR) reporting. From 1 October, there was an interim LCR template and simplified
LCR template with accompanying notes. From 15 October, UK banks, building societies and designated investment banks should report intraday liquidity data metrics (starting for the period 1 July to 30 September) using further templates and notes described on the updated webpage. Separately, the EBA has published a call for advice from the Commission on the EBA’s reports on Net Stable Funding Requirements and the leverage ratio as required under the CRR. The EC has asked the EBA for advice on proportionality (simplified reporting requirements for smaller institutions), scope of application (should some credit institutions be exempted?) and impact of the Net Stable Funding Ratio (such as on bank lending, market liquidity and business models).

Comment – The NSFR is controversial. Even more than the LCR, banks fear that they will be required to hold such a large volume of high-quality liquid instruments to fund their medium-term liabilities that they will be forced to reduce their businesses, including lending in a stagnant EU economy. Watch this space!

MARKET RISK
The EBA has published a review on its website on the consistency of RWAs across large EU institutions. This covers RWAs for large corporate, sovereign and institutions’ internal ratings-based (IRB) portfolios – known as ‘low default portfolios’. It explores policy options to reduce variations. Globally, Basel has issued instructions in respect of its impact study on the proposed frameworks for market risk and the credit value adjustment (CVA) risk. This is part of the Basel III monitoring exercise of the entire trading book. Banks had to complete their templates by 14 September this year in accordance with national regulators’ workbooks.

Comment – Basel’s trading book review under Basel III is important and controversial, given that the impact on many banks has been to shrink their trading books, reducing liquidity and securitisation. It is a potentially systemic risk, so banks are lobbying for a lighter or at least more nuanced regime.

PRUDENTIAL REPORTING
The EC has formally adopted the implementing technical standards drafted by the EBA on supervisory reporting of institutions under the CRR. It was published in the Official Journal of the EU and applied from 15 June 2015.

STRESS TESTING
The Bank of England has confirmed that it will now carry out its bank stress testing on an annual basis. The results of the 2015 stress tests will be published on 1 December 2015. The annual stress test will reflect policymakers’ assessment of the state of the financial cycle, and every other year there will be a second scenario to explore a wider range of risks that might threaten financial stability. The inclusion of banks in the stress testing will be the same as previously: all PRA-regulated banks and building societies with total retail deposits greater than £50 billion, whether on an individual or consolidated basis, at a bank’s financial year end date.

The ECB has published a press release announcing that it has completed its comprehensive assessment of nine banks in November 2015. The assessment will cover both the asset quality review and stress tests. The banks are a mix of existing significant banks and those qualifying for it in 2016.

OPERATIONAL RISK
Basel is planning a second consultation in Q4 2015 on the standardised approaches to operational risk. This is likely to remove the advanced measurement approach from the regulatory framework. A Quantitative Impact Study (QIS) will be made in Q1 2016.

8. HOW WILL THE DIGITAL REVOLUTION AFFECT BANKS?
McKinsey has made a report on banks’ future profitability. It sees profits shrinking on some banking services by up to two-thirds as non-banks introduce disruptive technology to target the banks’ most profitable services, eg, payments leaving banks as balance-sheet providers only. “They want to squeeze themselves between the customer and the bank and skim the cream
off’, the report said. These services include payments processing, lending to SMEs, wealth management and mortgages. “The most significant impact we see is price erosion, as technology companies allow delivery of financial services at a fraction of the cost, and this will mostly be transferred to the customer in lower prices.” The report suggests that banks must either fight for the customer relationship or become low-cost providers of credit. However, if regulators require non-banks to be as capitalised as banks, this process will slow down.

“The most significant impact we see is price erosion, as technology companies allow delivery of financial services at a fraction of the cost, and this will mostly be transferred to the customer in lower prices.”

McKINSEY

One example of how banks are joining the technology revolution is the adoption of blockchain structures (the use of distributed ledgers) (see Change, August 2015, Wholesale/Capital markets section, ‘And the wider issue of regulatory barriers to digital and mobile solutions’, p. 38). Thirteen banks in the US are part of an initiative to find an industry consensus on how banks can use the blockchain approach. Possible applications include settlements and payments between banks.

9. INTERESTING PRA AND BRRD DEVELOPMENTS

In the UK, the PRA is consulting on ensuring operational continuity in resolution. It sets out its proposed framework to facilitate continuity of firms’ critical shared services in resolution, based on its October 2014 discussion paper. Its scope is restricted to ring-fenced banks and global systemically important banks (G-SIBs). However, there is a related question of which firms should ensure continuity of critical economic functions, so there will be an addendum issued later.

Comment – Many PRA-regulated firms have struggled with preparing and maintaining their recovery and resolution plans (RRPs) in a form acceptable to the PRA. Clearly this is a huge exercise for cross-border G-SIBs and this consultation ratchets up the RRP further. However, the requirements are not as severe as some expected.

The Association for Financial Markets in Europe (AFME) has published a model clause for use by UK issuers of New York law-governed debt securities that are subject to Article 55 of the Bank Recovery and Resolution Directive (BRRD) (‘bail-in’). This article requires that any liabilities within scope to bail-in, but that are governed by third-country law, must have a contractual term stating that the liability may be subject to write-down or conversion into equity, and that the creditor agrees.

10. CHANGES TO PAYMENT SYSTEMS REGULATION

The Payments Systems Regulator (PSR) has published a consultation on its regulatory fees for 2015/16. This proposes how they should be allocated across payment systems (equal allocation across different systems), how they should be calculated by direct members within those systems, and the amount of the PSR fees. The EC has just published the Level 1 text. Some of the changes that the new rules introduce are: introduction of strict security requirements for the initiation and processing of electronic payments and the protection of consumer financial data; opening the EU payment market for companies offering consumer or business-oriented payment services based on the access to information about the payment account; prohibiting surcharging irrespective of whether credit cards are used online or in shops; and enhancing consumer rights in numerous areas – including the liability for non-authorised payments, and the unconditional refund right for direct debits in euro.

Separately, the PSR has published an online survey for payment service providers that access payment systems indirectly. The PSR wants to find out their experiences and concerns. The information collected will help it in its two market reviews launched in March 2015 (see Change, May 2015, Banks section, “The UK Payment Systems Regulator (PSR) starts operations”, p. 62).

Comment – The two competition market reviews could lead to big changes in the ownership of payment systems such as CHAPS and Vocalink. Currently challenger banks and others say that the banks’ ownership of such systems is inhibiting their growth.

In the EU, the European Parliament has now adopted and published the Payment Services Directive 2 (PSD2). This recognises the technology changes since then. It will come into force two years after its approval by the Council and the publication in the Official Journal of the EU. PSD2 extends the existing 2007 Payment Services Directive to new services and providers, and to cover instruments issued by providers that do not manage the account of the customer.

11. WHEN CAN A BANK REDEEM DISQUALIFIED BONDS?

This interesting point is raised by Lloyds Bank, seeking to redeem a bond issue because it is a “capital disqualification event” since it can longer be treated as part of its capital buffer. The bondholders’ group argues that this is a breach of the issue prospectus. A court case decided that no capital disqualification event had taken place because the bonds might be taken into account in a future stress test. The bank is appealing. The PRA gave its consent to the redemption for prudential purposes. The bondholders are also appealing to the FCA.

Another bank facing litigation is RBS, which is being challenged over its £12 billion rights issue before the Government took it over. The shareholders claim that they were misled by the bank into supporting the issue. To date, RBS has collected 25 million pieces of information and is estimated to have spent £90 million on legal costs in its defence.

12. MORE PPI TROUBLE FOR BANKS, BUT AN END IN SIGHT

Finally, the FCA has listened to banks, and is consulting on an end date for Payment Protection Insurance (PPI) claims but on conditions. It proposes a 2018 deadline in order to “rebuild public trust in the retail financial sector”. Claims management companies (which may take as much as a third of compensation paid by the banks) expect a flood of claims before the deadline. Estimates of future payments by the relevant banks for payments until that date vary between £10 billion and £15 billion.

Comment – This FCA proposal is a change from the announcements of the previous FCA Chief Executive, Martin
Wheatley, who was reluctant to impose a deadline. It could be seen as part of Chancellor George Osborne’s ‘new settlement’ with the City announced in his Mansion House speech. The Commons Treasury Committee has asked for more information about this proposal.

The FCA proposes a 2018 deadline in order to “rebuild public trust in the retail financial sector.”

13. DID BANKS COLLABORATE TO BLOCK EXCHANGES TRADING CDSs?
A number of leading US investment banks have settled a claim against them in the US by several large buy-side institutions that they blocked the emergence of exchanges for credit default swaps (CDSs) by influencing the International Swaps and Derivatives Association (ISDA) to refuse licences for CDS products. The legal claim was that the banks therefore monopolised trading and conspired to control the market. The settlement was for $1.87 billion and the ISDA has changed its licensing practices.

Comment – The G20 commitment to bring trading in liquid derivatives, including CDS onto exchanges or platforms rather than over-the-counter (OTC) bilateral trades (and cleared through Central Counterparty Clearing Houses) is being gradually implemented.

14. ARE VIRTUAL CURRENCIES COMMODITIES?
The US commodity futures trading commission (CFTC) has made a ruling that an option on a virtual currency such as Bitcoin is a regulated “commodity”. Its Division of Enforcement said: “The CFTC for the first time finds that Bitcoin and other virtual currencies are properly defined as commodities. While there is a lot of excitement surrounding Bitcoin and other virtual currencies, innovation does not excuse those acting in this space from following the same rules applicable to all participants in the commodities derivatives markets.”

“"The CFTC for the first time finds that Bitcoin and other virtual currencies are properly defined as commodities”

CFTC

15. NORTH AFRICA FIGHTING SPILLS OVER INTO THE ENGLISH COURTS
The risks of having sovereign clients have been shown again in the English court case brought by the Libyan Investment Authority (sovereign wealth fund). With two rival managements of the fund, BDO has been appointed as administrator of its legal cases against Goldman Sachs and Société Générale arising out of their advice to it.
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* Release dates subject to change (updated 18/11/2015)

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The use of online videos and voice functions allowed me to study at home and on the go, which helped me make more use of my time. I would recommend this as a study aid as it accommodates a variety of learning styles.

Billy Snowdon, Team Leader, Brewin Dolphin
### Top 5

**Integrity & Ethics**
- High Level View
- Ethical Behaviour
- An Ethical Approach
- Compliance vs Ethics

**Anti-Money Laundering**
- Introduction to Money Laundering
- UK Legislation and Regulation
- Money Laundering Regulations 2007
- Proceeds of Crime Act 2002
- Terrorist Financing
- Suspicious Activity Reporting
- Money Laundering Reporting Officer
- Sanctions

**Financial Crime**
- What Is Financial Crime?
- Insider Dealing and Market Abuse Introduction, Legislation, Offences and Rules
- Money Laundering Legislation, Regulations, Financial Sanctions and Reporting Requirements
- Money Laundering and the Role of the MLRO

**Information Security and Data Protection**
- Information Security: The Key Issues
- Latest Cybercrime Developments
- The Lessons From High-Profile Cases
- Key Identity Issues: Know Your Customer
- Implementing the Data Protection Act 1998
- The Next Decade: Predictions For The Future

**UK Bribery Act**
- Background to the Act
- The Offences
- What the Offences Cover
- When Has an Offence Been Committed?
- The Defences Against Charges of Bribery
- The Penalties

### Conduct Rules
- Application and Overview
- Individual Conduct Rules – FCA & PRA
- Senior Management Conduct Rules
- Obligations on Firms

### Pensions Advice
- Advice or Guidance?
- Advice During Accumulation
- Defined Contribution Pension Freedoms
- Transfers and Decumulation
- Problems with Accessing New Freedoms

### Financial Planning (An introduction)
- Related Activities
- The Financial Plan
- Cash Flow Planning and Modelling
- Behavioural Finance and Financial Planning
- The Regulatory Framework
- The Future Landscape

### Senior Managers and Certification Regime
- Obligations
- Certification
- Conduct Rules
- Scope of the Rules
- Conclusion and Future Developments

### Best Execution
- What Is Best Execution?
- Achieving Best Execution
- Order Execution Policies
- Information to Clients & Client Consent
- Monitoring, the Rules, and Instructions
- Best Execution for Specific Types of Firms

### Approved Persons Regime
- The Basis of the Regime
- Fitness and Propriety
- The Controlled Functions
- Principles for Approved Persons
- The Code of Practice for Approved Persons

### Corporate Actions
- Corporate Structure and Finance
- Life Cycle of an Event
- Mandatory Events
- Voluntary Events

### Wealth

#### Client Assets and Client Money
- Protecting Client Assets and Client Money
- Ring-Fencing Client Assets and Client Money
- Due Diligence of Custodians
- Reconciliations
- Records and Accounts
- CASS Oversight

#### Investment Principles and Risk
- Diversification
- Factfind and Risk Profiling
- Investment Management
- Modern Portfolio Theory and Investing Styles
- Direct and Indirect Investments
- Socially Responsible Investment
- Collective Investments
- Dealing in Debt Securities and Equities

#### Banking Standards
- Introduction and Background
- Strengthening Individual Accountability
- Reforming Corporate Governance
- Securing Better Outcomes for Consumers
- Enhancing Financial Stability

#### Suitability of Client Investments
- Assessing Suitability
- Risk Profiling
- Obtaining Customer Information
- Suitable Questions and Answers
- Making Suitable Investment Selections
- Guidance, Reports and Record Keeping

### International

#### Foreign Account Tax Compliance Act (FATCA)
- Foreign Financial Institutions
- Due Diligence Requirements
- Reporting
- Compliance

#### MiFID II
- The Organisations Covered by MiFID
- The Products Subject to MiFID’s Guidelines
- The Origins of MiFID II
- The Products Covered by MiFID II
- Levels 1, 2, and 3 Implementation

#### UCITS
- The Original UCITS Directive
- UCITS III and IV
- Non-UCITS Funds
- Future Developments

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