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COMPLIANCE OFFICER BULLETIN

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Bingham's financial regulatory group advises its clients (which include institutional and alternative investment managers, retail and investment banks and brokerages) on all aspects of the financial regulatory framework in the European Union and the United Kingdom and on commercial and securities issues affecting the financial services industry. The group is particularly well known for its work acting for financial institutions and senior individuals who find themselves subject to investigation by regulators and exchanges.

ANNUAL REVIEW 2012

Introduction

2012 has been a year in which the regulatory reaction to the financial crisis has transitioned from policy debate and negotiation to policy implementation. It has also been a year in which the increasing complexity and the growing international dimension of financial regulation have been ever-present themes.

This *Bulletin* reviews some of the key regulatory developments at the European and national levels in 2012. In Section 1, the *Bulletin* reviews three major pieces of European financial services legislation: the Short Selling Regulation, the European Markets and Infrastructure Regulation and the Alternative Investment Managers Directive.

The Short Selling Regulation was the first of a series of European financial services legislative measures to be implemented as a regulation (with direct effect on market participants), rather than as a directive. The implications of this for the industry in the United Kingdom are profound: the FSA Handbook will no longer be a comprehensive resource describing all rules to which firms are subject and the FSA (and its successors) will eventually cease to be the primary rule-making body for regulated firms.

Compliance officers will increasingly be required to take into account and achieve compliance with European regulation (requiring direct reference to and understanding of European legislation without the benefit of further explanation or guidance from the UK regulators). However, European regulation will be enforced by national regulators, and compliance officers will therefore simultaneously have to ensure that firms understand and meet the expectations of national regulators. As explained in Section 2, which looks forward to the transition of regulatory responsibility from the FSA to the Financial Conduct Authority and Prudential Regulatory Authority, these expectations, in the case of the United Kingdom at least, will be increasingly demanding.

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As is often said, the more things change, the more things stay the same. In Section 3, the *Bulletin* focuses on some of the key enforcement actions taken by the FSA during the course of 2012. The FSA has continued to take aggressive enforcement action against firms and individuals that they consider to have abused UK markets, posed risks to financial stability or to have operated in a way that is detrimental to consumers. Furthermore, it is clear that the Financial Conduct Authority ("FCA") intends to pursue this approach of credible deterrence and, in utilising new powers allowing early and product specific intervention, to adopt an "act now, ask questions later" approach. Firms must be ready to demonstrate at short notice to regulators why these powers should not be used against them.

1 EU developments

Notwithstanding the distraction of the Eurozone crisis, the European Commission has continued to work to implement its plan to "Regulate Financial Services for Sustainable Growth".[1] The European system of financial supervisors, consisting of three European Supervisory Authorities ("ESAs")—the European Banking Authority ("EBA"), the European Securities and Markets Authority ("ESMA"), and the European Insurance and Occupational Pensions Authority—and the European Systemic Risk Board ("ESRB"), were established in January 2011 and have subsequently been working with the European Commission to develop legislative proposals that will have a profound impact on the way in which the financial services industry is regulated in the United Kingdom and across the European Union.

This section of the *Bulletin* will review three key pieces of European financial services legislation: (i) Regulation (EU) 236/2012 of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps ("the Short Selling Regulation" or "SSR") which was implemented on November 1, 2012; (ii) Regulation (EU) 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories ("EMIR") which came into effect on August 16, 2012 but which will not be implemented until mid-2013; and (iii) Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers (the "Alternative Investment Fund Managers Directive" or "AIFMD") which came into force on July 21, 2011 and is required to be implemented by Member States on July 22, 2013.

The SSR, EMIR and AIFMD are the vanguard of a wave of European financial services regulation that will be enacted or implemented through the use of regulations rather than directives. Unlike a directive, a regulation does not have to be transposed into national law and has "general application ... [and] ... shall be binding in its entirety in all Member States".[2] The use of regulations rather than directives is deliberate: European policy-makers consider that the single European market in financial services continues to be held back by discrepancies between the way in which national governments and regulators have implemented previous financial services directives (including, for instance, MiFID[3]).

The implementation of the system of ESAs and the increased use of regulations are intended to address these discrepancies and herald the introduction of a single European rule-book. This brings obvious advantages for industry—not least that (in theory) it should become easier to transact financial services business across Europe as the need to take account of local implementation of European rules should become increasingly redundant.

However, the increased use of regulations presents less obvious challenges. For example, regulations such as the SSR and EMIR (and the anticipated regulations implementing AIFMD) are not (or will not be fully) reflected in the FSA Handbook. Accordingly, market participants who wish to understand their obligations under the European rules must review the regulations themselves (in the case of the SSR, this includes the SSR itself and four pieces of secondary legislation). Unlike the FSA Handbook, no attempt has been made to draft the SSR or its supporting legislation in "plain English"—it is a dense and complex piece of European legislation reflecting both a complex legislative process and the need for it to be translated into (and understandable in) each of the working European languages. ESMA has published a "Questions and Answers" document[4] which does seek to clarify some of the questions that have arisen from practitioners' detailed review of the SSR. However, some aspects of the SSR that may be considered to be unclear or contradictory are simply not addressed, and some of the answers that are given are themselves unclear or the basis on which they are made is ambiguous.

Compliance officers can therefore no longer be comfortable that the FSA Handbook represents a comprehensive source for all of the regulatory obligations to which their firm is subject. Furthermore, they may find that the legal sources to which they now need to refer are significantly less accessible and subject to a greater degree of interpretation.

1.1 The EU Regulation on Short Selling and Certain Aspects of Credit Default Swaps

The SSR came into effect on November 1, 2012. It is supplemented by a number of secondary pieces of legislation that expand on the rules in the SSR. These secondary pieces of legislation include the Commission Implementing Regulation (EU) 827/2012 ("the Implementing Regulation") and the Commission Delegation Regulation (EU) 918/2012 ("the Supplementing Regulation").

1.1.1 The requirements of the SSR

There are four principal elements to the SSR:

- The SSR prohibits persons from entering into an uncovered short sale of shares listed on an EU regulated exchange or a multilateral trading facility (a "European Share"[5]) or of EU sovereign debt ("the Uncovered Short Prohibition").[6]
- The SSR prohibits persons from entering into credit default swap ("CDS") transactions in respect of EU sovereign debt on an uncovered basis ("the European Sovereign CDS Restriction").[7]
- The SSR requires persons who have taken short positions in shares listed on an exchange or a market in the European Union or in EU sovereign debt to make disclosures of those positions when they cross certain thresholds ("the Disclosure Requirements").[8]
- The SSR grants to ESMA and to national regulators "powers of intervention" which they may use to impose additional restrictions or prohibitions on short selling where there are "adverse events or developments which constitute a threat to financial stability or to market confidence" ("the Emergency Intervention Powers").[9]

1.1.1.1 The Uncovered Short Prohibition

Of the four principal elements of the SSR, the least controversial is the Uncovered Short Prohibition. Uncovered or "naked" shorting has always been frowned upon, not only by regulators but also many market participants because of the significant risk of settlement failure and its ability to create significant distortions in the market for a security. Although uncovered or naked short sales of securities have not previously been the subject of an explicit prohibition in UK law or regulation, the FSA has historically taken enforcement action against market participants which caused market failures as a result of the practice.[10] The Uncovered Short Prohibition therefore codifies what the FSA would always have considered to be best practice.

However, the SSR does not leave it to market participants to determine when their short sales are covered. Instead, the SSR provides[11] that a person may enter into a short sale of a European Share or of EU sovereign debt only where that person has:

- borrowed the relevant security or has made alternative provisions resulting in similar legal effect;
- entered into an agreement to borrow the share or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due and which meets the relevant criteria defined in the Implementing Regulation; or
- an arrangement with a third party under which that third party has, in terms that meet the criteria defined in the Implementing Regulations, confirmed that the share has been located.

1.1.1.2 European Sovereign CDS Restriction

If the Uncovered Short Prohibition was uncontroversial, the same could not be said of the European Sovereign CDS Restriction. The SSR provides that a person may only enter into a credit default swap in respect of EU sovereign debt (an "EU Sovereign CDS") if it does not lead to an uncovered position.[12] It is already clear at the time of the publication of this *Bulletin* that the (undoubtedly deliberate) effect of the European Sovereign CDS Restriction has been severely to restrict liquidity in the sovereign CDS market. It will be interesting to see whether the effect of this will be to cause any disruption in sovereign debt markets such that a Member State may suspend the European Sovereign CDS Restriction in respect of its debt.[13]

For the purposes of the European Sovereign CDS Restriction, an EU Sovereign CDS will only be considered to be covered where either:[14]

- it is being used to hedge against the risk of default of the issuer where the protection buyer has a long position in the sovereign debt of the issuer to which the EU Sovereign CDS relates; or
- it is being used to hedge assets or financial obligations that the protection buyer is able to demonstrate are correlated to the debt of the reference sovereign issuer.

In order for an asset or financial obligation to be considered correlated certain conditions, as set out in the Supplementing Regulation, must be met.

1.1.1.3 Disclosure requirements

The SSR requires that a person who has a net short position in a European Share notify the regulator of the Member State in which that share is issued when the net short position (aggregated across all positions held or managed by the group) reaches, exceeds or falls below 0.2 per cent, 0.3 per cent or 0.4 per cent of the issuer's share capital. If the short position reaches, exceeds or falls below 0.5 per cent (and each subsequent 0.1 per cent) of the issuer's share capital, that position must be disclosed to the market as a whole. For the purpose of the Disclosure Requirements, short positions must be calculated by netting any position that will confer a financial advantage where there is a fall in the price or value of the relevant security against any position that will confer a financial advantage where there is a rise in the price or value of the relevant security.

A person that has a short position in the debt of an EU Sovereign Issuer (including any short position arising as a result of an EU Sovereign CDS) is required to notify the relevant regulator of its net short position if its net short position in that debt reaches, exceeds or falls below 0.1 per cent of the total outstanding debt of the issuer (and each subsequent 0.05 per cent, e.g., 0.15 per cent, 0.2 per cent, 0.25 per cent etc). However, where the total outstanding debt of the EU Sovereign Issuer is in excess of €500 billion (or where there is an active futures market for the particular sovereign debt), the notification threshold is increased to 0.5 per cent (and each subsequent 0.25 per cent, e.g., 0.75 per cent, 1 per cent, 0.25 per cent etc).[15] ESMA has published (and will keep updated on a quarterly basis) the total outstanding debt of each EU Sovereign Issuer and the initial threshold for reporting a net short position at the following webpage: *http://www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers* [Accessed on December 5, 2012].

Each Member State has a slightly different procedure for making disclosures pursuant to the SSR. Some (notably France and Germany) impose time-consuming pre-registration requirements which should be taken into account if it is likely that significant short positions will be taken in those jurisdictions. ESMA has published a document containing links to the disclosure mechanism for each Member State at the following webpage: *http://www.esma.europa.eu/system/files/2012-680.pdf* [Accessed on December 5, 2012].

1.1.1.4 Emergency intervention powers

If there was a silver lining to the introduction of the SSR for market participants, it was that it introduced a pan-European regime for the regulation of short selling. Accordingly, compliance officers would no longer need to keep up to date with differing short-selling regimes in each Member State. However, as the Spanish regulator exercised emergency intervention powers on the first day the SSR was in force to impose an absolute restriction on the short sale of all Spanish listed shares, that silver lining was quickly tarnished.

The emergency intervention powers include the ability to prohibit short sales in all securities listed within a Member State (as Spain has done), or on certain types of security (e.g., shares issued by financial institutions). National regulators may also impose additional reporting requirements or require securities lenders to notify significant changes in lending fees. These measures must be notified to ESMA and other national regulators in advance. ESMA will subsequently issue an opinion as to whether the intervention is justified—but the Member State is not required to amend the intervention if this opinion is negative.

1.2 The European Market and Infrastructure Regulation

EMIR has established a new framework for the trading and clearing of derivatives (i.e., options, futures, swaps, forwards etc). EMIR imposes a number of obligations on all derivatives market participants, subject to limited exemptions, as well as on central counterparties ("CCPs") and derivatives trading venues.

The key obligations on market participants trading derivatives are as follows:

- reporting all transactions in derivatives to a trade repository;
- clearing of certain derivatives through a CCP; and
- employing risk-mitigation techniques for those derivatives that are not cleared through a CCP.

Although EMIR came into force in all EU Member States on August 16, 2012, the new obligations are not expected to apply to market participants until mid-2013, after ESMA's regulatory technical standards have been adopted by the European Commission (amended or unamended).

Once the new obligations are applicable, market participants will be required retrospectively to report derivatives transactions entered into or outstanding on or after August 16, 2012.

Although EMIR originates from the perceived need to address risks associated with the trading of over-the-counter derivatives, it has a wider impact on market infrastructure. EMIR will introduce significant new regulatory requirements, namely: the requirement that all transactions in those OTC derivative contracts that have met pre-defined eligibility criteria and have been entered into a register maintained by the ESMA must be cleared through a CCP ("the clearing obligation");[16] requirements for the authorisation or registration, supervision and operation of CCPs in the European Union (including requirements applicable to certain third-country CCPs wishing to access the European market); the requirement that derivatives contracts must be reported to trade repositories ("the reporting obligation");[17] and requirements for the authorisation and operation of trade repositories. The scope of the requirements relating to the clearing and reporting obligations, and to risk mitigation measures for non-centrally cleared derivatives is discussed in greater detail below.

1.2.1 Clearing obligation

1.2.1.1 To whom does the clearing obligation apply?

Broadly, the clearing obligation will apply to the following categories of market counterparties that enter into a transaction[18] in a contract within a class of derivatives subject to the clearing obligation:[19]

- an investment firm, bank or insurance company authorised pursuant to European legislation (a "financial counterparty");
- a corporation or entity established in the European Union, other than a financial counterparty (e.g., an energy company that enters into derivatives transactions as an ancillary activity to its main business) whose aggregate OTC derivatives positions exceed a certain threshold[20] ("non-financial party"); and

- an entity established outside the European Union that would be subject to the clearing obligation if it was established in the European Union (an "in-scope third-country entity") whose counterparty is a financial counterparty, a non-financial counterparty; an in-scope third-country entity if (i) the relevant derivatives contract being entered into has "a direct, substantial and foreseeable effect" within the European Union; or (ii) ESMA has determined that it is necessary or appropriate to apply the clearing obligation in order to prevent the evasion of any provision of EMIR.

1.2.1.2 To which derivatives does the clearing obligation apply?

The determination of whether a class of derivatives shall be subject to the clearing obligation shall be made primarily by CCPs, together with their national regulators.[21] A CCP will decide which classes of derivatives it will accept for clearing and inform its national regulator of the same. The national regulator must then authorise the CCP to clear the relevant class or classes of derivatives if appropriate and inform ESMA when it authorises the CCP to commence clearing the relevant class or classes of derivatives.

ESMA will establish and maintain a register of all classes of derivatives that are subject to the clearing obligation. The register will include, *inter alia*, those CCPs that are authorised (by an EU regulator) or recognised (third-country CCPs recognised by EU regulators), and the dates from which the clearing obligation shall apply to the relevant classes of derivatives.[22]

ESMA has six months from the date of such notification to decide whether the relevant classes of derivatives should be subject to the clearing obligation across the European Union.[23] When determining whether a class of derivatives should be subject to the clearing obligation, ESMA will consider, *inter alia*:

- the degree of standardisation of the contractual terms and operational processes of the relevant class of derivatives;
- the volume and liquidity of the relevant class of OTC derivatives; and
- the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivatives.

ESMA shall, after conducting a public consultation and, where appropriate, consulting third-country regulatory authorities, determine the date from which the clearing obligation in relation to a specific class of derivatives shall take effect, whether the clearing obligation should only apply to certain categories of counterparties and the minimum remaining maturity of the OTC derivatives contracts to which the clearing obligation shall be applied. In considering the timing of the clearing obligation becoming effective, including any phase-in period, ESMA will take into consideration, for example, the following the criteria:

- the expected volume of the relevant class of derivatives;
- whether any CCPs already clear the same class of derivatives;
- the ability of the relevant CCPs to handle the expected volume and to manage risk arising from the clearing of the relevant class of derivatives; and
- the period of time a counterparty subject to the clearing obligation needs in order to put in place arrangements to clear its derivative contracts through a CCP.

In addition, ESMA, on its own initiative, may consult with the ESRB to identify classes of OTC derivatives that should be included on the public register, notify the European Commission of its recommendations and publish a call for a development of proposals for the clearing of those classes of derivatives.

1.2.2 Reporting obligation

The reporting obligation requires certain details of derivative transactions to be reported to registered trade repositories. The purpose of the reporting obligation is to allow for a centralised system for the collection of information across Europe regarding transactions in the derivatives markets and allowing ESMA, national regulators and relevant central banks to monitor the emergence and build-up of risk, and to manage risk at a European, as well as a national, level.

The report must contain the details of the derivative contract entered into, modified or terminated to a registered trade repository no later than the working day following the execution, clearing or modification of the contract. If a trade repository is unable to record the details of the OTC derivative contract, financial counterparties should report details directly to their national regulator.

The reporting obligation applies to both centrally cleared and non-centrally cleared derivatives contracts. It is possible to discharge the reporting obligation by delegating the reporting of the derivative contract to a counterparty or a third party, including a CCP which can make the transaction report on behalf of both counterparties, provided this is clearly stated in the report. Where no trade repository is available, the reports must be made directly to the regulator.

The transaction reports must contain detailed information about the transaction, including details of the counterparties, brokers and beneficiaries and include the applicable data specified in the EMIR regulatory technical standards. The requisite data will include, among other things, the parties, the time of the transaction, maturity, notional value, price of the derivative contract and value and type of collateral.

1.2.2.1 To whom does the reporting obligation apply?

All counterparties and CCPs are required to comply with the reporting obligation. In addition, CCPs are required to comply with the reporting obligation.

As counterparties and CCPs must ensure that the reporting obligation is complied with without duplication, and EMIR explicitly permits the delegation of transaction reporting,[24] it is likely that the counterparties to an OTC derivative transaction will enter into arrangements with each other and/or with the relevant CCP to determine who is responsible for making the report.

1.2.2.2 To which derivatives does the reporting obligation apply?

The reporting obligation will apply to all derivatives contracts entered into on or after August 2012, as well as all derivatives contracts that were entered into before August 16, 2012 and which remain outstanding on that date.[25]

1.2.2.3 When does the reporting obligation start?

The reporting obligation shall first apply with respect to credit derivatives and interest rate derivatives and shall start either (i) on July 1, 2013, provided that a trade repository has been registered for the relevant class of derivatives by April 1, 2013; (ii) if no trade repository has been registered for the relevant class of derivatives by April 1, 2013, 90 days after a trade repository has been so registered; or (iii) on July 1, 2015, if no trade repository has been registered for the relevant class of derivatives by that date, and reports shall then be made directly to ESMA.[26]

With respect to derivatives other than credit and interest rate derivatives, the start date for the reporting obligation shall be the earlier of: (i) January 1, 2014, provided that a trade repository has been registered for the relevant class of derivatives by October 1, 2013; (ii) if no trade repository has been registered for the relevant class of derivatives by October 1, 2013, 90 days after a trade repository has been so registered; or (iii) July 1, 2015, if no trade repository has been registered for the relevant class of derivatives by that date, and reports shall then be made directly to ESMA.

1.2.2.4 Risk-mitigation measures in relation to non-cleared derivatives

As the central clearing obligation will only be applicable to certain, more standardised derivatives, a number of derivatives will continue not to be cleared by a CCP ("non-cleared derivatives"). Article 11 of EMIR requires counterparties to apply certain additional risk-mitigation measures to non-cleared derivatives.

1.2.3 Collateral

ESMA and national regulators are expected to follow the final recommendations of IOSCO and the Basel Committee[27] on the margin requirements for non-cleared derivatives. Accordingly, it is anticipated that implementing regulations will provide that cash, high-quality government and central bank securities, high-quality corporate bonds, high-quality covered bonds, equities included in major stock indices and gold will be deemed appropriate as eligible capital. National regulators will likely establish lists of eligible collateral that vary depending, *inter alia*, on the availability or demand for the collateral assets in each jurisdiction. In addition, it is anticipated that collected margin will be required to be subject to arrangements that fully protect the posting party in the event that the collecting party defaults, to the extent possible under applicable law. Further, cash and non-cash collateral collected as initial margin should not be re-hypothecated or re-used.

1.2.4 Portfolio compression and reconciliation

Financial counterparties and non-financial counterparties that have at least 500 non-centrally cleared OTC derivative contracts outstanding must at least twice a year assess whether it is possible to conduct a portfolio compression exercise with their counterparties in order to manage counterparty credit risk.[28] The portfolio compression requirement shall be enforced on a "comply or explain" basis.

A financial counterparty and a non-financial counterparty will be required to perform a portfolio reconciliation exercise (i) each business day if it has at least 500 OTC derivative contracts outstanding with the same counterparty; (ii) once per week if it has between 51 and 499 OTC derivative contracts outstanding with a counterparty at any time during the week; or (iii) once per quarter if it has 50 or fewer OTC derivative contracts outstanding with a counterparty at any time during the quarter.

A person that is not a financial institution and that is outside the scope of EMIR clearing obligation must perform a portfolio reconciliation exercise (i) once per quarter if it has more than 100 OTC derivative contracts outstanding with a counterparty at any time during the quarter; or (ii) once per year if it has 100 or fewer OTC derivative contracts outstanding with a counterparty.

1.2.5 Timely confirmation

An OTC derivative contract concluded between financial counterparties or non-financial counterparties and which is not cleared by a CCP shall be confirmed, where available by electronic means, as soon as possible.[29] Confirmations must be made at the latest:

- for credit default swaps and interest rate swaps concluded on or before February 28, 2014 ("1st Stage Swaps"), by the end of the second business day following the date of execution of the OTC derivative contract, and thereafter by the end of the next business day following the date of execution; and
- for equity swaps, foreign exchange swaps, commodity swaps and all other derivatives other than 1st Stage Swaps concluded on or before August 31, 2013, by the end of the third business day, from then until August 31, 2014 by the end of the second business day following the date of execution of the OTC derivative contract, and thereafter by the end of the next business day following the date of execution.

An OTC derivative contract concluded with a counterparty that is not a financial institution and that is outside the scope of EMIR clearing obligation shall be confirmed as soon as possible, where available by electronic means, and at the latest:

- for credit default swaps and interest rate swaps concluded on or before August 31, 2013 ("1st Stage OTC Swaps"), by the end of the fifth business day, from then until August 31, 2014, by the end of the third business day, and thereafter by the end of the second business day following the date of execution;
- for equity swaps, foreign exchange swaps, commodity swaps and all other derivatives other than 1st Stage OTC Swaps concluded on or before August 31, 2013, the end of the seventh business day, from then until August 31, 2014 the end of the fourth business day, and thereafter by the end of the second business day following the date of execution.

A transaction concluded after 16:00 local time, or with a counterparty located in a different time zone which does not allow confirmation by the set deadline, shall be confirmed as soon as possible and, at the latest, one business day following the deadline set out above, as relevant.

In addition, financial counterparties must report monthly to the relevant national regulator the number of unconfirmed OTC derivative transactions subject to the confirmation requirement described above that have been outstanding for more than five business days.

1.3 The Alternative Investment Fund Managers Directive

The Alternative Investment Fund Managers Directive ("AIFMD") came into force on July 21, 2011 and is required to be implemented by Member States by July 22, 2013.

The AIFMD will affect (i) all investment fund managers who are domiciled within the European Union (except to the extent that such manager exclusively manages UCITS funds), whether or not the funds that they manage are domiciled in the EU or elsewhere; (ii) all investment fund managers domiciled outside the EU but which manage an investment fund domiciled within the EU; and (iii) any investment fund manager domiciled outside the EU and managing an investment fund domiciled outside the EU but which seeks to market that fund to European investors (in each case, an "alternative investment fund manager" or "AIFM"). AIFMs with less than €100 million of assets under management (€500 million for funds which are unleveraged and do not permit redemption within five years of an initial investment) will not be subject to the full scope of the AIFMD, but will nevertheless be required to register as AIFMs with their local regulator.

From July 2012, an AIFM that is authorised pursuant to the AIFMD will be permitted to market any EU-domiciled funds that it manages to professional investors throughout the European Union on a passported basis. Between July 2012 and (at least) 2018, an AIFM (whether authorised or not) will be able to market any non-EU domiciled funds that it manages to professional investors on a private placement basis—however, it will have to comply with the AIFMD's transparency requirements (discussed below) and any additional restrictions imposed by an individual Member State. Non-EU domiciled AIFMs are required to notify the relevant regulator of their intention to market a fund in an EU Member State.

An investment fund manager domiciled within the European Union will be required to comply with the AIFMD from its implementation in July 2013, although it will not be required to obtain authorisation until 2014. The FSA anticipates that a firm currently authorised pursuant to MiFID will transition to AIFMD status via a "Variation of Permission" process.[30]

From July 2015 non-EU domiciled AIFMs will have the option of seeking authorisation pursuant to the AIFMD and which authorisation will allow it to market its funds on a passported basis. Similarly, from 2015 AIFMD-authorised firms will be able to seek a passport in respect of the non-EU domiciled funds that they manage.

The FSA issued a discussion paper on the implementation of the AIFMD in January 2012 ("the FSA AIFMD Discussion Paper"). As the FSA notes in that paper, "certainty on the precise application of [AIFMD to UK investment fund managers] still depends to a significant extent on the outcome of elements of the subordinate measures". As of the date of writing this *Bulletin* (late November 2012), the EU Commission had not issued the "Level 2" rules (detailed rules giving effect to the general principles discussed below). The Level 2 rules will be in the form of one or more EU Regulations which (like the SSR and EMIR) will have direct effect in all Member States and will therefore not have to be transposed into UK law or regulation.

1.3.1 General requirements

The AIFMD will introduce for the first time a regulatory regime that is directed specifically at "alternative" investment managers. Nevertheless, many of its requirements will be familiar to UK-authorised firms that are used to complying with the FSA's Systems and Controls and Conduct of Business Sourcebooks.

The AIFMD sets out general principles for the organisation and management of an alternative investment fund manager that is authorised pursuant to the directive (an "Authorised AIFM"). An Authorised AIFM will be required to comply at all times with "principles" including a duty to act honestly, with due skill, care and diligence and fairly in conducting their activities, to act in the best interests of the funds that they manage and to treat all investors fairly and to take all reasonable steps to avoid conflicts of interest, or where they cannot be avoided, to fairly manage those conflicts.

An Authorised AIFM will also be required at all times to use adequate and appropriate human and technical resources necessary for the proper management of the funds that it manages. The Authorised AIFM must have sound administrative and accounting procedures, controls and safeguards for electronic data processing and adequate internal controls.[31] The AIFMD also requires functional and hierarchical separation of an Authorised AIFM's risk-management function from its other functions, including that of portfolio management. An Authorised AIFM must at least "implement an appropriate, documented and regularly updated due diligence process when investing" and identify, measure and control risks on an ongoing basis.[32] Accordingly, an Authorised AIFM's systems and controls will be required to include appropriate policies and procedures, systems to ensure consistency between risk profiles and risk limits, periodic reporting to those tasked with governance, stress-testing and sufficient and appropriate risk-monitoring systems.

Authorised AIFMs will be required to ensure that (i) a single depository is appointed for each EU-domiciled fund that it manages;[33] and (ii) one or more entities are appointed to carry out certain depository functions[34] in respect of non-EU domiciled funds. AIFMs that are not domiciled in the European Union (and which have not, after 2015, elected to be authorised pursuant to AIFMD) will not be required to have a depository.[35]

1.3.2 Investment strategy restrictions

The AIFMD includes a number of provisions which may be construed as placing limitations on the types of investment strategy that may be run by an investment manager.

Perhaps most notably but least commented upon is that the AIFMD empowers national regulators to "restrict the scope of the authorisation, in particular as regards the investment strategies of the [funds] that the AIFM is allowed to manage".[36] This may enable a regulator to determine, for example, that a manager with significant experience and track record in managing an equity long-only fund should not be permitted to expand its product range into other areas including hedged strategies.

The AIFMD requires Authorised AIFMs to set a maximum level of leverage for each fund under management. This maximum level should be set in the context of a number of factors including investment strategy, the type of fund that is being managed and the need to limit the exposure of the fund to any single counterparty.[37] The Authorised AIFM must be able to demonstrate that these self-imposed limits are then complied with. When applying for authorisation, an AIFM will be required to provide the regulator with information relating to its policy on the use of leverage.

Where a fund acquires or disposes of control of a non-listed company, the Authorised AIFM must notify its regulator of that fact. Furthermore, following the acquisition of control of the non-listed company the Authorised AIFM shall not, for a period of 24 months, be allowed to facilitate, support or instruct any distribution (including the payment of dividends), capital reduction, share redemption or acquisition by the company of its own shares.[38]

1.3.3 Capital requirements

Investment managers currently authorised pursuant to MiFID typically have core capital requirements of €50,000. Managers authorised pursuant to the AIFMD will be required to carry significantly higher levels of capital. Broadly, the AIFMD requires that an externally appointed AIFM must have initial capital of at least €125,000 and additional own funds equal to 0.02 per cent of assets under management in excess of €250 million, subject to an overall limit of €10 million. Furthermore, an Authorised AIFM must have additional own funds or insurance that covers potential liability risks arising from professional negligence.[39]

1.3.4 Transparency obligations

When marketing their funds to investors in Europe after July 2012, AIFMs (whether authorised pursuant to AIFMD or not) will be required to make prescribed pre-sale disclosures to potential investors including disclosure of information about the investment strategy and objective, restrictions on leverage, incorporation details, information about liquidity risk management, and valuation basis etc.[40] Much of this information is already disclosed to prospective investors as market practice.

However, the AIFMD also requires pre-sale disclosure of certain categories of information that are, currently, less commonly disclosed. For example, AIFMs will be required to make disclosures in respect of their risk profile and risk management and their use of leverage. The AIFMD also introduces new requirements on fund managers for disclosure of remuneration in the annual report of any fund marketed in the European Union. The information must cover the total amount of remuneration in a given financial year, split into fixed and variable remuneration, paid by the fund manager to its staff and other beneficiaries, as well as the carried interest paid by the AIF to the fund manager, if relevant. The annual report must also contain the aggregated amount of remuneration broken down by senior management and material risk takers (i.e., staff whose actions have a material impact on the risk profile of the fund manager or the AIF).

AIFMs will also be required to disclose how they will ensure the fair treatment of all investors in relation to each AIF marketed in the European Union and must identify the type of investors who obtain preferential treatment.

In addition to disclosures to investors, AIFMs will be required to report regularly to the regulator the principal markets and instruments in which they trade on behalf of AIFs marketed in the European Union, as well as on the principal exposures and concentrations in the relevant AIF portfolios. AIFMs employing leverage on a "substantial basis" must make available to the FSA a variety of information detailing such leverage arrangements. To this end, a non-EU AIFM will have to make an assessment for each AIF it markets in the European Union about whether leverage is being employed on a substantial basis.

2 Transition to the FCA and PRA

The transition of responsibility for regulation of firms and markets from the Financial Services Authority ("FSA") to the Financial Conduct Authority ("FCA") and Prudential Regulatory Authority ("PRA") is a major move towards the new structure for financial regulation that is being introduced in the wake of the financial crisis. It will herald significant changes in the supervision of firms and in their relationship with regulators whose culture and approach is intended to be very different to that of the FSA. The third element of the new regulatory structure will be the Financial Policy Committee ("FPC") of the Bank of England ("BoE") which will have statutory responsibility for reducing risks to the financial system as a whole.

Commentators have argued that the FSA's focus on conduct of business matters at the expense of prudential issues in large systemically important firms was flawed and allowed unacceptable risks to develop unchecked. Prudential regulation (i.e., regulation that is designed to promote the safety and soundness of firms), for those firms which are broadly viewed as having the greatest potential impact on the system, will be undertaken by the PRA. Prudential regulation for around 1,700 firms comprising deposit takers, insurers and for a small number of major investment firms will transfer to the PRA.

Conduct regulation (i.e., regulation that is aimed at protecting consumers and the integrity of markets) will fall to the FCA. The FCA will have responsibility for conduct supervision for *all* firms (around 26,000 including those firms regulated by PRA for prudential purposes referred to as "PRA-authorised firms" or "dual-regulated firms"); for prudential supervision of those firms not prudentially supervised by the PRA—"FCA-only firms" (about 24,000); and for markets regulation. A major criticism of the regulatory structure in place during the financial crisis was the lack of clarity between the FSA and the BoE about who had responsibility for the overall stability of the financial system and who should have foreseen and avoided the macro-economic risks that the system faced. This will be the role of the FPC, which, among other things, will have the power to give directions and make recommendations to the PRA and the FCA in order to enable it to meet its objectives.

As this *Bulletin* is being written, the Bill that will bring the new structure into law is going through the final stages of parliamentary scrutiny. It is anticipated that legal cutover to the new framework will take place on April 1, 2013.

The new structure will also bring a new approach to regulation from the PRA and the FCA. This new approach will represent a shift towards "judgment-led" regulation, from what has now been seen as "narrow, rule-based compliance[41]". In prudential regulation, the FSA's approach allowed large institutions to become highly stressed at times of market instability and volatility, and the taxpayer was required to step in at great expense to ensure those institutions and the critical services they supplied to the financial system could survive. In conduct of business regulation, the FSA's approach was found wanting in allowing product mis-selling to go unchecked and markets to be rigged for the benefit of large institutions. In the debate surrounding the introduction of the new regulatory structure, there has been a strong emphasis on the need for regulators to hold firms and individuals to account faster and more effectively and to act earlier and more decisively, learning from the mistakes made by the previous regulator.

2.1 The objectives of the PRA and the FCA

To deliver clarity about the roles and responsibilities of the new organisations, the PRA and the FCA will have different and separate objectives under the new statute. These will shape the way in which the regulators operate and the issues to which they apply their resources.

The FCA's strategic objective is to ensure that relevant markets[42] function well. This is underpinned by three key operational objectives:

- securing an appropriate degree of protection for consumers[43] (the consumer protection objective);
- protecting and enhancing the integrity[44] of the UK financial system[45] (the integrity objective); and
- promoting effective competition[46] in the interests of consumers in the market for regulated financial services (the competition objective).

The PRA has the statutory objective to promote the safety and soundness of PRA-authorised firms. It will be required to do this by seeking to ensure that the business of PRA-authorised firms is carried on in such a way as to avoid adverse effects on the stability of the UK financial system and by seeking to minimise the effect that a failure of a PRA-authorised firm could be expected to have on the stability of the UK financial system. The "adverse effects" which the PRA is required to seek to avoid and minimise include in particular the effect of the disruption of the continuity of financial services.

In relation to insurers, the PRA has the additional objective of securing an appropriate degree of protection for those who are or may become policyholders.

Both regulators must carry out their general functions (rule making and setting the general policy and principles by which they act) with regard to the Regulatory Principles.[47] These include the regulator using resources in the most efficient and economical way; imposing burdens that are proportionate to the benefits expected; the general principle that consumers should take responsibility for their decisions; the responsibilities of senior management; and the desirability of transparency of action as a means to contribute to the advancement of their objectives. The specific reference to transparency is new and is a clear indication that the FCA (in particular) will seek to gain leverage from earlier and more effective publication of its actions.

2.2 Threshold conditions

Threshold conditions are a feature of the current regulatory structure. The threshold conditions are the minimum conditions that a firm has to meet in order to be permitted to carry on regulated business. Different threshold condition requirements will be imposed by the FCA and PRA.[48] The PRA will apply separate threshold conditions to banks and insurers. One set of threshold conditions will be applied to all firms by the FCA (save that the FCA condition concerning financial resources will not apply to dual-regulated firms). Threshold conditions will form the benchmark against which applications for authorisation will be judged and they must be met by firms on a continuous basis. The threshold conditions of each regulator are aligned to the objectives of each regulator and new conditions have been introduced where considered appropriate. Dual-regulated firms will need to meet the threshold conditions of both PRA and the FCA; FCA-only firms will need to meet the FCA conditions.

For PRA-authorised firms, there is a new condition that a firm's business must be conducted in a prudent manner. In determining whether a firm has satisfied the condition, the PRA will take account of the effect that the firm's failure may have on the UK financial system. The greater the effect, the greater the expectations of the PRA. The FCA's threshold conditions include a new reference to the risks that might be posed to a firm, its customers and the integrity of the UK financial system by deficiencies in its business model.[49]

Both the FCA and the PRA threshold conditions refer to the "probity" of a firm's management. This will include a consideration by the FCA and (where dual regulated) the PRA, of the entirety of a firm's board and non-board senior management. This condition may become of particular relevance to a firm where it is engaged in business in more than one jurisdiction and where the probity of the management of the UK firm may be called into question by adverse findings or action by overseas regulators. The FCA has said that, when considering applications to act as an approved person, it will take into account the individual's record of treating customers fairly.

The FCA and PRA are also given a new power under the Act to make rules supplementing any or all of the threshold conditions. These rules will have the same status as the conditions themselves and will give the regulators the power to change the baseline requirements for firms to carry on business in reaction to new risks and developments.

2.3 Dual regulation

PRA-regulated firms will be regulated for conduct by the FCA. As indicated above, it is anticipated that around 1,700 firms will be prudentially regulated by PRA. This will include all deposit takers and insurers and certain other significant investment firms (which have been individually designated by the FCA). All other firms will be regulated for both prudential and conduct purposes by the FCA. Those firms that are regulated by both the PRA and the FCA will need to implement systems to work effectively with both regulators.

Whilst the FCA and the PRA will have separate authorisation functions, they will have a single administrative process for dual-regulated firms with PRA taking the lead.[50] Firms that are dual-regulated will apply to the PRA, unless directed otherwise. If a dual-regulated firm applies to the PRA for authorisation (i.e., a new deposit taker or insurer), or voluntary variation of permission or approved persons, then the FCA will be required to give or refuse to give consent to the application. Where the FCA does not give consent then the PRA must refuse the application. When considering whether to give consent, the FCA will focus on conduct issues and will accept the PRA's view on financial soundness. When a dual-regulated firm applies to the PRA for change of control, a PRA rule waiver which is materially important to the FCA objectives, passporting, transfer of insurance business or cancellation of permission, then the PRA must consult the FCA. The PRA will take account of the FCA's views but will not be bound by them.

The FSA is currently consulting on the changes that will be needed to the approved persons regime to minimise duplication for dual-authorised firms[51] and the individuals filling controlled functions, and the regime will aim to ensure that individuals do not need to apply for approval from both PRA and the FCA in order to carry out a single function. This issue potentially arises with significant influence functions (chief executive) which will be designated by both the FCA and PRA. Customer-facing functions will only be designated by the FCA.

A draft memorandum of understanding has been agreed between the FCA and the PRA. The supervisors of each regulator will make their own, separate regulatory judgments against their respective objectives. The FCA will coordinate with the PRA to exchange information that is relevant to individual objectives, but will act separately when engaging the firms, reflecting an independent but coordinated approach to regulation.

2.4 The approach of the regulators

Both the PRA and the FCA have published outlines of their approach to meeting their objectives, key points of which are discussed below.

2.5 The FCA

The FCA has indicated that its approach to regulation will be characterised by a willingness to intervene earlier to prevent harm to customers, rather than by following the more traditional approach of dealing with risks after they have crystallised. The FCA will be heavily reliant on its data gathering and analysis capabilities to enable it to spot emerging issues both at a firm-specific and sector-wide level. It will be under pressure to take swift and effective action to mitigate risk and prevent damage to consumers. Firms likewise will need to adjust their own approaches to ensure that they are fully aware of emerging issues within their industry sector and are keeping abreast of the FCA's work, so that they can avoid damage to their business from unforeseen action by the FCA.

Firms will need to ensure that they have fully embraced the lessons of the FSA's Treating Customers Fairly initiative, since the FCA will "be looking for firms to base their business model, their culture, and how they run their business, on a foundation of fair treatment of customers as set out in the Treating Customers Fairly initiative."[52] This focus on achieving a fair deal for the customer will be central to all of the FCA's thinking. The FCA will be confident that it can require firms to go beyond the letter and detail of its rules when setting its expectations and judging the extent to which firms are complying with them.

The FCA has said that its approach will have five main elements:

- *To be more forward looking in assessment of potential problems*—The FCA will seek to address issues before problems crystallise. It will challenge firms on their business models[53] with regard to achieving positive outcomes for consumers.

- *Intervene earlier*—There will be greater appetite for earlier intervention. This will mean that the FCA is likely to take action in relation to particular products more quickly than the FSA has done previously. This may involve it using its new product intervention powers[54] if an approach cannot be agreed or agreed quickly enough with the industry to prevent unacceptable levels of customer harm.
- *Address the underlying causes of problems, rather than just the symptoms*—The FCA will focus on and attack underlying problems (reflecting its proactive approach). The FCA believes that a focus on root causes will help to bring about more change and will be a more effective use of resources than waiting to deal with the individual problems resulting from those root causes. Particular issues that are likely to continue to be addressed will be incentives and conflicts of interest. Future issues are likely to include the excess profitability of products where competition is ineffective to prevent consumer exploitation.[55] Although the FCA recognises that there will be a certain amount of after the event work that will need to be undertaken, it is aiming to reduce the amount that is necessary.
- *Secure redress for consumers if failures do occur*—Securing redress will be a high priority for the FCA. Where firms continue in existence following an event which causes customer loss, then the FCA will require proactive redress exercises, together with changes to the firm's systems and controls to ensure that post-sales processes deliver fair outcomes for consumers.
- *Take meaningful action against firms that fail to meet standards through levels of fine that have a credible deterrence*—The FCA will continue to pursue the robust enforcement approach of the FSA, using its powers to prohibit individuals from the industry and focusing on senior management responsibility. The FCA will be committed to "bringing more enforcement cases and pressing for tough penalties for infringements of rules" and "pursuing more cases against individuals and holding members of senior management accountable for their actions".

2.5.1 Pre-emptive action

The FCA will have new powers to step in early to pre-empt and prevent widespread harm to consumers. The impact on firms of the use of these powers may be considerable. The FCA will be able to ban misleading financial promotions by individual firms.[56] The FCA will be able to remove promotions immediately from the market or prevent them being issued in the first place.[57] It will also be able to publish an explanation of its reasons for banning a promotion. The procedure requires the FCA to give a written notice and the notice is required to inform the person of his right to make representations to the FCA within a specified period. If the notice is not revoked following representations, then the recipient may refer the matter to the Upper Tribunal. However, the FCA will publish its action in the meantime.

The FCA will also be able to make product intervention rules that ban the sale of particular products by all firms. These rules can be made where it appears to the FCA that they are necessary or expedient for the purpose of advancing the consumer protection objective or the competition objective (or if the Treasury make an order to that effect, the integrity objective). The rules can be made on a temporary basis for a period of 12 months and without prior consultation[58] where the FCA considers that it is necessary or expedient to do so in order to advance the objectives. The FCA is required by the Bill to prepare, consult and publish a statement of policy with respect to the making of temporary product intervention rules and the FSA has issued a draft statement of policy.[59] The draft statement of policy gives examples of the scenarios in which such rules may be made which include:

- products being sold outside their target market or products being inappropriately targeted—for example, widespread sales of risky products to customers who do not have the appropriate capacity for loss;
- products with particular features that make them inappropriate for certain types of customers—this could include wide-ranging exclusions on insurance policies aggressively marketed but sold on a non-advised basis;
- highly profitable products which are only appropriate for certain categories of customers but which are sold more widely and where the sales force are incentivised to deliver volume rather than quality of sale;
- products sold in markets where competition is not properly effective to deliver appropriate sales, for example where competition is focused on irrelevant features;

- products sold in markets where firms restrict choice or product range and accessibility in order to exploit customers. This may include markets where firms offer different customer groups different products and restrict access for no good or valid reasons; and
- inherently flawed products which offer such poor value or have such disadvantageous features that the majority of customers or specific customers are unlikely to benefit.

Product intervention rules have the potential to remove important income streams for firms in circumstances where the firm has not been engaged with the regulator. Given that product intervention is effected under the FCA's rule-making power any challenge would lie in judicial review. The consequences of breaching product intervention rules will also be significant with enforcement action likely to follow. Any agreement entered into in breach of a product intervention rule will be unenforceable with money to be returned to the customer and compensation to be paid. The FCA has said it will use these new tools in a "measured way[60]" with an approach based on a proper understanding of the issues and a full consideration of the potential solution. However, the FCA has also indicated that it will use these powers where particularly rapid action is important in seeking to prevent or reduce the risk to consumers of detriment. It has said that it will be willing to act on some hard evidence, rather than waiting for a comprehensive search for all possible evidence.[61]

Firms will need to consider the potential implications of the FCA's appetite for early and decisive action when they are asked for information by the FCA as part of the FCA's work on issues and products, and in particular when a firm reports a matter to the FCA (as the rules will require it to do). Firms will need to ensure that (to the extent possible) they have adequate proposals and plans to mitigate any ongoing risk as a result of a breach of failure; address the payment of redress; and appropriate arrangements for the monitoring of remedial work and reporting to the FCA.

2.5.2 Product design and governance

The FCA will place a greater emphasis on product design and governance. It will expect providers to ensure that products reach the consumers they were designed for and that they function as expected. Providers will be challenged on the value for money of their products and on ensuring that charging structures can still ensure good outcomes for consumers. The FCA will scrutinise firms' product governance processes including how firms design, operate and sell their products. The FCA will be concerned to assess whether the product has been properly targeted and whether the needs of the target market were taken into account in product design, whether there is sufficient product oversight and monitoring of potential outcomes for consumers and whether distribution strategies are appropriate. The FCA will build on the FSA's approach in this area where the FSA had already proposed turning existing guidance on provider responsibilities into rules to complement point of sale obligations and cover the distribution chain.

2.5.3 How the FCA will supervise

The extent of regular contact that a firm will have with its supervisor will depend on the risk categorisation of the firm. Firms will be categorised according to the risk that they pose to the FCA's objectives. In simple terms, the greater the number of retail customers a firm has and/or the greater the size of its trading operations, the greater the level of regulatory supervision the firm will receive. The FCA foresees that fewer firms will have regular direct contact with supervisors.

Firms will be categorised into four groups for conduct purposes which will determine the nature and extent of the supervisory relationship that the firm has with the FCA:

- *C1* firms will include banking and insurance groups with a very large number of retail customers and universal/investment banks with very large client assets and trading operations;
- *C2* firms across all sectors, with a substantial number of retail customers and/or large wholesale firms;
- *C3* firms across all sectors, with retail customers and/or a significant wholesale presence;
- *C4* includes smaller firms, including almost all intermediaries.

The FCA expects to write to firms in early 2013 to advise them of the category in which they have been placed.

C1 and C2 firms will have a nominated FCA supervisor. The vast majority of firms will be C3 and C4 firms. These firms will be supervised by a team of sector specialists and will not have a nominated supervisor. As part of the FCA's aim for greater and more effective engagement with firms, heads of supervision will be given responsibility for specific sectors and will be expected to engage with groups of firms and trade associations as appropriate to gain a more in-depth understanding of specific sectors, along with building an open and transparent relationship.

The FCA carries out firm-specific supervision by applying its Firm Systematic Framework ("FSF") (the ARROW risk assessment will be phased out) to assessment of conduct risk a firm poses for firms operating in both retail and wholesale markets. The FSF will aim to answer the question of whether the interests of customers and market integrity are at the heart of how the firm is run. The FSF will contain the following features:

- Business model and strategy analysis—aimed at assessing the sustainability of the business from a conduct perspective and the main risks facing it.
- Assessment of how the firm embeds fair treatment of customers and ensures market integrity. This involves consideration of:
    - governance and culture;
    - product design;
    - sales or transaction process; and
    - post-sale service/transaction handling.

The FCA will then decide what actions are required and will communicate them to the firm. The extent and intensity of the assessment will depend on the potential impact of the firm to the FCA's objectives. Firms that are C1 will be assessed on a firm-by-firm basis. C2s will be assessed by taking a group of similar firms in the same industry sector and assessing what risks are posed more generally. C3s will involve consideration of a sample of firms. For C1s and C2s, the FCA will work through the assessment areas on a two-year cycle.

The FCA expects to cater for those firms without nominated supervisory resource through its contact centre. The FCA envisages that the contact centre will be able to provide guidance to firms. This increased functionality will be particularly important given that fewer firms will be directly supervised. The FCA plans to "up-skill" its contact centre with the intention that it will be able to handle more issues as the first point of contact for many firms without the need to refer them to supervisors. Online support for firms will also be improved with the FCA saying that more people will be on hand, including sector specialists who can answer detailed questions. The FCA plans proactively to contact newly authorised firms to explain their regulatory obligations.

2.5.4 Event-driven work

The FCA intends to have fewer supervisors assigned to individual firms and it will have more resource to apply to events and products and issues. It anticipates that it will have a flexible workforce which it will be able to apply where needed. The FCA expects to act quickly where information suggests significant loss or risk of loss to consumers or damage to market integrity. The FCA will want to ensure that such work is carried out quickly and effectively given its stated appetite for risk and loss.

2.5.5 Issue and product work

The FCA will use sector risk assessment to drive issue and product work. This will provide an assessment of the conduct risks across the sector and complement the firm-specific work, so that the FCA can identify risks, whether they are cross-firm issues, firm-specific issues or product issues. The key questions that the FCA will ask when assessing and prioritising issue and product work are:

- What are the cross-firm and product issues that are behind poor outcomes for consumers or endanger market integrity?

- What is the degree of potential harm?
- What is the discovery and mitigation work proposed?

Specialist sector teams will work together to deliver these assessments, making use of external data and market intelligence.

2.5.6 Supervision of wholesale market participants

The FCA will not make a clear distinction in its approach to supervision of participants in wholesale markets and retail markets. This is because it views activities in retail and wholesale markets as connected, and considers that risks caused by poor conduct in the wholesale market can be transmitted to the retail market. What may start with institutional or wholesale relationships often affects retail customers and therefore the FCA considers that this interaction is relevant to both the FCA's consumer protection and market integrity objectives.

The FCA's framework for supervision of participants in wholesale markets will be the same as that for participants in retail market. It will be made up of the FSF, issues and product work and event-driven work. It will use a single FSF to cover all types of firms, with additional wholesale conduct modules in the FSF for a limited number of insurance, banking and investment C1 and C2 firms, with more thematic work on key risks and priorities; wholesale C3 and C4 firms, which could include large international banks with smaller wholesale businesses in the United Kingdom, will not be subject to the same form of regular assessment as retail firms. They will be supervised mainly through issues and product work. However, if information indicates that their risk profile has significantly increased, they will be subject to an assessment.

2.5.7 The FCA's approach to prudential supervision

The FCA will be responsible for the prudential supervision of the vast majority of financial services firms. It is estimated that around 24,000 firms will be prudentially supervised by the FCA. In carrying out prudential supervision, the FCA's approach will:

> "be based on managing failure when it happens rather than focusing on reducing its probability—this is because isolated failures of FCA-only firms would not generally represent a risk to the integrity of the financial system."[62]

The FCA will seek to protect client assets and ensure that a firm can be run down without adversely affecting consumers.

For prudential purposes, firms will be categorised as:

- *Prudentially critical firms (CP1):* firms where a disorderly failure would have a significant impact on the market in which they operate and disorderly failure of one player could not easily be assimilated by other firms in that market and/or where there are significant client asset and money holdings.
- *Prudentially significant firms (CP2):* firms where a disorderly failure would have a significant impact on the functioning of the market in which they operate but there is a smaller client asset and money base where an orderly wind down can be achieved.
- *Prudentially insignificant firms (CP3):* firms where failure, even if disorderly, is unlikely to have a significant impact.

CP1 firms will continue to have reviews of ICAAP[63] and individual liquidity adequacy assessments where they are MiFID investment firms subject to the Capital Requirements Directive.

CP2 firms will have very limited going concern supervision. CP3 firms will be monitored against minimum requirements with supervision stepped up only when the firm is close to failure or failing.

2.5.8 Enforcement

The FCA's approach envisages a flexible enforcement division that works closely and in conjunction with the other departments within the FCA. The FCA sees itself as an organisation where enforcement plays a vital role:

> "... to help make sure firms put consumers at the heart of their business and markets are sound stable and resilient."[64]

The FCA will inherit the current enforcement powers of the FSA. However, the indications are that the FCA will expect to use those powers more regularly than the FSA. The FCA is committed to bringing more cases and imposing tougher penalties with a focus on taking action against individuals and securing compensation for consumers. The FCA will continue to seek criminal prosecution for insider dealing and market manipulation and will take action against unauthorised business. The FCA will also be concerned to ensure that firms have effective arrangements to prevent them being used to facilitate financial crime and this will be a continued priority both for supervision and enforcement. This focus on financial crime will include action against firms for inadequate anti-fraud, anti-money laundering or anti-bribery and corruption systems.

The FCA has committed itself to retaining broadly the same internal decision-making structures of the FSA as regards enforcement decisions. This includes the retention of the Regulatory Decisions Committee ("RDC") as the body that issues Warning, Decision and Final Notices in Enforcement cases.[65] However, the FCA has also committed itself to being more transparent in its enforcement activity. Under the Bill, the FCA will, for the first time, be able to publish Warning Notices which it issues when it decides to take disciplinary action against a firm or individual but before the firm or individual has the formal right to make representations in response.

2.6 The PRA

In October 2012, the PRA set out its intended approach to supervision of those firms that will fall within its remit, namely deposit takers, certain significant designated investment firms and insurers.[66] The PRA issued two separate documents, one covering its approach to deposit takers and investment firms and the other covering its approach to insurers. Its approach was expressed in high-level policies and it is anticipated that more detailed material will be published by the PRA following further consultation. It has stated that it will consult as to the use of its enforcement powers. However, in this regard it is clear that the FCA will be the main enforcement agency.

2.6.1 The PRA's approach to supervision

The PRA's general objective is to promote safety and soundness in those firms it supervises. It will focus primarily on the harm that firms can cause to the stability of the UK financial system. As regards insurers, the PRA will have a specific objective to contribute to securing an appropriate degree of protection for those who are or may become policyholders. However, it will not be the PRA's role to ensure that "no firm fails". When firms do fail, the PRA will seek to ensure that they do so in a way that avoids significant disruption to the supply of critical financial services.

The PRA will supervise firms to judge whether they meet its policies at the time of assessment and on a forward-looking basis, and will take action where necessary to restore safety and soundness. Supervision will be tailored to the particular firm.

The criteria against which firms' safety and soundness will be assessed will be rooted in the PRA's statutory objectives, the statutory threshold conditions for authorisation, and UK and EU law. In general, the PRA will inherit the prudential aspects of the FSA's detailed policy framework. The main message to firms is that they need to maintain sight of the overriding principle of their safety and soundness and act accordingly.

The PRA will approach supervision focusing on those firms that in its view, pose the greatest risk to the stability to the UK financial system. Firms that pose greater risk will experience more frequent and intense supervision.

2.6.1.1 PRA risk framework

PRA supervisors will apply a risk framework when forming judgments. The risk framework will be based on:

- the potential impact that a firm could have on financial stability (both in terms of the way the firm carries on its business and in the event of failure). In the case of insurers, the PRA will also take account of the potential impact on policyholders;
- how the external context in which the firm operates and the business risks it faces might affect the viability of the firm; and

- mitigating factors including a firm's management and governance and its risk management and controls, financial strength and resolvability. Where possible, the PRA will take an integrated view of the elements of mitigation that a firm has in place. Firms must meet minimum levels of adequacy in all areas, for example, high levels of capital cannot act as a long-term substitute for sub-standard management.

The PRA will divide firms it supervises into five categories of impact with the most significant firms with the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner ranked as Category 1,[67] and those firms whose size complexity, interconnectedness and business type give them almost no capacity individually to cause disruption to the UK financial system but where difficulties across a whole sector or subsector may have the potential to generate some disruption as Category 5.

Firms will be told the category to which they have been assigned and this will give them a broad indication of the level of supervisory interaction to expect. The PRA will conduct its assessment work on a continuous cycle. It will undertake a set of "core" supervisory activities in order to inform its overall assessment of the firm. Category 1 and 2 firms will have continuous interaction with PRA. Two-thirds of the PRA's staff will be assigned to these (approximately 90) firms. Those firms that are individually unlikely to create disruption to the wider financial systems will be supervised on a "portfolio" basis. Use will be made of automated tools in order to analyse firms' regulatory returns which will issue alerts highlighting outliers and trends. Low-impact firms will not have an individual named supervisor and will not be visited on a fixed cycle by the PRA.

In addition to the assessment of a firm's potential impact, the PRA will consider a firm's proximity to failure when drawing up its supervisory plan. This will be caught in what the PRA calls its "Proactive Intervention Framework" ("PIF"). The PIF will have five stages from low risk to viability of the firm (Stage 1), to the firm being in resolution or being actively wound up (Stage 5). Every firm will be placed at a point on the PIF at each point in time and as a firm moves higher up the PIF, supervisors will review their supervisory actions accordingly. Each firm's PIF stage will be reviewed at least annually and in response to material developments. The PRA will not disclose its judgments on the firm's proximity to failure to the markets. These will also not currently be disclosed to firms themselves given the obligation of disclosure which may then apply to the firm itself. Such disclosure could further jeopardise the stability of the firm.

The PRA will seek to engage with boards and senior management in forming its decisions, using this dialogue to ensure it takes account of all relevant information in reaching its judgments and to communicate clearly its rationale for its decisions. To support its broad information gathering and analysis, the PRA will require firms to participate in meetings with supervisors. It will also, as appropriate, conduct on-site testing and inspections of a particular area, and require information from firms to support their judgments about key risks.

The PRA will have statutory powers which it can use in the course of its supervision if it considers it necessary to do so to reduce risks. For example, it may vary a firm's permissions or impose a requirement on the firm to prevent or curtail it undertaking certain regulated activities.

2.6.1.2 PRA's expectation of firms

The PRA will expect firms to meet its expectations on both a consolidated basis for groups headquartered in the United Kingdom, and for UK subgroups of wider global groups and at the level of regulated legal entities. This is because a regulated firm's relationships with other entities in its group may affect its prudential soundness.

The PRA will expect firms to go beyond its detailed requirements, which will often mean firms acting more conservatively than they would otherwise choose. Boards and management will be required to understand the kind of behaviour that will deliver an acceptable level of safety and soundness from the point of view of the financial system, and act accordingly. Culture and behaviour of firms will also be important as the PRA will expect firms to have a culture that supports their prudent management. The PRA will approach the responsibility of board members as individual as well as collective.

Firms will need to be able to show that they have robust frameworks for risk management and financial and operational controls, commensurate with the nature, scale and complexity of their business and consistent with their safety and soundness.

2.6.1.3 Capital

The PRA will require firms to maintain appropriate capital resources both in terms of quantity and quality, consistent with their safety and soundness and taking into account the risks to which they are exposed. Some part of this will need to be in ordinary shares and reserves. Location of capital will also be taken into account, with the PRA expecting capital to be located in the regulated entities where it is needed. For banks, building societies and designated investment firms, the PRA will determine a minimum regulatory capital level and a buffer on top of this. Where a firm uses an internal model in calculating its regulatory capital requirements, the PRA will expect this to be appropriately conservative. Where such internal models are used for regulatory capital purposes, they will be expected to contribute to prudent risk management and measurement.

2.6.1.4 Enforcement

The PRA will cooperate closely with the FCA, but will also have its own enforcement powers. These include the power to impose financial penalties and publish public censures.[68] In deciding whether to take action against individuals, the PRA has stated that it will take into account:

- the impact the individual's behaviour has had or is having on the PRA achieving its objective—including the behaviour of those for whom the person is responsible—and whether that behaviour calls into question the individual's fitness to be an approved person; and
- the individual's behaviour towards the regulator, including how open and cooperative the individual has been and the steps taken to put right the issues identified.

As regards enforcement action against firms, the PRA will have the power to impose financial penalties and publish public censures where a firm fails to meet the PRA's policies or where directions or restrictions imposed by the PRA are ignored by the firm. The PRA anticipates that it may use disciplinary powers where it wants to change and promote high standards of regulatory behaviour at the level of an individual firm or at the level of the regulated community as a whole.

3 Contentious regulatory law 2012: key FSA enforcement actions

Over 2012, the FSA has continued its credible deterrence approach, with its emphasis on consumer outcomes and concerns around suitability evident in some of the most significant Final Notices issued. Along with other overseas regulators, the FSA has been active in the LIBOR investigation, with the Barclays Final Notice (imposing a fine of £59 million) anticipated to be the first of several actions taken against banks in this area. The FSA has demonstrated a continued appetite for market abuse cases against firms and high-profile, senior individuals.

Scrutiny continues to be given to the roles of senior management with action taken against CEOs, as well as compliance officers. The FSA issued a final notice imposing a fine of £500,000 and a partial prohibition to Peter Cummings, the ex CEO of the HBOS Corporate Division, but was unsuccessful in its case against John Pottage, the CEO of UBS's wealth management division. The Upper Tribunal rejected the FSA's case, saying that there was insufficient evidence to prove the allegation that Mr Pottage had failed to take reasonable steps to ensure that the business of the firm complied with the requirements and standards of the regulatory system. The case demonstrates the value of referring a Decision Notice to the Upper Tribunal, as it should not be assumed that the FSA's analysis will always be accepted.

The year also showed, however, that a referral to the Upper Tribunal carries the risk that the Upper Tribunal may expand the case against the applicant and/or increase the penalty imposed by the FSA. Mr Sejean referred the Decision Notice he received from the FSA imposing a fine of £550,000 for market abuse to the Upper Tribunal. The Upper Tribunal allowed the FSA to include in its case an additional, related allegation that had not been present in the FSA's Decision Notice. Having found Mr Sejean guilty of the additional allegation (as well as the allegations included in the Decision Notice), it increased his fine by £100,000. Given the Upper Tribunal's wide discretion to include additional (albeit related) issues and increase fines, any decision to refer requires careful analysis of the risks of doing so, as well as the potential reward.

The FSA has made it clear that it will not be deterred from taking difficult cases against senior individuals and the FCA is likely to take a similarly robust approach against high-profile individuals in order to achieve maximum impact on the regulated community.

3.1 LIBOR

The Final Notice issued to Barclays on June 27, 2012 imposed the FSA's largest fine to date of £59.5 million (discounted from £85 million for early settlement) for misconduct in relation to Barclays' rate setting for LIBOR and EURIBOR. This was coupled with fines imposed in the United States. Barclays' failings related not only to its rate setters taking into account requests from its derivative traders to adjust the rates to benefit their trading positions, but also the suggestion that Barclays had adjusted its rate submission so as to avoid negative media commentary about its financial position at the peak of the financial crisis. Barclays' compliance and systems and controls in this area were also criticised.

Martin Wheatley, CEO designate of the FCA conducted a review into LIBOR[69] and concluded that it should be reformed rather than replaced. The government has accepted the recommendations of the Wheatley review and proposes to update the draft Financial Services Bill.[70]

The draft Financial Services Bill amendments[71] will:

- bring LIBOR activities within the scope of statutory regulation, including the submission and administration of LIBOR;
- create a new criminal offence for misleading statements in relation to benchmarks, such as LIBOR, as well as amending the language of existing offences; and
- give the FCA specific power to make rules requiring banks to submit to LIBOR, with reference to a Code of Practice produced by the rate administrator.

Market participants will continue to play a significant role in the production and oversight of LIBOR. It was not considered appropriate for the authorities to take over the process of producing a benchmark which exists primarily for the benefit of market participants.

The FSA has not ruled out action against individuals with regard to LIBOR failings, but it may take some time before such proceedings crystallise.

The implications for banks coming out of the LIBOR scandal could extend beyond regulatory fines. The High Court recently agreed that Guardian Care Homes could pursue its case against Barclays, in which it alleges that its losses of £12 million were the result of the manipulation of LIBOR. It will be the first LIBOR damages trial in the United Kingdom, and will be closely watched as a test case for potential future claims against other banks in this area.

3.2 Market abuse and insider dealing

The FSA has continued aggressively to pursue cases of market abuse and insider dealing, with key cases emerging in both the civil and criminal jurisdictions.

Nicholas Kyprios[72] (Head of Credit Sales at Credit Suisse Securities (Europe) Limited ("Credit Suisse")) was fined £210,000 (discounted from £300,000 to reflect early settlement) for disclosing information to a potential investor that was confidential to Credit Suisse's client Liberty Global, Inc ("Liberty"). Mr Kyprios disclosed information that had been treated as inside information by his firm, and that he did not have Liberty's permission to disclose.

The information related to a potential multi-billion euro bond issue[73] ("the information"). The information was not price sensitive in relation to qualifying investments,[74] but was price sensitive in respect of outstanding floating rate notes[75] and credit default swaps.[76] Credit Suisse had prohibited Mr Kyprios from discussing the information with anyone outside Credit Suisse and told him it was inside information. Nonetheless, Mr Kyprios signalled certain aspects of the information to a fund manager who was a potential investor, despite the fact the fund manager had asked not to be wall crossed.[77]

Although the FSA accepted that the information disclosed by Mr Kyprios was not "inside information" as defined in s.118C of FSMA, Mr Kyprios was considered to have failed to observe the proper standards of market conduct. Mr Kyprios sought to disclose the information indirectly by playing guessing games, for example, asking the potential investor to guess the correct issuer in a game of "getting warmer". The FSA considered that the content and meaning of the calls was clear and did not accept Mr Kyprios's explanation that the conversation was merely banter. As this case was settled, the FSA's analysis was not tested before the Upper Tribunal.

The FSA's case against Ian Hannam[78] (who at the time of events was the Global Co-head of UK Capital Markets at J P Morgan[79]) concerned "non-deliberate" market abuse. The FSA says that Mr Hannam disclosed inside information to contacts in relation to Heritage Oil Plc ("Heritage"). Heritage was an existing J P Morgan client for which Mr Hannam was the lead adviser. The information is said to have been disclosed in two e-mails, one containing information about a potential offer for Heritage and the second (in which Mr Hannam said "Tony has just found oil and it is looking good") conveying information oil had been found.

Mr Hannam's arguments included the assertion that the FSA should have applied the criminal standard of proof, that the information conveyed was insufficiently precise and price sensitive to constitute inside information, and that information contained in the first e-mail had already been disclosed to the party Mr Hannam was communicating with (and so he was already aware of the information). Mr Hannam also said that the FSA was taking his communications out of context, he was either acting in the proper course of the exercise of his employment, profession and duties,[80] or he had believed he was acting in the proper course of the exercise of his employment, profession and duties and therefore believed on reasonable grounds that he had not committed market abuse.[81] The FSA rejected these arguments and imposed a financial penalty of £450,000.

Mr Hannam has referred the Decision Notice to the Upper Tribunal, with the hearing expected to take place in July 2013.

The FSA has successfully pursued other enforcement actions against firms and individuals who have unknowingly received and traded upon the basis of inside information. In those cases, the FSA has argued that market participants must have robust systems in place to identify inside information and to treat it accordingly (even where, for example, the firm has specifically requested that it not be provided with inside information (i.e., "wall-crossing").

In September 2012, the Upper Tribunal issued its judgment[82] on the referrals by Stefan Chaligné, Patrick Sejean, and Tidiane Diallo of the FSA's decision to fine Mr Chaligné and Mr Sejean and impose full prohibitions on all three for market abuse.[83] Mr Chaligné, a Swiss-based fund manager, was both the fund manager and a shareholder in a Cayman Islands-based hedge fund. He was said to have deliberately manipulated the market in a number of securities by placing orders through a broker which were designed to increase the closing price of the securities. This increased the value of the hedge fund on two key portfolio valuation dates (known as "window dressing the close"). Mr Sejean and Mr Diallo assisted Mr Chaligné by effecting and executing his orders, despite knowing these were manipulative in nature.

The Upper Tribunal upheld the penalty and prohibition imposed on Mr Chaligné, and the prohibition imposed on Mr Diallo. Interestingly, although the FSA's Regulatory Decisions Committee ("RDC") chose not to include an additional (related) allegation of market abuse by Mr Sejean, the Upper Tribunal made it clear that it had the jurisdiction to consider all relevant material, and was not restricted by the RDC's view of it. The Upper Tribunal allowed the FSA to include the additional allegation, and having found it proved, increased the penalty imposed on Mr Sejean from £550,000 to £650,000.[84] The case is a useful reminder that the Upper Tribunal has a wide jurisdiction (albeit its enquiry must be limited to facts and events connected with the subject matter of a referred decision notice) and although rare, it can choose to increase a financial penalty from that imposed in a Decision Notice.

The FSA achieved criminal convictions against six individuals[85] involved in a complex and sophisticated insider dealing ring. The defendants obtained confidential and price-sensitive information from investment banks concerning proposed or forthcoming takeover bids. They then used a large number of accounts to place spread bets ahead of the announcements knowing that when the information became public, the price would rise. It was an attempt to deal on inside information over a long period, and involved one of the most intensive and long-running FSA investigations to date.

3.3 Anti-money laundering

Following the publication of its thematic review in June 2011, the FSA has taken a number of cases against firms for anti-money laundering ("AML") failings. The cases have involved a variety of firms, with significant fines imposed. The cases signal how seriously the FSA takes failings in this area, and is an approach likely to be continued under the FCA. The FSA has taken action against firms as well as individuals, and has emphasised that firms must be vigilant when dealing with jurisdictions that do not have UK-equivalent AML controls.

Coutts & Company[86] received a financial penalty of £8.75 million (reduced from £12.5 million for early settlement), for failing to establish and maintain effective AML systems and controls in relation to customers that posed a higher money laundering risk. Coutts's misconduct was viewed as especially serious as it occurred at a time when Coutts was expanding its customer base, and targeting customers that had a higher risk of money laundering, as they were from jurisdictions where the AML requirements were not equivalent to those in the United Kingdom.

Habib Bank AG Zurich[87] ("Habib") was fined £525,000 (reduced from £750,000 for early settlement) for AML systems and control failures for nearly three years. Habib's misconduct included failing to establish and maintain an adequate procedure for assessing the level of money laundering risk posed by prospective and existing customers, failing to conduct sufficient enhanced due diligence in relation to higher risk customers, carry out adequate reviews of its AML systems and controls and revise its training to address shortcomings identified in AML practice. Approximately 45 per cent of Habib's customers were based outside the United Kingdom, and these customers accounted for 70 per cent of its deposits. Around a third of these customers (and approximately 50 per cent of Habib's deposits) came from jurisdictions which carried a higher risk of money laundering[88] and as such, Habib's weakness in its AML procedures was viewed as particularly serious. Habib's policy of excluding Pakistan and Kenya from its high-risk country list was considered by the FSA to be "seriously misconceived" given the higher risk of money laundering they presented[89] which was not negated by Habib's physical presence in these countries, or any specialist knowledge of them. When Habib added Pakistan and Kenya to its high-risk country list in November 2010 (following the recommendation of a skilled person), it resulted in the reclassification of 170 accounts from normal to higher risk. The FSA also fined Habib's money laundering reporting officer[90] £17,500 after discount for early settlement.

The FSA imposed a fine of £294,000 (reduced from £420,000 for early settlement) on Turkish Bank (UK) Ltd[91] ("TBUK") for widespread anti-money laundering failings in relation to its correspondent banking activities. This is the first case in which the FSA has taken enforcement action against a firm in relation to money laundering weaknesses in its correspondent banking activities.

Correspondent banking is considered to attract a higher risk of money laundering because it is not "face-to-face" business. Correspondents often do not have a relationship with the underlying parties to a transaction (and therefore are unable to verify their identities), and often have little information about the nature or purpose of the underlying transactions.[92] As such, the FSA considers that extra vigilance is required. TBUK acted as agent for respondents in Turkey and Northern Cyprus, providing its respondents' underlying customers with services that those respondents could not provide themselves. TBUK relied on its respondents' AML controls over their underlying customers, but this was insufficient because Turkey was not a jurisdiction with UK-equivalent AML requirements at the relevant time and Northern Cyprus had not been assessed as having UK-equivalent AML requirements. Despite FSA supervisors warning TBUK in 2007 that it had deficiencies in its money laundering controls, TBUK still failed sufficiently to address these.

The cases reinforce the risk of banks failing to apply rigorous due diligence and risk monitoring to customers in relation to AML. In its thematic review findings, the FSA noted that:

> "Some banks appeared unwilling to turn away or exit very profitable business relationships when there appeared to be an unacceptable risk of handling the proceeds of crime. Around a third of banks ... appeared willing to accept very high levels of money laundering risk if the immediate reputational and regulatory risk was acceptable".[93]

The recent cases have made it clear that such an approach is unacceptable to the FSA who will take enforcement action if required.

3.4 CASS breaches/client money

The FSA continues its pursuit of firms with regard to client money failings. BlackRock Investment Management (UK) Limited ("BIM") was fined £9,533,100 (reduced from £13,618,800 for early settlement) for breaches of client money requirements and failings in its systems and controls.[94] BIM did not comply with the requirement to provide appropriate notification and obtain trust letters from institutions in relation to a number of its client money market deposits in the period between October 1, 2006 and March 31, 2010. BIM's breaches arose after a series of organisational and system changes which took place following its acquisition by BlackRock group in September 2006. The FSA said that the changes resulted in a weakening of the client money oversight and compliance arrangements and the consequential departure of certain members of staff with institutional knowledge contributed to the firm's delay in identifying and addressing the issues. As part of its investigation, the FSA contacted four of the counterparty banks with whom BIM placed the majority of money market deposits over the relevant period without trust letters in place. The majority of these banks confirmed that they had thought BIM was the legal owner of the deposits and they were not aware that this was client money. The FSA considered that in the event of insolvency, clients would have suffered delay in securing the return of their funds and may not have recovered their money in full. The case is a warning to firms that they must ensure that there is continuity of oversight and compliance in these areas, as if left unmonitored, breaches could go unnoticed for an extended period of time.

3.5 UCIS (unregulated collective investment schemes)

UCIS are collective investment schemes which do not satisfy the criteria to be regulated collective investment schemes.[95] Although the schemes themselves are not regulated, those individuals that carry on regulated activity in relation to them will fall within the FSA's jurisdiction.

UCIS investments typically aim to generate high returns, but have a number of additional risks which an adviser should consider when deciding whether to make a recommendation. Depending on the structure of the scheme, the management and protection of its assets may not be covered by the Financial Ombudsman Service ("FOS") or the Financial Services Compensation Scheme ("FSCS"), although customers can pursue FOS claims against the investment advisers where they have breached their obligations in relation to advice or promotion of the scheme. The FSA has published proposals[96] to ban the promotion of UCIS and similar products to the majority of retail customers in the United Kingdom. The proposed rules will restrict promotion to sophisticated investors and high net worth individuals for whom the products are more likely to be suitable.

The FSA has taken robust enforcement action against firms who have recommended and sold UCIS in breach of the regulatory requirements. IFA firm Topps Rogers Management Limited was fined £97,600 for failing to promote UCIS in accordance with regulatory and statutory requirements, or ensure the suitability of its recommendations.[97] Enforcement action was also taken against two directors of MNFA Limited ("MNFA") who were involved in promoting a UCIS scheme known as the Environmentally Beneficial Plant Scheme ("EBP Scheme"). The UCIS was sold to customers in breach of regulatory requirements and without adequate compliance monitoring. Customers invested around £11.6 million in the EBP Scheme that was unlawfully promoted and the majority of investors subsequently sustained substantial losses. Anthony Adams, who was a director and MNFA's compliance officer, was prohibited from holding roles as an SIF other than as or through an appointed representative.[98] Richard Rhys, who was a director and the leading approved person promoting and marketing the EBP Scheme, was given a full prohibition. MNFA was part of a group of companies that had gone into liquidation, and this is likely to be why no action was taken against the firm.

3.6 Mis-selling

A topic of significant media comment has been the mis-selling of interest hedging products to certain small and medium businesses ("SME"). From 2001 to date, banks are believed to have sold around 28,000 of these products to customers. The FSA conducted a review of these sales in 2012 and found a range of poor sales practices that included poor disclosure of exit costs, failing to ascertain customers' understanding of risk, non-advised sales straying into advice, over-hedging and sales and incentives being a driver of these practices. The FSA has reached agreements with a number of banks including Barclays, HSBC, Lloyds and RBS that they will provide appropriate redress where mis-selling of interest rate hedging products has occurred. The banks have also agreed to stop marketing interest rate structured collars to retail customers.

The FSA fined Savoy Investment Management Limited ("Savoy") £412,000 (after discount for early settlement) for failing to take reasonable care to ensure the suitability of the investment portfolios of its wealth-management clients.[99] Investment managers were allowed significant discretion in advising clients, and Savoy's controls and processes were not sufficient to ensure the suitability of that advice and portfolio management. Files lacked information on the clients' personal and financial circumstances and contained out-of-date and inadequate client information. The FSA considered that clients were therefore at risk of having investment decisions made that did not match their expectations and attitude to risk. The FSA reviewed Savoy as part of its thematic review of the wealth-management sector, and we can expect further enforcement action in this area.

3.7 Systems and controls

The FSA issued a public censure to Bank of Scotland[100] ("HBOS") as a result of the failings of the firm in relation to its corporate banking division ("Corporate") over 2006 and 2008. The FSA was critical of Corporate pursuing an aggressive growth strategy between January 2006 and March 2008, despite what were said to be "known weaknesses" in the control framework. Although the FSA accepted that the firm had initiated a number of projects designed to improve the control framework and that the severe financial crisis and economic downturn in the course of the relevant period was not reasonably foreseeable it still found that the firm's standard of conduct fell below what was reasonable in the circumstances.

On November 25, 2012, the FSA imposed a fine of £29.7 million (after discount for early settlement) on UBS AG for failures in its systems and controls in its Global Synthetic Equities ("GSE") business conducted from its London Branch. These breaches became apparent when UBS discovered that its trader Kweko Adeboli had amassed losses of £2.3 billion through his trades on the exchange-traded funds desk in the GSE division. The fine imposed was calculated under the FSA's 2010 penalties framework, based on revenues on the GSE desk over a 12-month period. The FSA noted its expectation that firms should give consideration to whether systems and controls deficiencies identified in an enforcement action (in this case, that taken against UBS in 2009) are applicable to other business areas within the same branch and whether remedial action is necessary.

The FSA also took action against the CEO of the corporate division, Peter Cummings.[101] The FSA imposed a financial penalty of £500,000 on Mr Cummings for failing to act with due skill, care and diligence as a SIF holder and being knowingly concerned in the contraventions by HBOS. This is the highest fine to date imposed on a senior executive for management failings.[102] Mr Cummings was also prohibited from performing any significant influence function in any authorised firm that was a bank, building society, or banking-related firm.

In contrast to the result achieved against Mr Cummings, the FSA was unsuccessful in its case against John Pottage, the CEO of UBS's wealth-management business.[103] The case against Mr Pottage was viewed by many as something of a test case for the FSA in pursuing a SIF holder in relation to alleged failures in oversight and supervision of the business for which he was responsible. The FSA alleged that Mr Pottage had failed to take reasonable steps to identify or remediate flaws in the governance and risk-management frameworks and ensure that the firm complied with regulatory requirements. Mr Pottage was also criticised for failing to initiate a "comprehensive bottom-up review of systems and controls across the whole business sooner than he did".[104] Although Mr Pottage had taken steps to identify deficiencies in the framework and investigate compliance issues that arose, the FSA considered that he had not taken sufficient account of warning signals within the business and as a result failed to make himself aware of shortcomings in the firm's systems and controls as quickly as he should have. It sought to impose a fine of £100,000. The Upper Tribunal held that the FSA's allegations were not supported by the evidence, saying:

> "Put positively, we think that the actions that Mr Pottage in fact took prior to July 2007 to deal with the operational and compliance issues as they arose were reasonable steps".

Significant fines were also imposed on firms relating to failures in systems and controls around discretionary management of unlisted investments,[105] as well as serious failures in corporate governance and controls following a decision to expand and diversify into a new business area.[106]

3.8 Conclusion

The cases over the course of 2012 have shown the FSA's continued appetite for robust enforcement action. It has demonstrated its increasing confidence as a regulator, pursuing difficult cases against senior individuals, accepting that it will not always succeed. Those facing enforcement action must carefully analyse the merits of their case in order to decide whether to settle or defend their position. It should not be assumed that the Upper Tribunal will agree with the regulator's characterisation of a case, but equally, on rare occasions, the Upper Tribunal may impose a harsher penalty than that imposed in a Decision Notice.

Recent cases, have also foreshadowed the approach that is anticipated under the FCA, with emphasis given to value for money of products in assessing issues around mis-selling. We can expect the FCA to focus its resources on the cases it believes will make greatest impact on the regulatory community. It is likely that the FCA will pursue cases that send strong messages to the market and on breaches by high-profile individuals. The agreement reached between the FSA and certain banks with regard to interest rate swaps and customer redress illustrates a pragmatic approach that achieved a swift outcome, without the necessity for immediate enforcement action. It will be interesting to see whether the FCA will strive to achieve similar outcomes in the future.[107]

Notes

1 See Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank (Brussels, 2.6.2010 COM(2010) 301 final).

2 See art.288 of the Treaty on the Functioning of the European Union.

3 European Parliament and Council Directive 2004/39/EC on Markets in Financial Instruments.

4 See *http://www.esma.europa.eu/system/files/2012-666.pdf* [Accessed December 5, 2012].

5 Note that the SSR includes an exemption for European Shares where the primary market for those shares is outside the European Union. ESMA maintains a list of the securities that qualify for this exemption and which are therefore not subject to either the Uncovered Short Prohibition or the Disclosure Requirements at *http://www.esma.europa.eu/page/List-exempted-shares* [Accessed December 5, 2012].

6 See arts12 and 13 of the SSR.

7 See art.14 of the SSR.

8 See arts 5, 6 and 7 of the SSR.

9 See Ch.V of the SSR.

10 See, for example, the £500,000 fine imposed on Evolution Beeson Gregory Limited on November 12, 2004 for its failure to have a "reasonable settlement plan" in respect of its short selling of the Room Service Group Plc.

11 See arts12 and 13 of the SSR.

12 See art.14 of the SSR.

13 See art.14 of the SSR.

14 See art.4 of the SSR.

15 See art.21 of the Supplementing Regulation.

16 See art.4 of EMIR.

17 See art.9 of EMIR.

18 Other than an intra-group transaction, see art.3 of EMIR.

19 See art.1(2) of EMIR.

20 Defined in the draft Regulatory Technical Standards submitted to the European Commission on September 27, 2012 as €1 billion in gross notional value with respect to equity and credit derivatives and €3 billion with respect to other classes of derivatives.

21 See art.5 of EMIR.

22 See art.6 of EMIR.

23 See art.5(2) of EMIR.

24 See art.9(1) of EMIR.

25 See art.9(1) of EMIR.

26 See art.5(2) of the draft Implementing Technical Standards on trade repositories.

27 See *http://www.bis.org/publ/bcbs226.pdf* [Accessed December 5, 2012].

28 See art.12 of the draft Regulatory Technical Standards on OTC derivatives ("Draft OTC Standards").

29 See art.11 of the Draft OTC Standards.

30 See FSA Consultation Paper CP12/32 Implementation of the Alternative Investment Fund Managers Directive.

31 See art.18 of the AIFMD.

32 See art.15 of the AIFMD.

33 See art.21 of the AIFMD.

34 See art.36 of the AIFMD.

35 See art.42 of the AIFMD.

36 See art.8(4) of the AIFMD.

37 See art.15(4) of the AIFMD.

38 See art.30 of the AIFMD.

39 See art.9 of the AIFMD.

40 See art.22 of the AIFMD.

41 Treasury Select Committee: The FSA's Report into the failure of RBS October 19, 2012, p.48 (which refers to the conclusions from the Treasury Select Committee Inquiry into LIBOR).

42 "Relevant markets" are defined as "the financial markets"; "the markets for regulated financial services"; and the markets for those services provided by non-regulated persons who carry on regulated activities without breaking the prohibition (i.e., the markets for those services provided by exempt persons)—Financial Services Bill 2011 s.1F.

43 When deciding what degree of protection may be appropriate, the FCA must have regard to: the differing degrees of risk involved in different transactions; the different experience and expertise that different consumers have; the needs of consumers for timely information and advice that is fit for purpose; the general principle that consumers should take responsibility for decisions; the principle that providers of financial services should provide an appropriate level of care having regard to the risk involved in the transaction and the capabilities of the consumer; any information which the financial consumer education body has provided to the FCA; and any information the FOS has provided to the FCA under its duty to provide information that it considers would or might be of assistance to the FCA in advancing one or more of its operational objectives—Financial Services Bill 2011 s.1C.

44 Integrity of the financial systems includes its soundness and stability; it not being used for purposes connected to financial crime; it not being affected by market abuse; its orderly operation; and the transparency of the price-information process in those markets—Financial Services Bill 2011 s.1D.

45 The "UK Financial System" is defined as the financial system operating in the United Kingdom including: financial markets and exchanges; regulated activities; and other activities connected with financial markets and exchanges—Financial Services Bill 2011 s.1I.

46 The competition objective applies to the markets for regulated financial services; and the markets for services provided by recognised investment exchanges where they carry on regulated activities that are exempt from the general prohibition. As regards competition, the matters to which the FCA is expected to have regard include: the needs of different consumers including their need for information which enables them to make informed choices; the ease with which consumers can change their supplier of services; the ease of entry to the market for new participants; and the extent to which competition encourages innovation—Financial Services Bill 2011 s.1E.

47 Financial Services Bill 2011 s.3B.

48 The Draft Financial Services and Markets Act 2000 (Threshold Conditions) Order 2013 contains the full text of the proposed threshold conditions and should be referred to for the full text.

49 At the time of writing, the FCA is due to consult on how the business model threshold will be applied.

50 FCA-only regulated firms will of course make use of the FCA process.

51 CP12/26 Regulatory Reform: the PRA and FCA regimes for approved persons.

52 Journey to the FCA, p.25.

53 The FCA's threshold conditions will include a "Business Model" threshold condition.

54 See "pre-emptive action" at para.2.5.1 below. The FCA has stated that it does not presently envisage introducing a product pre-approval process. Such a scheme would require a significant increase in regulatory resource and runs the risk that consumers assume that all products had been endorsed by the regulator and were therefore "safe".

55 "It is likely we will go further than the FSA has previously done in challenging providers on the value for money of their products and checking that charging structures can still deliver good outcomes for customers", p.13, Journey to the FCA.

56 Financial Promotion Rules: Directions given by FCA—s.137Q of the Financial Services Bill 2011.

57 The FSA focus on accuracy of product literature can be seen in the action taken against Santander UK Plc (Final Notice February 16, 2012), where the firm was fined £1.5 million (after discount) for failing to clarify FSCS cover on two of its structured products.

58 Sections 137C–137D and 137L (General exemptions to consultation), Financial Services Bill 2011.

59 See *http://www.fsa.gov.uk/static/pubs/other/draft-statement-policy-temporary-pi-rules.pdf* [Accessed December 12, 2012].

60 Launch of the "Journey to the FCA", speech by Martin Wheatley, October 16, 2012.

61 Firms will need to be conscious that the context in which the FCA will be making decisions on the use of its powers is that of an organisation in which its predecessor board (the FSA board) decided that "it would have zero tolerance of absolute loss in excess of £250 million and that smaller but still significant total losses should not occur more frequently than once every five years" (Journey to the FCA, p.43). The FCA believes that these figures are too high and that it will expect to act in relation to issues very early if it thinks an issue has the potential to grow and cause harm. It recognises that it will need to gather data and identify risks that are quite small and gives an example of where 10,000 customers have lost £300 each. This indicates that the FCA will have a low risk threshold. This may also have significant impact for firms given the FCA's statement that:

"In practice, we will be more concerned about consumers—especially more vulnerable consumers who might lose money or become further indebted than about firms being able to continue in business (where the FSCS provides a safety net) except when the integrity of the market is threatened or the firm represents a prudential risk" (Journey to the FCA, p.44).

62 Journey to the FCA, p.33.

63 Internal Capital Adequacy Assessment Process.

64 Journey to the FCA, p.37.

65 In summary, a Warning Notice is issued to give notice of intended action and of the subject's right to make representations in response to the intended action; a Decision Notice sets out the decision reached by the regulator following any representations—it also gives notice to the subject of his/her right to refer the matter to the independent Tribunal; a Final Notice is issued to the subject if he/she fails to refer the matter to the Tribunal within the specified period.

66 The Bank of England, Prudential Regulation Authority: The PRA's approach to banking supervision October 2012; The Bank of England, Prudential Regulation Authority: The PRA's approach to insurance supervision October 2012.

67 For insurers, Category 1 will be those whose size (including number of policyholders) and type of business means that there is very significant capacity to cause disruption to the interests of a substantial number of policyholders.

68 The Bank and the FSA will consult prior to the PRA's establishment as prudential regulator on its policy and procedures regarding the exercise of disciplinary powers.

69 The Wheatley Review, issued in September 2012.

70 The detail of the activities which are to be regulated under FSMA, and the investments, activities and benchmarks to which the new criminal offences apply are all to be set out in secondary legislation. The government proposes in its November 2012 consultation document to bring LIBOR within the scope of regulation and to specify LIBOR as the relevant benchmark to which the new criminal offence will apply. The amendments to the Financial Services Bill will also make it possible for the government to act quickly to bring additional benchmarks within the scope of regulation, and to extend the list of benchmarks for which the new criminal offence apply, should this prove necessary (HM Treasury "Implementing the Wheatley Review", November 2012, p.4).

71 HM Treasury Press Release October 17, 2012.

72 Final Notice March 13, 2012.

73 Liberty agreed to acquire Unitymedia GmbH ("Unitymedia"). Liberty appointed Credit Suisse as lead book runner for the potential bond issue, the proceeds of which were likely to be used in part to finance Liberty's acquisition of Unitymedia, and in part to refinance outstanding listed Unitymedia bonds in a complex transaction. Although the bond was initially to be issued by a different subsidiary of Liberty it was referenced on the assets of Unitymedia, to be pushed down to Unitymedia upon issuance and publicly marketed as a Unitymedia bond.

74 As would be required under the definition of "inside information" in s.118C of FSMA 2000.

75 Unitymedia floating rate notes.

76 Unitymedia credit default swaps.

77 Mr Kyprios also contacted a second fund manager (who had not been wall crossed) and disclosed information about the potential issuer, using hints and word play. The second fund manager is not described in the Final Notice as being a potential investor.

78 Decision Notice February 27, 2012.

79 J P Morgan Cazenove Ltd.

80 FSMA s.118(3) includes disclosing inside information to another person otherwise than in the proper course of the exercise of his/her employment, profession or duties as a behaviour that constitutes market abuse.

81 FSMA s.123(2) defence to the FSA imposing a fine for market abuse.

82 *Stefan Chaligné, Patrick Sejean, Cheickh Tidiane Diallo v The FSA* (Upper Tribunal FS/2011/0001, FS/2011/0002, FS/2011/0003, September 28, 2012).

83 The FSA fined Mr Chaligné £900,000, required him to disgorge his financial benefit of £266,924, and prohibited him from working in financial services. Mr Sejean was also given a full prohibition, and the FSA imposed a financial penalty of £550,000. Mr Diallo was given a full prohibition, and would have been fined £100,000, but for his financial hardship.

84 Mr Sejean has made a serious financial hardship application which could result in the amount he has to pay being reduced.

85 Ali Mustafa, Pardip Saini and Paresh Shah were sentenced to three years and six months, Neten Shah was sentenced to 18 months, Bijal Shah and Truptesh Patel were both sentenced to two years.

86 Final Notice March 23, 2012.

87 Final Notice May 4, 2012.

88 Countries that do not have AML requirements equivalent to those in the United Kingdom and/or carry a higher risk of money laundering.

89 Both Kenya and Pakistan are considered to be higher risk jurisdictions.

90 Syed Itrat Hussain Final Notice May 4, 2012.

91 Final Notice July 26, 2012.

92 Banks' Management of High Money Laundering Risk Situations, FSA June 2011 (para.151).

93 Banks' Management of High Money Laundering Risk Situations, FSA June 2011 (para.7).

94 Final Notice, September 11, 2012.

95 See Pt.XVII of FSMA and COLL.

96 Consultation Paper 12/19 (Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes).

97 Final Notice February 13, 2012. The sole partner and adviser at the firm, Martin Rigney was fined £117,330 and given a full prohibition.

98 Final Notice Anthony Adams February 21, 2012, Final Notice Richard Rhys July 27, 2012.

99 Final Notice November 13, 2012.

100 Final Notice March 9, 2012.

101 Final Notice September 12, 2012.

102 FSA press release September 12, 2012.

103 UBS AG was fined £8 million (after discount for early settlement) for failures in its systems and controls in its London branch of the wealth-management business (Final Notice, August 5, 2009).

104 *John Pottage v FSA* (Upper Tribunal, FS/2010/33, April 20, 2012).

105 Martin Currie Investment Management Ltd and Martin Currie Inc were fined £3.5 million (reduced from £5 million for early settlement), Final Notice, May 3, 2012.

106 Mitsui Sumitomo Insurance Company (Europe) Ltd ("Mitsui") was fined £3,345,000 (reduced from £4,780,000 for early settlement), Final Notice, May 8, 2012. Mitsui's Executive Chairman, Yohichi Kumagai (CF1 and CF3) was fined £119,303 (reduced from £170,433 for early settlement) and prohibited from holding a SIF function.

107 FSA Press Release—June 29, 2012.

Issue 103—The client asset regime

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COMPLIANCE OFFICER BULLETIN

The regulatory environment in which financial institutions operate has been one of constant change and evolution in recent years, not only as a result of the FSA's own regulatory initiatives, such as the move to more principles-based regulation, but also as a direct consequence of the need to implement European directives within the United Kingdom, and domestic and international responses to the credit crisis.

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