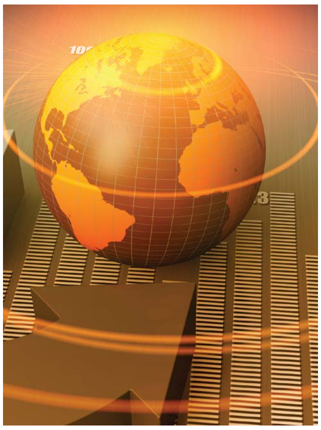
FINANCIAL REGULATORY UPDATE

# In Principle

## 10 THINGS YOU NEED TO KNOW FOR 2017
## THE WORLD OF FINANCIAL REGULATION AFTER THE UK REFERENDUM





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# IN PRINCIPLE: 10 THINGS YOU NEED TO KNOW FOR 2017 – THE WORLD OF FINANCIAL REGULATION AFTER THE UK REFERENDUM

On 23 June 2016, the UK shocked the world, and perhaps itself, when it voted in favour of a "Brexit" from the European Union. While the referendum result has brought significant uncertainty to the financial services sector, the Financial Conduct Authority (FCA) has made it clear that, from a regulatory perspective, it is "business as usual". Indeed, it is clear that firms cannot afford to stand still in the wake of the referendum result, since financial regulation has, as always, continued to evolve.

In this publication, we focus on 10 key issues that authorised firms should be aware of going into 2017:

- Brexit – key challenges ahead for financial services firms
- FCA Mission Statement – a new mission for the FCA?
- MiFID II – a whistle-stop tour for investment managers
- Extension of the Senior Managers and Certification Regime
- Market Abuse Regulation – market sounding guidance for buy-side firms
- Mandatory clearing obligations under EMIR
- AIFMD – ESMA advice on non-EU AIFM passports and proposed changes to Annex IV reporting requirements
- Increased regulatory scrutiny of the asset management industry
- Regulation of distributed ledger technology-enabled financial services
- Key takeaways from enforcement matters involving the FCA in 2016.

We begin by assessing the immediate challenges in the regulatory environment that Brexit would bring for financial services firms. We also examine the key themes in the FCA's new mission statement, which we expect will form the foundation of the regulator's 2017-2018 Business Plan.

We consider the key issues and upcoming developments that investment managers should be aware of as they go into a new year of business in 2017. In particular, we review the key issues for investment managers flowing from the implementation of the second Markets in Financial Instruments Directive (MiFID II), the extension of the Senior Managers and Certification Regime (SMCR) to all firms within the FCA's regulatory perimeter, new European Securities and Markets Authority (ESMA) guidance for information recipients in market soundings, mandatory clearing requirements under the European Market Infrastructure Regulation (EMIR), ESMA advice on the extension of passporting arrangements to third country Alternative Investment Fund Managers (AIFMs) under the Alternative Investment Fund Managers Directive (AIFMD) and proposed changes to the Annex IV reporting requirements for non-EU AIFMs.

Further, we examine changes in the regulatory environment for asset managers, including the package of reforms proposed in the interim report to the FCA's asset management market study. We also consider the prevailing regulatory thinking around the application of distributed ledger technology (DLT) in the financial services sector.

In addition, we reflect on the key takeaways from enforcement matters involving the FCA in 2016. Firms should be aware that the FCA appears to be placing increased focus on early intervention action, and we would expect this to continue in 2017. Further, it is clear from the cases brought by the FCA over 2016 that the regulator is continuing to punish firms for failings in relation to firm culture, market integrity, financial crime, and inadequate systems and controls. Although the FCA had brought very few cases against senior managers in 2016, we would expect this to change over the next few years since the regulator will no doubt begin to take action under the SMCR against banking firms (and eventually, non-banking firms).

All in all, although the financial sector has (understandably) been preoccupied with the potential ramifications of Brexit in the past year, firms must not lose sight of the myriad of regulatory change that is taking place in areas of EU financial regulation.

Firms are strongly encouraged to ensure that they are well-positioned to manage changes in the regulatory environment and to ensure that they are meeting regulatory expectations. The consequences of doing otherwise could be severe.

# Brexit – Key Challenges Ahead For Financial Services Firms

It is impossible to say with any certainty what the actual outcome and impact of Brexit will be, as nobody yet knows what the UK's future relationship with the EU will look like. We have highlighted issues that we expect to have impact on firms sooner rather than later. Firms are encouraged to closely monitor developments in this area and to seek advice on how their particular business may be impacted by the UK's departure from the EU.

## Passporting

Currently, UK-regulated firms can provide financial services across Europe through "passporting" arrangements. For example, MiFID provides a regime under which UK firms can provide investment services into the EU on a cross-border basis or through a branch without obtaining separate authorisation in each Member State in which they wish to do business. Similarly, under the Alternative Investment Fund Managers Directive (AIFMD), UK alternative investment fund managers can market EU-domiciled funds to professional investors across the EU without having to obtain approval in each Member State in which the fund is marketed.

Nearly 5,500 financial services firms passport their services out of the UK across the EU, while more than 8,000 firms passport their services from the EU into the UK.[1] Within the banking sector, it is reported that 91 UK-incorporated banks (representing more than 95% of UK banks by assets and staff) rely on the existing passporting arrangements, while London's investment banks use passporting for more than 20% of their total UK activities.[2] According to Robert Rooney, chief executive of Morgan Stanley International, the loss of single market access would raise serious concerns as it could "result in higher costs, lower liquidity, more trapped capital and less efficient capital markets".[3]

Although a hard Brexit with the loss of single market access would bring a high degree of uncertainty for UK firms that currently rely on their EU passports to provide financial services in Europe on a cross-border basis, firms need to be aware that it may not necessarily mean they must relocate to, or otherwise establish a subsidiary in, a remaining Member State in order to continue providing financial services across the EU.

1 Letter from Financial Conduct Authority to the Chairman of the Treasury Committee dated 17 August 2016.
2 *"Regulators reveal UK's close links with EU finance system"*, Laura Noonan, Patrick Jenkins and Harriet Agnew, *Financial Times*, 26 September 2016.
3 See footnote 2 and Theresa May's opening speech to the Conservative Party conference, 2 October 2016.

Both the MiFID II and AIFMD regimes contemplate the possibility of extending passports to third-country firms (which will include UK firms once the UK is no longer a part of the EU) in certain circumstances. Under the MiFID II regime, where the European Commission has determined that the legal and supervisory arrangements of a third country have "equivalent effect" to the requirements of MiFID II, third country firms from that jurisdiction are able to register with ESMA to provide investment services and perform investment activities throughout the EU. Similarly, the AIFMD contains a mechanism that enables the European Commission to extend the AIFMD passport to non-EU managers if ESMA advises that there are no significant obstacles regarding investor protection, market disruption, competition or the monitoring of systemic risk impeding the extension of the AIFMD passport to the relevant third country (we discuss this in more detail in a separate article).

Although nothing in this process is certain, it is worth noting that, at the point of departure from the EU, the law in the UK will not only have equivalent effect to that in the EU, but will in fact be **exactly the same**. As such, it is difficult to conceive a scenario in which the EU could justify that regulatory equivalence does not exist. However, much will depend on the appetite of the EU to ensure that the UK can maintain its financial services base.

## Costs

Brexit is estimated to add between £14 billion - £20 billion in regulatory costs for firms over 10 years.[4] Although the FCA has said that firms need to continue with their implementation plans for European legislation that has not yet come into effect (e.g., MiFID II), it is likely that at least some implementation costs borne by UK firms will be duplicated, as firms will need to try to anticipate the impact of Brexit on the application of new legislation in addition to navigating through the legislation itself.[5]

## UK regulatory influence

Post-Brexit, it is likely that the UK's influence on financial regulation at the European level will diminish. The FCA has tacitly acknowledged this, noting recently in its Board meeting that it is making international engagement with a view to influencing global standards a priority.[6] The UK regulators have historically been leaders in the drafting of financial services regulation, and it remains to be seen how the European authorities will approach this in the absence of a strong UK voice.

## What does this mean for UK-regulated firms?

The Prime Minister has said that she will trigger Article 50 (the clause needed to start the Brexit process) by the end of March 2017, which means the UK may leave the EU by mid-2019. However, the High Court's decision in R *(Gina Miller and Deir Tozetti Dos Santos) v The Secretary of State for*

4 *"Brexit: changing out of the engine of finance – the technical and leadership challenges ahead"*, JWG, 11 May 2016.
5 *"Brexit will add another layer to MiFID II implementation burden and costs"*; Rachel Wolcott, *Regulatory Intelligence*, 7 September 2016.
6 The FCA appears to be alive to the possibility that it may not be able to take international engagement for granted post-Brexit. For example, in July 2016, the regulator noted at board level that consideration should be given to the FCA bolstering its international engagement activity with a view to influencing global standards more intensively (FCA Board Minutes, 27 and 28 July 2016).

## EU/UK Financial Services Regulatory Practice

Akin Gump's EU/UK Financial Regulatory Practice – which forms part of the Firm's wider Global Financial Regulatory Group – advises its clients (which include institutional and alternative investment managers, retail and investment banks, brokerages and senior individuals) on all aspects of the UK and EU financial services regulatory framework. The Practice has taken a leading role in advising the global financial services industry on regulatory actions, the impact of EU legislation and on commercial and securities issues that affect it. The Practice is particularly well known for its work acting for financial institutions and senior individuals who find themselves subject to investigation by regulators and exchanges.

*Exiting the European Union*[7] casts uncertainty about the timing of Brexit[8] and, at the time of writing, the Government has provided little clarity around the type of post-Brexit relationship that the UK is seeking with the EU.

Regardless of the form of post-Brexit relationship the UK will have with the EU, we believe it is likely that UK financial institutions will find a way to maintain a relationship with Europe. For now, UK firms should consider how much reliance their business places on passporting. They should also consider how alternative scenarios resulting from Brexit (particularly in the context of passporting) should feed into their contingency planning and risk management, and closely monitor the Government's negotiations with Europe.


# FCA Mission Statement - A New Mission for the FCA?

On 26 October 2016, the FCA published a Mission Statement entitled *Our Future Mission*. The Mission Statement is described by Chief Executive Andrew Bailey as a "flagship" piece and is his first major initiative since taking on his current role in June 2016.

Firms should be aware of the key themes coming out of the Mission Statement, as it is anticipated that the FCA will use the Mission Statement as guidance in its next Business Plan. Through the Mission Statement, the FCA is seeking to "start a discussion to decide how we can make the biggest difference in making markets work well, now and in the future". The aim of the publication is to "establish a set of guiding principles" that explain how the FCA pursues its strategic and operational objectives and decides on its priorities and the tools used to deliver them.

The FCA has sought comments on the Mission Statement by 26 January 2017.

## The Mission Statement – Main Points

### Ensuring markets function well

The FCA plans to ensure that it applies a combination of forward-looking judgement in Supervision and backward-looking judgement in Enforcement, where rules have been breached. When failures occur, they are orderly and should not undermine the FCA's statutory objectives.

### What the FCA regulates

The FCA observes that many of the problems in the market from 2008 onward have been caused by regulated firms acting outside the regulatory perimeter (e.g., FX, LIBOR). The FCA has the power to intervene in these activities, but will prioritise intervention outside the perimeter when it believes its objectives are threatened (i.e., where the unregulated activity is illegal or fraudulent or has the potential to undermine confidence in the UK financial system; calls into question the suitability of a firm; or is closely linked to, or may affect, a regulated activity).

7 [2016] EWHC 2768.
8 The Government's appeal of the High Court's decision was heard in December 2016. At the time of writing, the Supreme Court's decision was not yet available.

## Financial conduct regulation and other areas of public policy

The FCA notes that some factors may impact consumers but lie outside its regulatory remit. It will establish where it should use financial conduct regulation to address these issues and where it should leave matters to be resolved by public policy making.

## Protecting consumers

The FCA is focussed on "ensuring the appropriate degree of protection for consumers". What is appropriate protection will depend on both the capability of the consumer and the complexity of the product or service.

## Consumer redress

The FCA believes it has a role (with the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS)) to ensure that consumers can receive redress through cheaper and quicker routes than through the courts. In deciding whether redress should be effected, it will consider:

- how quickly and urgently the redress is needed
- the amount of consumers affected
- if the activity that led to the harm occurs inside or outside the regulatory perimeters.

## Vulnerable customers

The FCA intends to give some consumer groups in some markets higher levels of protection than others.

## Defining harm

In assessing harm, the FCA will consider the impact it has, either in terms of the numbers affected or the severity of the harm likely to be caused. The FCA will look at the cause of the harm, as well as its impact, and will use its intervention framework to decide the most proportionate and effective use of tools to tackle it. This could range from direct action with one firm to a market-wide approach.

## Transparency and disclosure

The FCA believes it can play a greater role in helping consumers access the right services for their needs by influencing how they make decisions. This can include changing the way firms present choices to consumers. The FCA will consider restrictions on a market where it feels that behavioural "nudges" and other ways of presenting consumers with information are not working, but it has said that it will use some measures cautiously, as it does not wish to limit choices for consumers or innovation in the market.

## Intervention to stop potential harm

In deciding whether to intervene, the FCA will consider:

- whether solving the problem would help meets its objectives
- whether using the powers would address the problem effectively or whether intervention by another authority would be more effective
- whether the activity in which the FCA is intervening has a broader social benefit and how that may affect that provision
- what degree of consumer protection and responsibility is appropriate in that market.

It will seek to be more transparent about the interventions it makes and decides not to make.

## Market design

Part of the FCA's standard setting involves influencing the conditions for competition to work well. It uses market studies and can also use its powers under the Competition Act to take action for breaches of competition law.

## Supervising firms

The FCA emphasises that, while it sets the standards by which financial services firms operate, it is not a substitute for firm governance. Firms, particularly through the Senior Managers and Certification Regime, are expected to develop a culture of responsibility to identify harm developing from behaviour and take steps to address this risk. When firms do fail, the FCA intends to ensure that the firms exit the market in an orderly way and that disruption and harm to consumers is minimised.

## Enforcement

The FCA continues to approach enforcement focusing on deterrence, but it also has the aim of underlining the value of the rule that may have been breached and building market and public confidence that wrongdoing will be identified and dealt with. In cases where a formal investigation and public sanction does not emerge despite a rule breach, the FCA has indicated that it will work with firms to agree lessons learned and ways forward. It intends to review its use of private warnings.

## Measuring what the FCA does

The FCA will assess its performance by:

- measuring operational efficiency using a value for money framework
- measuring the impact of policy interventions
- measuring the outcomes in markets as a whole.

## Conclusion

Although this is no doubt a well-intentioned document, it is questionable how much real impact it makes for those operating in the market or for consumers, or indeed for the regulator itself. Most of the material set out in the Mission Statement has been said in one way or another in previous FCA publications or FCA guidance. It is curious that the FCA, having operated since 2013, feels it must now articulate its mission.


# MIFID II - A Whistle-Stop Tour for Investment Managers

## Introduction

The second Markets in Financial Instruments Directive (MiFID II) was originally due to come into effect in January 2017. However, in late 2015, the European Commission recognised that neither European nor national regulators would be ready to implement MiFID II within that time scale and that industry would be equally unready to comply. Accordingly, amending legislation was proposed and, in June 2016, passed, which had the effect of postponing the implementation date to January 2018.

Although many in the industry are cynical as to whether even the revised timetable will be met, the European Commission has reiterated that there will be no further delays. Furthermore, in the immediate aftermath of the UK's referendum on its membership of the EU, the UK regulators confirmed that regulated firms should "continue with implementation plans for legislation that is still to come into effect".[9] Notwithstanding the continuing uncertainty as to the UK's future relationship with the EU, there are good policy reasons for the UK regulators to take this stance and for the UK to press ahead with implementation of MiFID II.

Firstly, the UK was one of the principal policy drivers behind MiFID II. The vast majority of the changes provided for in the new legislation implement the UK regulators' own policy objectives.

Secondly, and most intriguingly, one of the reforms introduced by MiFID II is the "third-country passport". In short, this introduces a mechanism that would allow the European Commission to grant a cross-border passport to provide financial services into EU member states to firms regulated by a jurisdiction that is deemed to have a regulatory environment that is "equivalent" to MiFID II. If the UK has fully implemented MiFID II, it will – in its negotiations with the EU on the terms of its exit – be able to argue that its regulatory environment is not just equivalent to MiFID II, but **exactly the same**. Although the equivalence determination is a political decision entirely in the hands of the European Commission, this will be a difficult argument to resist (assuming a modicum of political goodwill).

It therefore appears more than likely that MiFID II will be implemented in full and on time in the UK. Although not as radical as some regulatory changes that have been seen in the aftermath of the financial crisis, MiFID II will have a significant impact on investment managers (including those authorised under the AIFMD), investment advisers, wealth managers and brokers; banks and other credit institutions when providing investment services and/or performing investment activities; operators of trading venues, including any pure market operator; financial counterparties (and certain non-financial counterparties) subject to EMIR; Central Counterparties (CCPs) and persons with proprietary rights to benchmarks; and non-EU firms who wish to provide investment services or activities in any EU member state.

The delay in implementation has given such firms breathing space, but, if they have not already, they should immediately implement a project to assess the impact of MiFID II on their business model and to plan accordingly.

## Structure and objectives of MiFID II

MiFID II consists of a revised Directive and the accompanying Markets in Financial Instruments and Amending Regulation (MiFIR), which is here referred to, together with the revised Directive, as MiFID II without further distinction), both of which are legislative measures of the European Commission and the European Parliament. MiFID II is a material departure and development of the legislative framework introduced by MiFID.

Key policy objectives of MiFID II include increased investor protection; improved efficiency of financial markets through greater transparency of trading information; enhancement of supervisory powers, both at a national and an EU-wide level; protection of the integrity of the EU financial markets through identifying, monitoring, and restricting abusive or potentially harmful practices; and the harmonisation of the rules governing access to the EU markets by third country firms.

In broad terms, the revised MiFID II Directive contains the rules that govern the operation of investment firms and operators of trading venues and other trading-related market infrastructures, which rules will be separately implemented into national legislation. By contrast, MiFIR will be directly applicable across the EU, and the regulatory requirements set out therein in respect of the trading of financial instruments are maximum harmonisation measures as there will be no national divergence in the implementation of those rules.

Lack of space prevents us from detailing all of the changes introduced by MiFID II; however, we set out below a summary of the five headline issues that are of most immediate concern to investment managers.

9 FCA statement on European Union referendum result, 24 June 2016, https://www.fca.org.uk/news/statements/statement-european-union-referendum-result.

## Use of dealing commissions to pay for research

MiFID II extends the rules applicable to investment firms on incentives. While firms under the existing MiFID rules are not permitted to accept inducements, (i.e. "fees, commissions or any monetary or non-monetary benefits paid or provided by any third party") other than in limited circumstances, original, meaningful research is currently considered to be a permissible benefit as it falls within the limited circumstances permitted. MiFID II will effectively prohibit investment firms from receiving investment research from brokers pursuant to bundled commission arrangements, which is currently market practice. Investment managers may continue to receive research, provided that such research is paid for, either from the resources of the manager itself or from a "research payment account" that is separately funded by the manager's clients. Where a firm decides to operate a research payment account, it is required to "regularly assess the quality of the research purchased based on robust quality criteria".

The key objective and effect is to sever any link between execution volumes and research spend. The FCA has confirmed that these dealing commission rules will be applied to UK managers authorised under the AIFMD. Managers should therefore be considering how they will fund and operate the research payment account and, in particular, what mechanisms they will put in place to assess and attribute a value to the research that they consume.

## Best execution

MiFID II aims at enhancing the best execution regime by requiring greater transparency of execution quality of different execution venues. Execution venues will be required to publish their execution quality data annually based on factors including price offered, execution costs, and speed and likelihood of execution.

The aim is that investment managers will use the data provided by the execution venues to select the venues they use going forward. Investment managers, in turn, will be required to publish their top five execution venues per asset class in terms of volume, as well as information on the execution quality obtained. This is ultimately intended to be a mechanism to allow investors to compare best execution between investment managers, as well as between execution venues.

Additionally, MiFID II will introduce a higher best execution standard by requiring firms to take "sufficient steps" to achieve best execution (rather than "reasonable steps", as is currently required).

The FCA has confirmed that the requirement to publish the top five execution venues per asset class will be applied to UK managers authorised under the AIFMD. However, the new best execution standard will only apply to UK managers authorised under the AIFMD to the extent that those managers have an extended authorisation to provide MiFID services and when providing those MiFID services.

## Regulatory reporting and recording requirements

The MiFID transaction reporting regime, aimed at providing information to regulators to assist in the monitoring and investigation of market abuse, will be considerably broader under MiFID II. The scope of transaction reporting is extended to all financial instruments traded on an EU trading venue, as well as derivatives where the underlying is such an instrument.

This represents a material expansion of scope, both in terms of the instruments covered, and the scope of information to be reported. The number of data items to be completed has increased from the original 23 to more than 60, and includes short sale flags and the identification of the individual trader or the algorithm responsible for the decision to trade and the execution of the trade.

While delegation of transaction reporting will still in theory be permitted, in practice, the buy-side is reluctant to provide much of the granular information required by the new reporting fields to their brokers (which would be necessary if the broker were to report on their behalf), and there is little appetite amongst sell-side firms to accept formal responsibility for transaction reporting on behalf of their investment management clients; therefore, it is expected that, for the vast majority of investment managers, the preferred solution will be to undertake the transaction reporting in-house.

The FCA has provided some welcome relief from this obligation for managers authorised pursuant to AIFMD and indicated that they will not apply the transaction reporting rules to those managers. However, those investment managers who are authorised pursuant to MiFID (for example, the UK sub-advisors and managers of global investment houses) will have to comply.

## Trade reporting

Under MiFID II, investment firms will be required to make public trade reports regarding a much broader scope of financial instruments and transactions than under the existing requirements. Currently, an investment firm must report Over-the-counter (OTC) trades in shares that have been admitted to trading on a regulated market or a Multilateral Trading Facility (MTF). Under MiFID II, the post-trade public reporting requirements will be significantly extended and such reportable instruments will include not only shares but a wide range of “equity-like instruments”, such as depositary receipts, exchange-traded funds and certificates; and, significantly, bonds, derivatives and certain other categories of instruments that are traded on a trading venue.

As the extended scope of the trade reports will also apply to the pre-and post-trade reporting requirements to which trading venues are subject, there should be considerably more market data available regarding a much expanded body of financial instruments. MiFID II preserves exemptions for the publishing and reporting of illiquid shares, large orders and transactions; overall, the transparency regime is expected to be calibrated to the instrument and the trading venue.

## Telephone recording

MiFID II introduces a requirement to record telephone conversations and electronic communications relating to the reception, transmission and execution of client orders and any order on own account. The UK (along with some other EU member states) already mandates the recording of telephone calls that actually result in a client transaction. While in the UK the existing recording obligation is subject to an exemption allowing investment managers to rely on EU brokers to record the calls, MiFID II contains no such exemption. In addition, the retention period for such records will be extended from six months under the existing FCA rules to five years under MiFID II.

## Investor protection

A central policy objective for MiFID II was the enhancement of the investor protection afforded under it. With a view to ensuring the same, MiFID II introduces more robust controls on firms with respect to designing and distributing products, and expands the supervisory powers of the national competent regulatory authorities under ESMA’s guidance. Regulators will have powers to intervene in the process of product development, as well as powers to require the suspension or withdrawal of products or marketing materials where there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial or commodity markets or stability of the whole or part of the financial system, and provided that certain other conditions are satisfied.

In addition, while currently under MiFID business dealings with eligible counterparties are effectively outside the scope of the investor protection requirements, MiFID II extends some existing investor protection requirements currently applicable to dealings with retail and professional clients to eligible counterparties.

MiFID firms will be expressly required, when dealing with eligible counterparties, to act honestly, fairly and professionally; to communicate in a way that is fair, clear and not misleading; and to provide certain information and reports to eligible counterparties.

The actual impact of this on existing market practices is unclear, and, to date, there has not been any guidance or further clarification as to the meaning of acting honestly, fairly and professionally, or communicating in a manner that is fair, clear and not misleading in relation to eligible counterparty business.

# Extension of the Senior Managers and Certification Regime

In 2017, non-bank financial services firms will need to devote significant time and resources to understand and plan for the extension of the SMCR which will be rolled out to all firms authorised under the Financial Services and Markets Act 2000 (FSMA) by 2018. The SMCR came into force for banks, insurers and Prudential Regulation Authority (PRA) designated firms on 7 March 2016.

In this article, we provide an overview of the extended SMCR and consider the FCA's feedback on the banking sector's implementation of the regime, which will be instructive for non-bank firms planning ahead.

## The extended SMCR

At the time of writing, details around the proposed form of the extended SMCR have not been announced. However, the high-level framework of the extended regime is expected to reflect the framework currently in place for the banking sector. In particular:

1. Compared with the existing Approved Persons Regime (APR), there will be a reduction of individuals who are subject to regulatory pre-approval as senior managers. Certain responsibilities prescribed by the FCA will be allocated to senior managers, and each senior manager's responsibilities will need to be set out in a "Statement of Responsibilities", which will accompany the senior manager's approval application. The FCA is also expected to more closely scrutinise the allocation of key responsibilities within firms.

2. Senior managers are subject to a statutory duty of responsibility to take reasonable steps to prevent regulatory breaches in their areas of responsibility.

3. Firms will need to maintain a "responsibilities map" showing the individuals responsible for key responsibilities within the firm and the lines of accountability.

4. Most current approved persons who fall below senior management level are expected to become certified persons and will not require regulatory pre-approval. Additionally, some roles that do not require regulatory pre-approval under the APR, but which involve responsibilities that are capable of causing significant harm to customers or the firm, will also become certified persons.

5. Firms will be responsible for assessing and certifying the fitness and propriety of certified persons, both at the time of recruitment and at least annually thereafter.

6. All employees, except for ancillary staff, will be subject to new conduct rules.

The FCA has expressly acknowledged the diversity of firms that will be caught by the extended regime and that it will need to consider how to apply the new regime proportionately and effectively. While for now, firms must wait to see the specifics of the extended regime, it is helpful that the regulator has acknowledged that it is "conscious of the need to implement a cohesive yet flexible and proportionate regime across all FSMA firms".[10]

## Lessons from the banking sector's implementation of SMCR

The implementation of the SMCR by banking firms suggests that the transition into the new regime may not be straightforward. Nine months after the commencement of the SMCR, the regulator is still consulting on certain aspects of the SMCR in order to strengthen the regime and has not yet finalised rules on these matters. An example of this is the regulator's discussion paper on *Overall responsibility and legal function* (DP16/4), which considers whether the SMCR should capture the management of the legal function.[11]

Having conducted a review of Statements of Responsibilities and responsibilities maps, the FCA also identified a number of issues in the implementation of the regime. These included:

- evidence of "overlapping or unclear allocation of responsibilities"[12]
- responsibility appeared to be shared amongst more junior staff and the individuals who were genuinely responsible were obscured[13]
- responsibilities maps submitted by firms that omitted certain required information
- insufficient information on some firms' governance arrangements, particularly where the firm was part of a larger group.[14]

Given the amount of resources that banks have put into the implementation of the SMCR, it is concerning that the FCA still found certain firms' efforts did not meet their expectations.

The FCA has provided more detailed feedback in *Feedback Statement FS16/6: Senior Managers and Certification Regime: Feedback for all UK banks, investment firms and building societies* ("Feedback Statement"). It is also providing tailored feedback to certain firms and warned that it will keep "a watchful eye" on firms' progress.[15] It is likely that the FCA will apply a similarly interventionist approach to non-bank firms once the extended SMCR is effective. Moreover, non-bank firms will be expected to have reflected on the messages articulated in the Feedback Statement when implementing the extended regime.

Putting the regulator's sentiments to one side, how else will the extension of the SMCR impact non-bank firms? Are there potential unintended consequences that non-bank financial institutions may be exposed to? The experiences of the banking sector following the implementation of the SMCR suggests that the answer may be "yes". Informal feedback suggests that although compliance teams within banks have observed increased interest and engagement by staff with their regulatory responsibilities, there are signs that individuals have become more concerned about their personal positions and are more likely to seek independent legal advice with regards to their personal exposure when the firm they work at is faced with a regulatory issue.[16] It also appears that the new accountability regime has made it harder to recruit for senior roles in UK banks as senior individuals seek to step outside this framework. While there has not yet been any enforcement action against senior managers under the new regime, the FCA has said that investigations could start as early as 2017.[17] It will be interesting to see how non-banks react to the new system and in particular what steps the regulator will take to ensure that the framework can be applied to the diversity of models for non-banks; it can only be hoped that its quest for senior accountability does not have the effect of reducing the number of qualified senior managers who are willing to take on senior roles in financial services firms.

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10 Speech by FCA CEO Andrew Bailey delivered at the FCA's 2016 Annual Public Meeting, 20 July 2016.

11 In addition to DP16/4, in September 2016, the FCA also published a number of consultation papers relating to the enforcement of the duty of responsibility under the SMCR (CP 16/26), extending the conduct rules to all non-executive directors in banks and insurers (CP16/27) and a new requirement for UK branches of overseas banks to tell their UK based employees about the whistleblowing services offered by the FCA and the PRA (CP16/25).

12 *FCA Press Release*, "FCA proposes new measures to maintain firms' focus on culture", 28 September 2016.

13 See footnote 12.

14 *Feedback Statement FS16/6: Senior Managers and Certification Regime: Feedback for all UK banks, investment firms and building societies,* page 4.

15 See footnote 12.

16 "Six months on, Senior Managers Regime has increased interest in individual accountability, experts say", Michael Ruck and Elena, Out-Law.com, 5 September 2016.

17 Oral Evidence by FCA CEO Andrew Bailey before the Treasury Committee, 8 November 2016, Questions 103-105.

# Market Abuse Regulation – Market Sounding Guidance for Buy-side firms

The EU Market Abuse Regulation (MAR)[18] came into effect on 3 July 2016. While firms devoted significant resources to prepare for the commencement of MAR, engagement with the new market abuse regime must not stop there. ESMA has continued to publish important guidance for firms following the commencement of MAR. One such example is ESMA's guidelines for information recipients in market soundings ("Guidelines"), which set out the procedures that firms should have to ensure that information received in this context is dealt with appropriately.[19] Firms to whom the Guidelines apply should review the Guidelines against their internal processes to minimise their exposure to allegations of market abuse or failings in systems and controls.

## Market sounding framework under MAR

Market soundings allow market participants to gauge interest in a transaction from certain investors before the transaction is publicly announced. They must be carefully conducted to ensure they do not give rise to breaches of market abuse legislation.

Article 11 of MAR introduced a framework for disclosing inside information in the course of market soundings. Where market participants comply with certain requirements, they will be protected from allegations of improper disclosure of inside information. Before conducting a market sounding, a disclosing market participant (DMP) must consider whether inside information will be disclosed, and record its conclusions and reasons in writing. In addition, the DMP is required to comply with a strict procedure prescribed by MAR (which broadly includes an obligation to obtain consent from the market sounding recipient (MSR) to receive inside information, remind the MSR of the prohibition to use inside information to trade, ensure that the MSR keeps the information confidential and keep appropriate records).

Although the market sounding framework offers a safe harbour for DMPs, it provides little protection for buy-side firms. Further, Article 11(7) of MAR expressly requires MSRs to independently assess whether it is in possession of inside information.

18 Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC.

19 *MAR Guidelines,* "Persons receiving market soundings", ESMA/2016/1477, dated 20 October 2016.

## Guidelines for MSRs

In October 2016, ESMA published final Guidelines for MSRs in the context of market soundings. The Guidelines set out the internal procedures that should be implemented to limit the spread of inside information.[20]

In summary, MSRs should:

1. Designate a contact point to receive market soundings and make that information available to DMPs; in practice, this may mean designating a relationship manager or including the relevant information on the firm's website.

2. After being addressed by a DMP, notify the DMP if it does not wish to receive market soundings on particular types of transactions, or all potential transactions.

3. Independently assess whether the information received is inside information; in doing so, it should take into account the DMP's assessment as to whether inside information has been provided, and all information available to the individual or body within the MSR that is responsible for conducting that assessment, including information not obtained from the DMP.

4. If it determines that it is in possession of inside information, identify the issuers and financial instruments to which it believes the inside information relates.

5. Ensure that inside information received in the course of internal soundings is internally communicated through pre-determined channels and on a need-to-know basis only and that the flow of this information is appropriately managed.

6. Maintain a list of persons within the MSR who have access to the information communicated in the course of market soundings, listed in a chronological order for each market sounding.

7. For unrecorded soundings, sign the notes of the sounding provided by the DMP (if the content is agreed) or provide the DMP with a signed copy of its own notes within five business days after receiving the DMP's notes.

8. Keep records of all internal procedures or documents relating to the above for at least five years.

The internal procedures maintained by MSRs should be appropriate and proportionate to the scale, size and nature of their business activity. Further, MSRs must ensure that staff involved in receiving and processing information in the course of market soundings are properly trained on the firm's internal procedures and the relevant market abuse prohibitions.

Although buy-side firms do not have the benefit of protection under the MAR market sounding framework, the Guidelines should help firms to identify weaknesses in their own market abuse systems and controls.

## What firms should do now

Over the past year, the FCA has repeatedly emphasised the need for firms to have appropriate market abuse controls, going so far as to say that it places "as strong an emphasis on identifying weaknesses in regulated firms' controls as [it does] in pursuing market abuse".[21] Firms should take heed and consider whether ESMA's Guidelines necessitate changes to internal systems and controls that are designed to manage the flow of inside information.

Firms should also be aware that the FCA is continuing to articulate its expectations on firms' market abuse systems and controls. For example, in September 2016, the FCA published its findings from the *Market Maker Review*, which identified weaknesses in market abuse risk awareness, information barriers, wall-crossing procedures and insider lists, and ongoing monitoring and surveillance in the firms examined.[22] It is vital that firms monitor the FCA's

20 The Guidelines reflect the procedures set out in *ESMA Final Report*, "Guidelines on the Market Abuse Regulation – market soundings and delay of disclosure of inside information", ESMA/2016/1130, 13 July 2016.

21 *FCA Market Watch* No. 51, September 2016.

22 For example, following the completion of the FCA's *Market Maker Review* (in which the regulator reviewed the market abuse systems and controls of a sample of market makers) in September 2016, the FCA published its findings on the following areas: market abuse risk awareness, information barriers, wall-crossing procedures and insider lists, and on-going monitoring and surveillance.

messages in this area – the regulator has said that it is continuing to monitor the effectiveness of firms' market abuse systems and controls as part of its supervisory work[23] and will no doubt expect firms to have reflected on its guidance when assessing whether there are failings in a firm's systems and controls.

## Mandatory Clearing Obligations under EMIR

Long awaited, the mandatory clearing obligations set out in Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR) finally began to take effect in 2016.

Whilst EMIR is not directly applicable to non-EU funds (other than non-EU funds managed by an EU AIFM authorised pursuant to the AIFMD), EMIR still has an indirect impact on the non-EU funds with whom EU counterparties trade (since these EU counterparties must revise all of their trading relationships in order to comply with their own EMIR obligations).

Amongst various other EMIR requirements, EMIR mandates the central clearing (through an authorised EU Central Clearing Counterparty (CCP) or a recognised third country CCP) of certain classes of OTC[24] derivative contracts that are "entered into or novated" on or after a set date (the Clearing Obligation Effective Date). Currently, the only recognised third country CCPs are the CME (USA), JSCC (Japan) and OTC HK (Hong Kong).

Pursuant to Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015 ("the Delegated Regulation no. 1 on the clearing obligation"), Commission Delegated Regulation (EU) 2016/592 of 1 March 2016 ("the Delegated Regulation no. 2 on the clearing obligation") and Commission Delegated Regulation (EU) 2016/1178 of 10 June 2016 ("the Delegated Regulation no. 3 on the clearing obligation"), several classes of interest rate OTC derivatives denominated in EUR, GBP, JPY, NOK, PLN, SEK and USD and several classes of credit OTC derivatives denominated in EUR are now required to be centrally cleared with authorised EU CCPs or recognised third country CCPs.

When a particular counterparty has to start complying with the EMIR mandatory clearing requirements (i.e., the Clearing Obligation Effective Date) and whether that counterparty is subject to "front-loading obligations" (i.e., the requirement to centrally clear trades that had been entered into or novated before the Clearing Obligation Effective Date) depends on the particular "Category" of that counterparty and the particular Delegated Regulation.

For all Delegated Regulations so far, a fund, whether in the form of Undertakings for The Collective Investment of Transferable Securities (UCITS) or an Alternative Investment Fund (AIF) and whether incorporated within or outside the EU (assuming it is not a direct member of a CCP), would be considered as a "Category 2" or a "Category 3" entity (the criteria for these categories are consistent throughout the various Delegated Regulations (though they may differ in future Delegated Regulations)).

23 See footnote 21.
24 "OTC" for these purposes means any contract not concluded on an EU regulated market or an equivalent non-EU regulated market (under Art.19(4) MiFID). At present, there are no such equivalent non-EU regulated markets recognised by the European Commission.

- A "Category 2" fund is one for which the month-end average of outstanding gross notional amount of non-centrally cleared derivatives for January, February and March 2016 is calculated to be above EUR 8 billion.
- If the calculated amount does not exceed EUR 8 billion, that particular fund will fall within Category 3.

**Dates for Delegated Regulation no. 1 on the clearing obligation (IRS denominated in the G4 currencies):**

- The Clearing Obligation Effective Date for a Category 2 fund is 21 December 2016.
- The Clearing Obligation Effective Date for a Category 3 fund is 21 June 2017.

**Dates for Delegated Regulation no. 2 on the clearing obligation (Index CDS):**

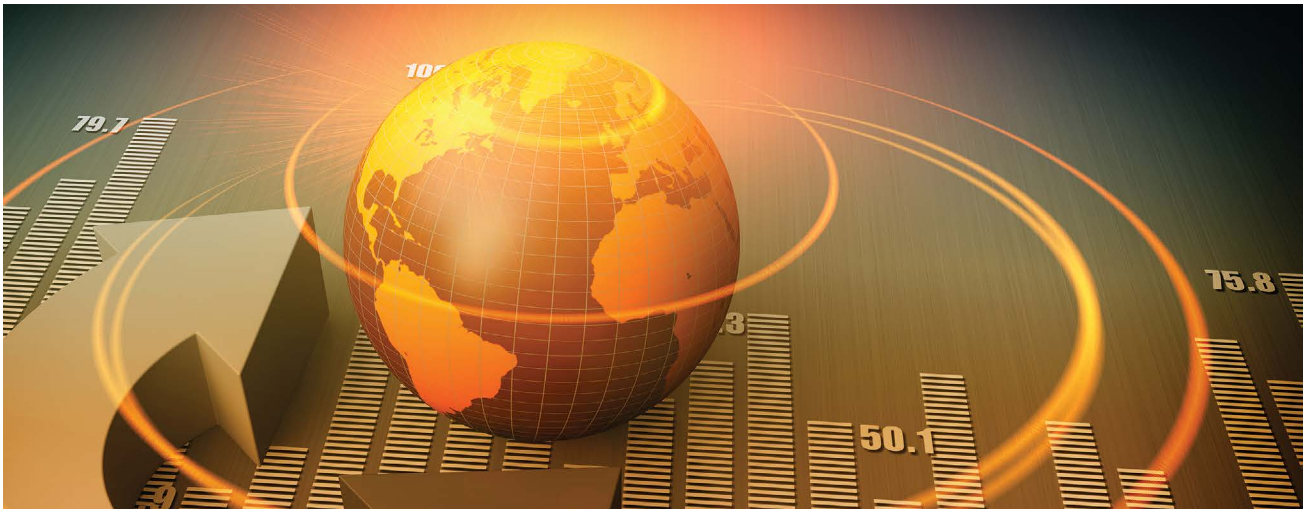
- The Clearing Obligation Effective Date for a Category 2 fund is 9 August 2017.
- The Clearing Obligation Effective Date for a Category 3 fund is 9 February 2018.

**Dates for Delegated Regulation no. 3 on the clearing obligation (IRS denominated in some EEA currencies):**

- The Clearing Obligation Effective Date for a Category 2 fund is 9 August 2017.
- The Clearing Obligation Effective Date for a Category 3 fund is 9 February 2018.

**Front-loading**

In each of the Delegated Regulations to date, Category 2 (but not Category 3) funds are subject to front-loading obligations.




# Alternative Investment Fund Managers Directive

## ESMA advice on non-EU AIFM passports

A mechanism exists in the AIFMD that could enable a non-EU alternative fund manager domiciled outside the EU to become authorised by an EU regulator and then to utilise the "AIFMD passport". The AIFMD passport would allow the non-EU manager to market funds throughout the EU following a simple regulatory notification process and would be an alternative to the "patchwork" of country-specific private placement rules that are currently in place for non-EU managers seeking to market funds in the EU. To date, this passporting mechanism has not yet been activated by the decision-making bodies of the EU.[25]

25 ESMA is required to base its opinion and advice on the AIFMD passport and the National Private Placement Regimes on the considerations specified under Article 67 of the AIFMD. Such considerations include investor protection, market disruption, monitoring of systemic risk and inter-regulator cooperation, including information-sharing.

## Summary of ESMA's advice (so far) on the AIFMD Passport

ESMA has taken a "country-by-country" approach to considering the jurisdictions to which the AIFMD passport may be extended.

On 30 July 2015, ESMA published its first set of advice to the European Parliament, Council and Commission as to whether the AIFMD passport should be extended to managers and funds in non-EU jurisdictions. ESMA determined that it only had sufficient information to undertake a substantive assessment of six jurisdictions: Guernsey, Hong Kong, Jersey, Singapore, Switzerland and the United States. Of these, ESMA recommended that the AIFMD passport be extended to three jurisdictions only: Guernsey, Jersey and Switzerland.[26]

As a follow-up, on 16 July 2016, ESMA published a second set of advice to the European Parliament, Council and Commission on the application of the AIFMD passport to 12 non-EU countries (including jurisdictions that were included in the first set of advice but on which no definitive views had been provided, and other jurisdictions that were considered for the first time): Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Isle of Man, Japan, Jersey, Switzerland, Singapore and the United States.[27]

According to ESMA's advice:[28]

- There are no significant obstacles impeding the application of the AIFMD passport to **Canada, Guernsey, Japan, Jersey** and **Switzerland**.
- If ESMA considers the assessment only in relation to AIFs, there are no significant obstacles impeding the application of the AIFMD passport to AIFs in **Hong Kong** and **Singapore**. However, both Hong Kong and Singapore operate regimes that only facilitate the access of UCITS from certain EU Member States to retail investors in their territories.
- There are no significant obstacles regarding market disruption and competition impeding the application of the AIFMD passport to **Australia**, provided the Australian Securities and Investments Commission extends to all EU Member States the "class order relief" from certain requirements of the Australian regulatory framework, which is currently only available to some EU Member States.
- There are no significant obstacles regarding investor protection and the monitoring of systemic risk that would impede the application of the AIFMD passport to the **United States ("US")**. With respect to the competition and market disruption criteria, there is no significant obstacle for funds marketed by managers to professional investors which do not involve any public offering. However, in the case of funds marketed by managers to professional investors that do involve a public offering, an extension of the AIFMD passport to the US risks an un-level playing field between EU and non-EU AIFMs. The market access conditions which would apply to these US funds in the EU under an AIFMD passport would be different from, and potentially less onerous than, the market access conditions applicable to EU funds in the US and marketed by managers involving a public offering. ESMA suggests, therefore, that the EU institutions consider options to mitigate this risk.
- For **Bermuda** and the **Cayman Islands**, ESMA cannot give definitive advice with respect to the criteria on investor protection and effectiveness of enforcement since both countries are in the process of implementing new regulatory regimes and the assessment will need to take into account the final rules in place.
- For the **Isle of Man**, the absence of an AIFMD-like regime makes it difficult to assess whether the investor protection criterion is met.

ESMA's advice will now be considered by the European Commission, Parliament and Council as required under the AIFMD (although early indications are this will not be a rapid process). Meanwhile, ESMA will continue its assessment of other non-EU countries with a view to delivering further submissions to the European Parliament, Council and Commission. For those non-EU jurisdictions with which there are currently no supervisory cooperation arrangements in place for the purposes of the AIFMD, ESMA will continue its efforts to agree a Memorandum of Understanding with the authorities concerned.

26 In respect of Switzerland, ESMA's advice only applied following changes in Swiss legislation that was expected to come into effect on 1 January 2016.
27 A revised version of the advice was published on 12 September 2016, with clarifications with respect to the assessment of the Isle of Man.
28 See ESMA website (www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries).

## Meanwhile, business as usual

The most common fund structure a US manager will use to market to EU investors is a fund established in the Cayman Islands (or in certain other key offshore jurisdictions) managed by a US manager. For such a structure to benefit from the AIFMD passport, the AIFMD passport must be extended to both the United States and the Cayman Islands (or other relevant offshore jurisdiction).

This will take time, and it would be premature for non-EU managers, including US managers (and potentially UK managers, depending on the terms ultimately agreed with the EU post-Brexit), to plan any material changes to their business structures or marketing plans based on the prospective extension of the AIFMD passport. It is likely that, for the foreseeable future, managers will continue to rely on existing National Private Placement Regimes when marketing in the EU, and any real improvements to the marketing process under the AIFMD will comprise ESMA's efforts to ensure greater regulatory convergence.

## Proposed changes to Annex IV reporting requirements

On 4 July 2016, the FCA published its 13th quarterly consultation paper (CP16/17) in which the regulator proposed changes to the transparency reporting requirements as contained in Article 24 of the AIFMD. The proposals affect the reporting obligations of Non-EU AIFMs (as defined below) and could potentially impact UK AIFMs following the UK's exit from the EU.

Article 24 of the AIFMD requires that Alternative Investment Fund Managers based in the EU (EU AIFMs) and those based outside the EU (Non-EU AIFMs) comply with certain reporting obligations in relation to AIFs under their management which (with respect to Non-EU AIFMs only) are marketed in the EU (the Article 24 Reporting Requirement). The information contained in each report (an Article 24 Report) is intended to provide EU national regulators with better oversight of, and therefore better ability to supervise, AIFs based in, or otherwise marketed in, their respective EU jurisdictions.

Under the new proposals, both EU and Non-EU AIFMs will be required to submit Article 24 Reports in relation to both master and feeder funds (even if the master fund is neither EU incorporated nor being marketed to professional investors in the EU) (the Extended Reporting Requirement).

This proposal was prompted by an opinion published by ESMA on 1 October 2013, which stated that, if national regulators only received information about feeder AIFs in a master-feeder fund structure, they would not receive a "comprehensive set of information for a proper assessment of systemic risks". At the time, the FCA only applied the Extended Reporting Requirement to EU AIFMs employing a master-feeder fund structure (provided that the master and feeder AIFs are managed by the same EU AIFM).

Consultation for the proposals in CP16/17 has now closed. We expect to have the outcome of the consultation, including the FCA's final rules, in Q1 2017.

# Increased Regulatory Scrutiny of the Asset Management Industry

Over the past two years, the FCA has devoted significant effort to scrutinising and providing guidance to the asset management industry. Most recently, the regulator has published an interim report to its asset management market study, which proposes numerous significant reforms for the asset management industry.

In this article, we outline the key regulatory issues that asset management firms should be aware of as they head into a new year of business in 2017. We also examine the interim findings of the FCA's asset management market study and the proposals aimed at addressing the issues identified. We urge firms to review these, seek advice and engage with the regulator's consultation process; comments to the FCA are due by 20 February 2017.

## Thematic review – meeting investors' expectations

In April 2016, the FCA completed a thematic review which assessed whether UK authorised investment funds and segregated mandates operated in line with investors' expectations, as set by the fund's marketing and disclosure materials and investment mandates. The FCA found that, although most of the funds it sampled invested in line with their stated strategy and did not expose investors to undisclosed risks, some firms provided unclear product descriptions.

In *TR16/3* – Meeting investors' expectations, the FCA explained that firms must clearly describe how investment funds are managed, along with the risks of investing in particular funds. If a fund's strategy is based on an index and the investment manager's flexibility to invest differently from the index is constrained, this must be clearly communicated to investors.

The FCA also reminded asset managers to keep the investment practices of funds under review to ensure they match their stated aims and strategy, even if the funds are no longer actively marketed. Additionally, firms that distribute funds through third parties should monitor the distribution channels used by being alert to potential indicators of inappropriate sales.

Firms should review their internal systems and controls in light of the FCA's commentary as the regulator will expect firms to have heeded the messages it has articulated and taken steps to identify and correct any problems that are identified.

## Asset management market study

The FCA sees market studies as an important tool for developing market interventions. According to the FCA, they help to identify the underlying causes of harm or potential harm and allow the FCA to exercise powers to remedy the concerns identified.[29]

29 "Our Future Mission", published by the FCA in October 2016, page 37.

In November 2016, the FCA published interim findings to its asset management market study,[30] which examines whether competition is working effectively to enable investors to get value for money when purchasing asset management services. The FCA found that a number of industry players have been able to sustain high profits over a number of years. Price competition is weak among actively-managed funds, while value for money is poor for some passively managed funds. The FCA also found that fund objectives and performance were not always appropriately communicated, and identified conflict of interest issues in the investment consultant market.

The FCA has made numerous proposals to address these concerns, including introducing a strengthened duty on asset managers to act in the best interest of investors and measures aimed at helping investors identify which fund is right for them (e.g., proposals on the standardisation and communication of fund charges, the use of benchmarks and tools for investors to identify persistent underperformance). The FCA has also made a provisional decision to make a market investigation reference to the Competition and Markets Authority on the investment consultancy market.

The consultation period for the FCA's interim findings and proposals close on 20 February 2017. Asset managers are strongly encouraged to respond to the FCA's consultation to ensure their views are taken into account in the regulator's policy development processes.

## FCA Guidance on fund suspensions

In July 2016, the FCA issued Guidance on fund suspensions when it observed that some asset managers experienced above-normal levels of redemption requests in the aftermath of the Brexit referendum[31]. The Guidance reminded firms to consider how they can ensure the fair treatment of fund investors, and explained that, if an asset disposal was needed to meet an unusually high volume of redemption requests, the manager must ensure the disposals are carried out in a way that does not disadvantage new or remaining investors. The FCA requested the managers of authorised funds to contact it in advance of any proposed suspensions. It also provided additional guidance for managers of funds that hold a large proportion of illiquid or hard-to-value assets.

The FCA's Guidance created significant uncertainty for managers whose funds are characterised by some degree of maturity transformation. Firms considering implementing a suspension of fund valuation or dealings are strongly encouraged to seek advice in light of this Guidance.

## Key regulatory developments

In 2016, the FCA published four consultation papers on MIFID II implementation. The reforms introduced by MiFID II (discussed separately in this publication) are far-reaching and will affect numerous asset management functions, including trading, client services, compliance and IT. Asset managers should consider and action the FCA's proposals to ensure they will be ready to work within the new regulatory framework when it comes into force.

The MAR has been in operation since March 2016; nonetheless, asset managers must continue to monitor developments in this area. In October 2016, ESMA published final guidelines on the procedures to be adopted by information recipients in market soundings (discussed in a separate article above), which we expect would be relevant to many asset management firms.

Last but not least, asset management firms will be aware that in 2018, the SMCR will be extended to non-bank firms. Although the details of the extended regime are not yet known, asset managers must familiarise themselves with the high-level framework of the extended regime (summarised in a separate article above) to ensure that they are ready to actively engage with the FCA's proposals when they are available.

30 *See MS 15/2.2 Asset Management Market Study Interim Report.*
31 https://www.fca.org.uk/news/statements/guidance-fund-suspensions.

## Enhanced scrutiny and early intervention

The FCA considers "harm in financial services [to be] equally important in wholesale and retail markets".[32] In 2017, investment managers can expect the FCA to focus on applying a preventative approach to regulation.[33] In practice, this is likely to mean increased early intervention action and engagement with the FCA's supervisory teams.


# Regulation of Distributed Ledger Technology-Enabled Financial Services

DLT began as an "off grid" technology that entered popular discourse via the development of virtual currency "Bitcoin". In recent years, entrepreneurs, mainstream financial institutions, central banks and financial regulators have increasingly recognised the potential for DLT to revolutionise the world of finance. As businesses develop ways of applying DLT in the financial services sector at an increasing pace, regulators must respond by articulating whether, and how, existing regulatory frameworks will apply to DLT-enabled products and services. Firms interested in extending to the DLT space must, in turn, ensure that they are up to speed with regulatory developments in this area.

## Attraction of DLT for firms and regulators

DLT has the potential to enable financial instruments to be bought and sold without the intermediation of a bank or other third party. This has significant implications for the speed and cost of transactions, and is of obvious appeal to financial services firms. Total savings from the use of DLT in payments, securities trading and regulatory compliance is estimated to reach USD 15-20 billion per year by 2022.[34] Additionally, the World Economic Forum estimated that by 2027, assets worth 10% of global GDP may be held on distributed ledger.[35] It is reported that hundreds of investment companies and asset managers around the world are already using DLT.[36] According to the FCA, a number of firms have started to test DLT-enabled financial services through the regulator's regulatory sandbox.[37] Firms are also exploring the application of DLT to back office and compliance-related processes (such as know-your-customer (KYC), central clearing, and transaction settlement functions)[38] and the development of

32 See footnote 30, page 19.
33 See footnote 30, page 13.
34 "Big banks join the blockchain gang", 25 August 2016, Martin Arnold and Jane Wild, *Financial Times*.
35 See footnote 34.
36 "Wealth managers quick to adopt blockchain for transactions", Hugo Greenhalgh, *Financial Times*, 21 September 2016.
37 "Financial Conduct Authority unveils successful sandbox firms on the second anniversary of Project Innovate", FCA press release, 7 November 2016.
38 "Blockchain back office and compliance-linked projects surge, applications years away", Complinet, Rachel Wolcott, 23 September 2016.

DLT-enabled smart contracts (i.e., contracts that facilitate, verify and enforce contractual terms automatically and without the need for third parties).[39]

The application of DLT is also likely to be of appeal to financial regulators. The FCA sees innovation in the financial sector as important as it has a duty to promote competition in the interests of consumers and believes one of the best ways of doing so is to foster *"disruptive innovation".*[40] It has also acknowledged that there are opportunities to apply DLT in the context of helping firms meet KYC and anti-money laundering requirements more efficiently.[41] Further, if DLT can be applied in a manner which allows regulators to have instantaneous access to a single ledger that sets out the transactions executed in a particular market in chronological order, this could reduce firms' reporting costs, improve transparency and enable regulators to perform real-time analysis of trade data (e.g., for the purposes of detecting suspicious transactions and assessing the extent of systemic risk in particular markets).[42]

## Uncertainty around the regulation of DLT

Despite the strong level of industry interest in exploring the application of DLT, there are concerns that DLT solutions are being delivered in silos and that, as a result, the potential benefits of harnessing DLT-enabled processes or products may not fully materialise.[43] While this is due in part to the fragmented nature of the industry (it is reported that over 800 financial technology (Fintech) companies are experimenting with the use of DLT in financial markets), it is also attributable to the lack of industry standards in the DLT space.[44]

Fintech firms have expressed concern that key questions around compliance with regulatory requirements remain largely unexplored, and it is unclear whether regulators intend to adopt existing regulatory constructs for DLT-enabled products and processes or whether new, bespoke regulation will be created.[45]

In June 2016, the financial services industry welcomed a discussion paper by ESMA on the application of DLT to securities markets (the Discussion Paper).[46] The Discussion Paper recognises a number of potential benefits to the application of DLT in securities markets and points to various technological, governance, privacy and regulatory challenges that must be overcome before this would be possible. It also analyses how existing regulation would apply to DLT-enabled post-trading services, and urges businesses wishing to use DLT to be mindful of the existing regulatory framework.

The Discussion Paper would appear to show that ESMA is taking a cautious approach to policy development in this area – ESMA acknowledges that "[t]he capacity of DLT to fit into the existing regulatory framework may limit its deployment",[47] but has refrained from making any recommendations on the regulation of DLT-enabled products or transactions. In a recent speech on regulation and DLT[48], Patrick Armstrong[49] commented that although ESMA is actively learning about the technology it is adopting a "wait and see" approach to avoid stifling a potentially socially and economically useful product or process. Critically, Mr Armstrong said that ESMA "has not identified major impediments in the current EU regulatory framework that would prevent the emergence of DLT" and "expect(s) the private sector to share responsibility for deploying new technologies in ways that are at once consistent with existing regulation". On the other hand, Mr Armstrong also said that ESMA will use feedback on the Discussion Paper to develop its position on the use of DLT in securities markets and to assess whether a regulatory response may be needed.[50] With over 60 responses to the Discussion Paper,[51] it is clear that the articulation of ESMA's position, when available, will attract significant industry interest.

39 See footnote 38.
40 Speech by Christopher Woolard, "UK FinTech: Regulating for innovation", February 2016.
41 See footnote 40 and speech by Megan Butler – "A more effective approach to combatting financial crime", September 2016.
42 See footnote 38.
43 See footnote 38.
44 See footnote 38.
45 For example, this was an issue raised in Swift and Accenture's position paper on distributed ledger technologies, April 2016: http://www.ameda.org.eg/files/SWIFT_DLTs_position_paper_FINAL1804.pdf.
46 ESMA Discussion Paper – The Distributed Ledger Technology Applied to Securities Markets, ESMA/2016/773, 2 June 2016.
47 See footnote 46, paragraph 42.
48 Speech entitled "Regulation and DLT: Working to Strike the Right Balance" delivered on 22 November 2016.
49 Mr Armstrong is a Senior Risk Analysis Officer on ESMA's Innovation and Products Team.
50 See footnote 48.
51 See footnote 48.

## Where this leaves us

Since the financial crisis, significant developments in European financial regulation have been made which did not anticipate the deployment of DLT in mainstream financial markets. ESMA and other financial regulators must now consider the extent to which existing regulatory regimes should be applied to DLT-enabled financial products and transactions, and decide whether the investor protection and economic stability they provide justify the extent to which their application could inhibit the potential benefits of DLT. If not, a bespoke regulatory response to the application of DLT to financial markets may be warranted.

# Key Takeaways from Enforcement Matters Involving the FCA in 2016

It has been a relatively quiet year for the FCA in relation to significant enforcement cases. This is probably to be expected, given that the LIBOR and FX investigations have ebbed, but it is also evidence that the FCA is undertaking a greater degree of supervisory intervention and early intervention action. Although there was speculation following the referendum that the FCA may take fewer enforcement cases as it directed resources towards post-Brexit planning, the FCA has made it clear that it is still business as usual.

It is apparent from the cases that have been brought over 2016 that the FCA is continuing to punish firms for failings in relation to firm culture, market integrity, financial crime and inadequate systems and controls. Failure to be open and cooperative with the regulator remains an issue for firms, with the FCA taking strong enforcement action, particularly in relation to applications for approval or change in control, but also in relation to communications with the regulator more generally. There are still very few cases being brought against senior managers, but it is anticipated that we will see more cases in relation to individuals as the SMCR beds in for banks and is eventually rolled out across all authorised firms. The FCA has placed a significant amount of time into emphasising the importance of culture and accountability within firms and the values by which firms operate, and we can expect to see a continuation of cases that place culture at the heart of regulatory failings.

In 2017, we also expect to see a continuation of the FCA's approach to use supervisory intervention and negotiation to achieve positive consumer outcomes. This may mean fewer final notices, but more FCA publicity around its priorities and areas of focus. This will mean it is even more important for firms to monitor FCA speeches, thematic review reports and announcements to ensure they are aware of FCA expectations and approach. The FCA has made it clear that it will not shy away from enforcement action where necessary and will take a particularly dim view of failures where issues have been highlighted by the FCA in publications and correspondence.

It is of note that the FCA is currently going through a review of its enforcement process. Some of the areas the FCA is reviewing include its referral decision making, cooperation between the regulators in enforcement investigations, subjects' understanding and representations in enforcement investigations, settlements and the framework for partly contested cases. Firms should ensure that they are aware of any announcements in this area as the proposals have the potential to have real impact on the enforcement process.

## Anti-money laundering concerns continue to be a regulatory priority

Regulated firms are expected to maintain robust and risk-focussed anti-money laundering (AML) systems and controls, and to promote a culture that supports these controls and impresses on staff the importance of complying with them. Firms must also ensure they understand their obligations under applicable AML regulations, including those under the Fourth Money Laundering Directive, which will come into force in national law by 26 June 2017.

The FCA's final notice in relation to Sonali Bank (UK) Limited (SBUK) makes it clear that AML issues continue to be high on the regulator's agenda. On 12 October 2016, the FCA imposed a £3,250,600 fine on SBUK for failings in its AML governance and control systems, and imposed a restriction on SBUK which prevented the bank from accepting deposits from new customers for 168 days. The regulator also took action against SBUK's former money laundering reporting officer (MLRO) Mr Steven Smith. As a result, Mr Smith received a £17,900 fine from the regulator and was prohibited from performing the compliance oversight and money laundering reporting controlled functions in regulated firms.

The FCA found that, between 20 August 2010 and 21 July 2014, SBUK did not maintain adequate AML systems despite having previously received warnings from the regulator about weaknesses in its AML controls. The weaknesses in SBUK's AML controls were considered serious and systemic – they affected almost all levels of SBUK's business and governance structure, including its senior management team, MLRO function, oversight of its branches, and policies and procedures in relation to AML. Consequently, the FCA found that SBUK failed to take reasonable care to manage its AML risks (in breach of Principle 3). SBUK also failed to notify the FCA in a timely manner after it became aware of a potentially significant fraud that had occurred at SBUK while it was under investigation by the FCA (in breach of Principle 11).

Mr Smith was SBUK's MLRO and compliance officer from February 2011 and was responsible for overseeing the operation and effectiveness of SBUK's AML systems. The FCA found that, despite receiving repeated warnings from SBUK's internal auditors, Mr Smith failed to implement compliance monitoring plans which adequately demonstrated SBUK's AML systems were working effectively. Mr Smith reassured SBUK's board and senior management that the bank's AML systems were working effectively when they were not, and he failed to appropriately address the concerns raised by the bank's internal auditors or report the results of internal testing. As a result, the FCA found Mr Smith had failed to exercise due skill, care and diligence in managing the business of the firm for which he was responsible (in breach of APER 6) and was knowingly concerned in SBUK's breach of Principle 3 (Management and control).

Mark Steward, Director of Enforcement and Market Oversight at the FCA, commented:

> "[E]nsuring that AML controls are effective and viewed as important throughout the business are fundamental obligations of all regulated firms.
>
> There is an abundance of guidance for firms on how to comply with AML and financial crime requirements and no excuse for failing to follow it. The FCA will not hesitate to take action against firms and senior individuals who fall short of our standards".

## Candour in dealings with the regulator

A series of decisions by the FCA in the past year highlights the importance of full and frank disclosure in communications with the regulator and the need to demonstrate openness and cooperation when engaging with the FCA.

### Veena Bhandari

On 21 December 2015, the FCA refused an application by William Albert Securities Limited (WASL) for approval of one of its directors, Mrs Veena Bhandari, to perform controlled function CF3 (Chief executive) on the basis that it had insufficient information to assess Mrs Bhandari's competence and capability.

Mrs Bhandari was a director of WASL from 2007 to 2014 and holder of controlled function CF1 (Director). She also held controlled function CF8 (Apportionment and oversight) for several months in 2007. WASL's application contained little information about Mrs Bhandari's responsibilities and experience in her previous roles. Although the FCA repeatedly invited WASL and Mrs Bhandari to attend an interview in order to assess her fitness for controlled function CF3, the invitation was consistently refused on Mrs Bhandari's behalf. WASL argued that the invitation was unjustifiable as reliance should be placed on the regulator's assessment in 2007, when Mrs Bhandari was approved to perform controlled function CF8. The FCA did not agree that prior approval to perform the CF8 function or the CF1 function necessarily demonstrated competence and capability to perform the CF3 function, and considered that the information required for the purpose of assessing the application remained outstanding. In response to WASL's assertion that any questions which the FCA wished to ask could be put by email, the FCA noted that it was empowered to require an applicant to supply information in such form as it may direct.

This case illustrates that regulatory approval for an approved person to perform a new controlled function in the same organisation should not be taken for granted. It is also a reminder that cooperation and engagement with the FCA is vitally important.

### Aspect Garage Limited

On 11 April 2016, the FCA refused an application by Aspect Garage Limited (Aspect) for permission to carry on the regulated activities of credit broking, debt adjusting and debt counselling. Although Aspect disclosed that its sole director and owner, Mr Asa Dobbing, had been convicted of Assisting in the Management of a Brothel Used for the Practices of Prostitution and was due to be tried for the offence of Conspiracy to Supply Class A Drugs, it failed to disclose that he had been arrested and charged with the offence of Aiding and Abetting Misconduct in Public Office, and had previously received a caution for Battery.

The FCA found that Aspect was not fit and proper as it failed to disclose all information requested by the FCA concerning the outstanding criminal proceedings for which Mr Dobbing was due to face trial. In its Final Notice, the FCA commented that as Aspect and Mr Dobbing had not been open and cooperative in all their dealings with the regulator, it was concerned that Mr Dobbing did not have the skills and experience to manage Aspect's affairs if the application were to be granted. The FCA also stated that Mr Dobbing had not demonstrated he had the integrity to recognise matters about which the regulator would expect to be notified. Accordingly, it concluded that Aspect did not satisfy the threshold conditions for granting authorisation, in particular, threshold conditions 2.5 (Suitability), 2.3 (Effective Supervision) and 2.4 (Appropriate Resources).

### Lynda Jayne Croome

The FCA's objection to Ms Lynda Jayne Croome's Notice of Intention to acquire a 33% controlling interest in Ubiety Wealth Management Limited (**"Ubiety"**) (**"Notification"**) is yet another case which highlights the need to demonstrate openness and candour in communications with the regulator. On 4 January 2016, the FCA published a Final Notice in relation to its decision to object to the acquisition on the basis of Ms Croome's reputation. In particular, the regulator found that Ms Croome had demonstrated a lack of integrity in light of the following:

- The Form A submitted by Ubiety on 2 June 2014 seeking approval for Ms Croome to hold controlled functions CF1 and CF30 stated the date the controlled functions became effective was 2 June 2014, even though Companies House records show that Ms Croome had been appointed a director of Ubeity since 11 February 2014.
- The Notification merely stated that Ms Croome had resigned from Firm A and did not provide any adverse employment information in relation to Firm A. In fact, Ms Croome had been suspended and dismissed after Firm A had made various allegations against her.
- Insufficient detail regarding Ms Croome's dismissal from Firm B was provided both in the Notification and throughout the application process. The description provided suggested that Ms Croome was dismissed for administrative irregularities when in fact, Firm B had made serious allegations of AML failings against Ms Croome. In particular, Firm B alleged that Ms Croome had signed money laundering certificates confirming that she had met and identified clients, and verified the ID provided was a true likeness of the client, without having ever met them.

The regulator also took into account certain documentary submissions made for, and on behalf of, Ms Croome which suggested that communications with the FCA had lacked transparency. For example, when the Notification was first received by the FCA on 11 August 2014, the FCA established that Ms Croome had already become a controller on 11 February 2014 and acknowledged the Notification as a post notification. Ubiety responded by advising the FCA that it had reversed the transaction and withdrew the Notification on 14 November 2014, before resubmitting it on the same day in order to seek prior-approval for Ms Croome to be a 33% controller of Ubiety.

Like *Bhandari* and *Aspect*, this decision is a reminder of the seriousness the FCA attaches to indicators that communications with the regulator are lacking in transparency and candour. Individuals and firms should ensure that communications to the regulator contain full and frank disclosure, particularly in regards to issues that are likely to attract regulatory scrutiny.

## Achilles Macris

Mr Macris is perhaps best known for his action in challenging the FCA in relation to its failure to give him third party rights on the Final Notice issued by the FCA on 18 September 2013 to J P Morgan Chase Bank NA (the Bank) for failures relating to the "London Whale" trading. The FCA's appeal on that matter was heard in the Supreme Court in October 2016, though at the time of writing, the Supreme Court had not yet handed down its decision.

Separately, Mr Macris has settled the case that the FCA brought against him for failing to be open and co-operative (in breach of APER 4) and accepted a fine of £792,900.

Mr Macris was Head of Chief Investment Office International (CIO) for the Bank in London and an FCA approved person. The FCA said that between 28 March 2012 and 29 April 2012, Mr Macris failed to inform the FCA about concerns with the synthetic credit portfolio and as a result he failed to meet the standards expected under APER 4.

The synthetic credit portfolio began to suffer significant losses from the beginning of 2012. On 23 March 2012, the front office was instructed that no further trades should be executed on the portfolio until discussions had taken place. Mr Macris subsequently asked that daily risk reports for the synthetic credit portfolio be produced and in the following days took other measures, such as requesting assistance from outside CIO and arranging daily progress meetings with CIO Risk and the front office. Despite these measures, the synthetic credit portfolio continued to suffer losses.

On 28 March 2012, Mr Macris attended a supervision meeting with the regulator at which CIO International and the synthetic credit portfolio were discussed. Mr Macris did not provide the FCA with information about the full extent of the difficulties that the synthetic credit portfolio was then facing or take steps to ensure that the regulator understood there were causes for concern with the portfolio.

On 10 April 2012, Mr Macris took part in a telephone call with the FCA which was set up to try to correct any inaccurate impression that may have been given by the publication of articles about the "London Whale". By the time of the call, Mr Macris was aware that the position of the synthetic credit portfolio had worsened and its losses had increased. Mr Macris allowed an inaccurate impression to be given that there had been no material changes since the supervision meeting and that there were not wider causes for concern with the synthetic credit portfolio.

The FCA said that Mr Macris should have appreciated that, by failing to inform the regulator during the meeting and the call of the causes for concern and by allowing the regulator to be reassured concerning the position of the synthetic credit portfolio, the message delivered was not an accurate reflection of the state of the synthetic credit portfolio. At the very least, a high-level indication that there were causes for concern during the meeting, the call or at any time before 29 April 2012 would have provided the FCA with the opportunity to follow up with questions about the nature of the concerns and form its own assessment of the position. It would also have encouraged other staff to be open and cooperative in providing information in relation to their specific areas of expertise. Significantly, the FCA did not find that Mr Macris had been dishonest or acted with a lack of integrity.

Mark Steward, Director of Enforcement and Market Oversight at the FCA, said:

> "A failure to communicate openly with us can affect the well-running of markets and cause unnecessary harm to investors, especially in times of financial stress or crisis. Regulators need open communication with firms so that better decisions can be made sooner. Mr Macris should have explained the position more squarely especially when he knew the synthetic credit portfolio's losses had worsened".

## Successful challenge to refusal of authorisation

### Abi Fol Consulting

This case is of particular interest as it is an example of a successful challenge to the FCA's initial refusal to authorise a firm and approve an individual to hold controlled functions.

In 2014, Abi Fol Consulting Limited (Abi Fol) applied for FCA authorisation under Part 4A of FSMA. Abiodun Ladele (the firm's sole shareholder and director) was to hold various controlled functions. The FCA refused Abi Fol's application on the basis that it was not satisfied Mr Ladele had acted, or could be expected to act, with probity, and this meant that Abi Fol could not ensure that it would meet the threshold conditions (in particular, the suitability condition). The FCA's view was based on an issue that arose in 2010 when Mr Ladele was employed by HSBC and he was accused of committing fraud. Mr Ladele denied the allegation and contested his subsequent dismissal by the bank (which was settled through a compromise agreement). Mr Ladele was prosecuted, but a verdict of "not guilty" was entered after the Judge was informed by the prosecutor that there was little prospect of conviction.

Mr Ladele was interviewed by the FCA as part of the application for approval, and following the issue of the Warning Notice, made submissions to the FCA's Regulatory Decisions Committee. The FCA did not accept Mr Ladele's position; therefore, Mr Ladele referred the matter to the Upper Tribunal.

The Upper Tribunal found Mr Ladele's answers in cross examination to be satisfactory and considered he had sought to give honest testimony. The Tribunal said that the case against Mr Ladele was "not credible" and found on the "overwhelming balance of probabilities" that Mr Ladele had not committed the offence of fraud. The Upper Tribunal remitted the matter to the FCA to make the actual decision on Abi Fol's application for authorisation and to do so consistently with the findings it had made. The Upper Tribunal stated "we express the hope that he will be able to promptly resume his career in whatever way is appropriate". The FCA has since authorised Abi Fol.

It is rare for applicants to pursue applications for approval and authorisation through to the Upper Tribunal but this case demonstrates that it is worth challenging the FCA's position where the basis for refusal can be shown to be demonstrably weak.

## Action against senior managers

The action taken by the FCA against Andrew Tinney is one of the few cases this year where the FCA has sought to take action against a senior manager for breaches relating to integrity.

Mr Tinney was the Global Operating Officer of Barclays Wealth and Investment Management (BWIM) and was approved to carry out CF29 in his role as Chief Operating Officer at the time of the relevant events.

Mr Tinney was Chairman of a steering committee that had been appointed to oversee a remediation program that Barclays Bank plc (the Firm) was undertaking to correct certain regulatory deficiencies identified by the SEC during an examination of BWIM's US branch, Barclays Wealth Americas (BWA). The remediation program included a "Culture Audit" workstream which Mr Tinney is said to have initiated and personally communicated to the SEC as part of a programme designed to reassure the SEC that the Firm took the deficiencies seriously and would seek to identify their root causes(s). A third party consultancy was engaged to consider how the "tone at the top" flowed through BWA.

It seems that the third party consultancy prepared a report (the Report) which included quotes from certain BWA employees who were highly critical of some members of BWA's senior management and expressed an opinion that BWA had pursued a course of revenue at all costs and had a culture that was high risk and actively hostile to compliance. The main recommendation was that the Firm should replace, or consider replacing, some of BWA's senior management.

Mr Tinney discussed the Report's contents with his manager, and then took steps which the FCA said were aimed at ensuring the Report would not be seen by, or be available to, those senior individuals referred to in the Report or anyone else at the Firm, whilst also putting in place a plan to address the criticisms made in the Report.

The Firm received a copy of the Report from the third party consultancy and shortly afterwards suspended Mr Tinney. Mr Tinney has since resigned from the Firm.

The FCA said that it sees the misconduct as serious, noting further that it occurred during the Salz review which had been launched by the Board in the aftermath of the LIBOR settlements and was intended to examine the Firm's historical culture and to make recommendations for change.

The FCA acknowledged that Mr Tinney did not seek to suppress the conclusions of the Report and initiated actions that made others aware of some of the findings and which were intended to address some of BWA's cultural issues. Nonetheless, the FCA considered that Mr Tinney should have made it clear that the Report existed and that there was litigation risk, and should have circulated it as necessary subject to appropriate confidentiality restrictions.

The FCA issued a Decision Notice on 14 September 2016 seeking to impose a public censure on Mr Tinney and a partial prohibition preventing him from holding any senior management or significant influence functions. Mr Tinney has referred the Decision Notice to the Upper Tribunal.

Given the seriousness of an allegation of lack of integrity (APER 1), it is notable that the FCA has not sought to impose a financial penalty on Mr Tinney. Nonetheless, the impact of the FCA sanction on Mr Tinney's reputation and future career in financial services is considerable, and it will be a matter for the Upper Tribunal to assess whether a finding and sanction should be imposed on Mr Tinney at all. As the FCA seeks to bring more cases against senior managers, we can expect to see more referrals to the Upper Tribunal as the impact of an FCA sanction (even if limited to a censure) can be career ending.

## Keydata compliance officer publicly censured and prohibited

On 19 May 2016, 8.5 years after the FSA's investigation into the affairs of Keydata Investment Services Ltd (Keydata) began, the FCA publicly censured Keydata's former compliance officer, Peter Johnson, and prohibited him from performing any role in regulated financial services. The FCA determined that Mr Johnson was not fit and proper as he lacked integrity (in breach of Principle 1) and failed to demonstrate a readiness to comply with the requirements of the regulatory system (in breach of Principle 4). This decision is instructive for senior personnel in regulated firms as the FCA took the opportunity to articulate the actions Mr Johnson should have taken in the circumstances. It is also a reminder that an approved person's responsibilities under the regulatory regime are personal to the individual in question, a message we expect the regulator to reinforce in anticipation of the application of the SMCR to all FSMA-regulated firms.

Keydata was an investment manager that designed structured investment products and distributed them to retail investors through a network of independent financial advisors (IFAs). The products (Products) involved Keydata's investment in bonds that were issued by special purpose vehicles SLS Capital S.A. (SLS) and Lifemark S.A. (Lifemark) which, in turn, invested in portfolios of life settlement policies. As Keydata's compliance officer, Mr Johnson was responsible for conducting due diligence of the Products, approving financial promotions issued in respect of the Products and Keydata's compliance with regulatory standards. He was also responsible for Keydata's dealings with the FCA in relation to the Keydata Products.

The FCA found that Mr Johnson breached Principle 1 (integrity) as he was aware that Keydata received professional advice that its due diligence in relation to the Lifemark Products was inadequate and its financial promotions contained unclear, incorrect and misleading statements. He was also aware of the non-performance and the risk of non-performance, respectively, of the SLS Products and the Lifemark Products. Despite this, Mr Johnson recklessly failed to take adequate steps to ensure that Keydata addressed these issues or ceased marketing and selling the Lifemark Products, and explained the risk of non-performance of the Lifemark Products to investors. Further, the FCA found that Mr Johnson deliberately misled the regulator by representing that the SLS and Lifemark Products were on track to meet their payment obligations in two compelled interviews. The FCA also found that Mr Johnson breached Principle 4 (open and cooperative dealings with the regulator) by making misleading representations to the FCA in compelled interviews, withholding information about the performance of the Products in a meeting with the FCA and failing to notify the FCA about the non-performance and risk of non-performance, respectively, of the SLS and the Lifemark Products. In addition, although Mr Johnson was copied in an email to the FCA containing a spreadsheet which gave a misleading impression of the future income expected to be paid by SLS, he did not take steps to correct the information provided.

The FCA considered Mr Johnson's failings to be serious in light of the significant level of consumer detriment which arose from the sale of the Products and the impact this has had on the financial services sector. Had Mr Johnson been unable to provide verifiable evidence of financial hardship, the regulator would have imposed a fine of £200,000.

This case is instructive to compliance officers of regulated firms as the FCA commented on the steps it considers Mr Johnson should have taken in the circumstances. In particular, the FCA explained that Mr Johnson could have refused to sign-off the financial promotions for the Lifemark Products and made it clear that he would resign and/or notify the regulator of the problems relating to the SLS and the Lifemark Products if the board of directors did not commit Keydata to addressing them. Senior personnel in regulated firms should pay close attention to the FCA's articulation of its expectations in light of the extension of the SMCR to all regulated firms, under which senior managers will be subject to a statutory duty of responsibility to take reasonable steps to prevent regulatory breaches in the areas of the firm for which they are responsible.

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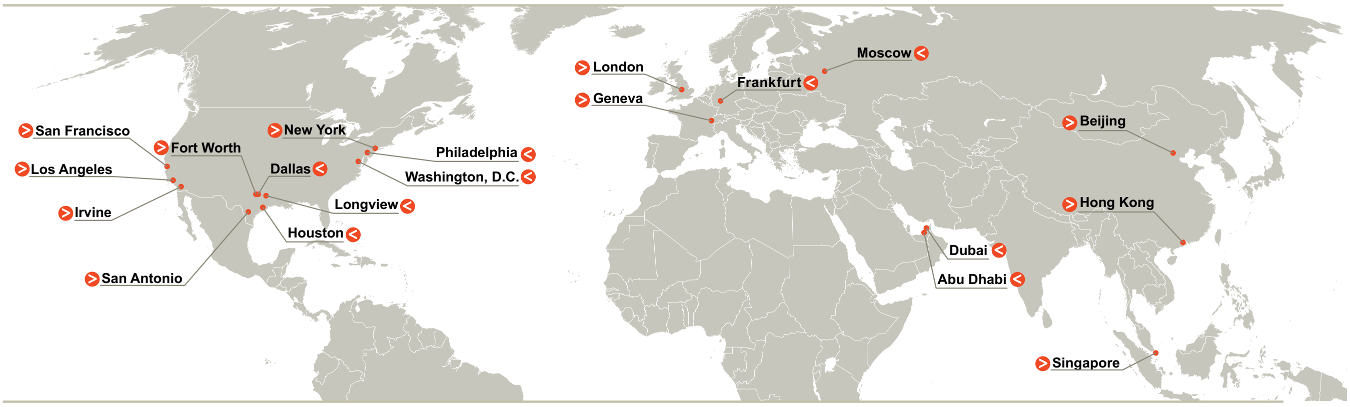


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