FINANCIAL REGULATORY UPDATE

In Principle

10 THINGS AUTHORISED FIRMS NEED TO KNOW FOR 2018

THE WORLD OF FINANCIAL REGULATION AS THE UK PREPARES TO EXIT THE EU

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IN PRINCIPLE: 10 THINGS AUTHORISED FIRMS NEED TO KNOW FOR 2018 – THE WORLD OF FINANCIAL REGULATION AS THE UK PREPARES TO EXIT THE EU

Introduction

There is much for authorised firms to consider in the year ahead. Firms have been through the intensive period of the enactment of the second Markets in Financial Instruments Directive (MiFID II), but must now step up their work on implementation of the General Data Protection Regulation (GDPR) and transition to the extension of the Senior Managers and Certification Regime (SMCR). The Brexit leave date of 29 March 2019 is fast approaching, and we can only hope that we will enter 2019 with greater certainty than 2018 as to how the regulatory landscape will look.

Executive Summary

In this publication, we focus on 10 key issues that authorised firms should have at the forefront of their minds as they enter 2018:

1. **GDPR:** Described as one of the biggest changes in data protection law for a generation, the GDPR – which is set to come into force on 25 May 2018 – is intended to strengthen, unify and harmonise the European Union (EU) data protection regime, ensuring that non-European companies will have to deal with only one set of data protection laws. The GDPR broadens the territorial reach of the EU data protection regime and, importantly, significantly increases sanctions for non-compliance. Despite the UK's impending exit from the EU, it is expected that the UK's post-Brexit data protection regime will embrace the GDPR.

2. **Increased regulatory scrutiny of the asset management industry:** The shift in regulatory focus of the Financial Conduct Authority (FCA) towards the asset management industry in recent times is notable. In the past year, there has been an FCA market study of the asset management industry, an FCA market investigation reference to the Competition and Markets Authority (CMA), and an FCA statement of objections issued to four asset managers alleging certain competition law breaches. The action taken by the FCA in this space demonstrates both the focus and priority that it places on the asset management industry. The regulator is evidently increasing in both confidence and willingness to utilise its wider tool kit, and firms should prepare themselves for further scrutiny and possible enforcement action.

3. **The extension of the SMCR:** Having successfully rolled out the SMCR to banks, building societies, credit unions and dual regulated investment firms in March 2016, the FCA is now preparing to extend the SMCR to all other authorised firms. The new regime is expected to be implemented in 2019 and while the extended SMCR retains key elements of the regime applicable to banks, the FCA has adopted a proportional approach to implementation for the rest of the financial services industry. The extension of the SMCR is expected to be an important weapon in the regulator's armoury to help ensure that individuals who have committed misconduct are brought to account.

4. **Industry codes of conduct:** The FCA's recent consultation paper recognised that its expectations for markets and activities not covered by regulatory rules and FCA Principles are not as clear as they could be. The FCA seeks to resolve this issue and proposes, among other suggestions, to publicly recognise certain industry codes that set out proper standards of market conduct for unregulated markets and activities. The FCA also discusses the possibility of extending the application of Principle 5 of the FCA's Principles for Businesses – which requires firms to observe proper standards of market conduct – to unregulated activities.

5. **EU regulatory developments:** Changes to EU regulation continue to take place at pace. The key development this year is undoubtedly the coming into force of MiFID II, which alters the regulatory landscape for firms and regulators alike. As with the implementation of any new rules, unforeseen consequences can

occur and it will be interesting to see how the regulators respond to this. In addition to MiFID II, 2018 will see advanced proposals (expected to be approved) for important changes to the marketing of investment funds, rules relating to short selling, proposals to amend the European Market Infrastructure Regulation (EMIR) and securities financing transactions (SFT).

6. **Enforcement action in relation to MiFID II:** The FCA has stated that the wider information available to it under MiFID II (in conjunction with that collected under the Market Abuse Regulation (MAR)) will shape its enforcement work – in addition to its supervision and policy assessments – for the better. In particular, it will allow the FCA to read across venues and markets, virtually in real time, to enable it to gain a holistic view of activity in wholesale markets. It remains to be seen how effective the FCA will be in utilising the additional information available to it and whether it has systems capable of synthesising the information in a manner that enables it to act quickly.

7. **Anti-money laundering developments:** The FCA's focus on financial crime and anti-money laundering (AML) has been a continuing theme for some years now, and was again emphasised in the regulator's 2017/18 Business Plan and in recent enforcement action (discussed below). Regulated firms are required to maintain robust and risk-focussed AML systems and controls, and to promote a culture that supports these controls and that impresses on staff the importance of complying with them.

8. **FCA investigations – a quiver full of arrows?** The FCA is taking a new approach to its investigations – it will not use investigations as a precursor to contemplated enforcement action when something has gone wrong, but rather as a tool for finding out what has happened. The regulator acknowledges that a necessary result of the change in approach is that an increased number of investigations will be open. Firms and individuals will therefore need to be prepared for more investigations and resource themselves accordingly. While enforcement action following an investigation may no longer be seen as inevitable, it will still remain a real risk.

9. **Challenges to privilege:** As firms have increasingly hired external law firms to conduct internal investigations, they have often assumed that any interviews conducted by the law firm with the firm's employees would attract privilege – particularly if these were investigations conducted after a notice of investigation had been received from the FCA. However, two recent cases have illustrated that the courts may take a narrower approach to privilege, especially in relation to material generated as a result of internal investigations.

10. **Key FCA enforcement cases in 2017:** Last year, we saw the FCA place particular focus on market abuse cases involving capital markets; the regulator used its power for the first time to require a listed company to pay compensation to investors, while individuals were held to account for disseminating false and misleading information relating to publicly listed companies. In addition, a firm was found to have breached the FCA's disclosure and transparency rules, action was taken in relation to failures in respect of EMIR reporting requirements, and a decision was handed down by the Supreme Court setting out the position on third party rights in the context of FCA regulatory action. In the course of this year, we can expect more investigations and, most likely, more action against senior individuals as the SMCR beds down for banks and insurers. We also expect to see firms and individuals beginning to utilise the new options in the enforcement decision-making process, such as making direct referrals to the Upper Tribunal.

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, and taking advice from legal experts where necessary. The consequences of doing otherwise could be severe.

1. GDPR

Another key piece of European legislation (following MiFID II), the GDPR[1], is set to come into force on 25 May 2018. Described as one of the "biggest changes in data protection law for a generation,"[2] the GDPR is intended to strengthen, unify and harmonise the EU data protection regime. The GDPR seeks to provide a single legal data protection framework across the EU, the product of which should be that non-European companies need only to comply with one set of data protection rules when dealing with European individuals' personal data.

1. Key changes

The key changes under the GDPR are as follows:

Broadened Territorial Scope[3]

The GDPR broadens the territorial reach of the EU data protection regime. The current EU data protection regime applies only to entities whose data processing activities were "carried out in the context of the activities of an establishment of the controller on the territory of the Member State"[4] or made use of "equipment, automated or otherwise, situated on the territory of the said Member State"[5] for purposes of processing personal data.

As expected, the GDPR will apply in full to the processing of the personal data of data subjects in the EU by a controller or processor that is established in the EU. In addition, and as a departure from the scope of the existing data processing rules, the GDPR will also apply to the processing of personal data of EU data subjects by a controller or processor that is not established in the EU, provided that the data processing activities relate to the offering goods or services to EU citizens;[6] or "the monitoring of behaviour that takes place within the [EU]."[7]

1 General Data Protection Regulation 2016/679
2 Information Commissioner's Office – messages for the boardroom
3 GDPR article 3
4 Directive 95/46/EC article 4(1)(a)
5 Directive 95/46/EC article 4(1)(c)
6 GDPR article 2(a)
7 GDPR article 2(b)

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.

Penalties[8]

The sanctions for non-compliance with the new regime can be significant, with fines up to €20 million or 4 per cent of the worldwide annual turnover (whichever is greater). The maximum fine is likely to be reserved for the most serious violations. Sanctions can be imposed on both controllers and processors.

Consent[9]

Where it is appropriate to obtain valid consent from the data subject, the GDPR strengthens the qualitative requirements applicable to such consent. Requests for consent must be made in an intelligible and easily accessible form, using plain and clear language. Furthermore, it must be as easy to withdraw consent as to give it.

Breach Notification[10]

The GDPR requires a breach notification to the supervisory authority in all Member States where a data breach is likely to result in a risk for the rights and freedoms of individuals[11]. The notification must be made without delay and where feasible not later than 72 hours after becoming aware of it[12].

Increased Control for Data Subjects[13]

Under the GDPR, data subjects have the right – free of charge[14] – to obtain confirmation from the data controller as to whether, where and for what purpose their personal data is being processed. The GDPR clarifies that the reason for allowing individuals to access their personal data is so that they are aware of and can verify the lawfulness of the processing[15].

Furthermore, in certain circumstances, data subjects are entitled to request the data controller to erase their personal data (right to be forgotten).

Wider Definition of Personal Data

Personal data now includes online identifiers, such as IP addresses[16].

The GDPR is intended to bring a more 21st century approach to the processing of personal data protection; the UK Information Commissioner has said, "The message about GDPR is continuity and change[17]". New technology and new regulation will be a challenge for regulators and businesses alike. Firms will need to take active steps to ensure compliance and have confidence that their systems can meet the regulatory requirements.

2. How will the UK data protection regime be affected by Brexit?

Territorial Scope of the GDPR

Even though the UK government has confirmed[18] that the GDPR will apply to the UK when it comes into force on 25 May 2018, and new data protection legislation is being passed setting out derogations from the GDPR and other national implementing measures[19], the regulation may not technically continue to bind the UK post-Brexit. In practice, however, many UK businesses will still need to comply with the provisions of the GDPR because of its wide territorial scope and application.

8 GDPR article 83
9 GDPR article 7
10 GDPR articles 33 and 40
11 GDPR recital 85
12 GDPR recital 85; article 33(1)
13 GDPR chapter III
14 Unless the request is manifestly unfounded or excessive, particularly if it is repetitive
15 GDPR recital 63
16 GDPR article 4(1)
17 GDPR and accountability (speech Elizabeth Denham 17 January 2017)
18 Culture, Media and Sport Committee ; Oral evidence: Responsibilities of the Secretary of State for Culture, Media and Sport, HC 764; Monday 24 October 2016 (http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/culture-media-and-sport-committee/responsibilities-of-the-secretary-of-state-for-culture-media-and-sport/oral/42119.html)
19 Data Protection Bill 2017-19

As a general rule, any business that collects, stores and/or processes personal data of EU subjects is likely to fall within the scope of the GDPR. Thus, UK companies that process data on behalf of an EU-based data controller, or UK companies that offer or provide services to, or monitor the behaviour of, EU citizens, will continue to be subject to the GDPR post-Brexit.

This is relevant for a number of businesses, including UK and other non-EU investment funds and their managers and other service providers. The fund, through the administrator and, in some cases, the manager, is likely to store and process the personal data of individual EU investors and, as a result, be required to comply with certain requirements under the GDPR. Such personal data may include contact details of prospective EU investors, payment details, identity documents, information relating to tax residency status, source of wealth and employment status.

In order to ensure that such companies and investment firms may continue to market to prospective investors in the EU, and hold and otherwise process the personal data of EU individuals, and in order to avoid significant disruption to business, it is important that the UK's post-Brexit data protection regime is consistent with the GDPR.

Restriction on the International Transfer of Data

The GDPR regulates the international transfer of personal data of EU subjects to third countries and requires that either the data protection regime in the jurisdiction to which the data is transferred is "adequate,[20]" that other appropriate safeguards are in place so as to ensure that the transferred data is sufficiently protected or that the relevant transfer falls within an exemption.

When the UK leaves the EU, in order for UK companies to be able to receive EU subject data, the UK must ensure the adequacy of data protection levels. This may be achieved by[21]:

a) An adequacy decision: the European Commission (EC) may decide that the UK offers an "adequate level of protection essentially equivalent to that ensured within the [EU][22]". If the UK wants to facilitate the transfer of EU personal data into the UK, it will need to ensure that its data protection regime is "adequate" (i.e., equivalent to the regime stipulated by the GDPR).

b) The use of model contract clauses (MCCs): MCCs are entered into between a controller of EU subject data and another controller or processor that is not based in the EEA so as to enable the transfer of EU subject data between those parties. The MCCs were approved by the EC and remain valid under the GDPR unless the EC repeals the approval or the MCCs are invalidated by the European Court of Justice[23].

c) The use of binding corporate rules ("BCRs"): BCRs are internal safeguarding rules adopted by multinational organisations that enable such organisations to transfer EU subject data outside the EEA but within their corporate group.

Data protection is an increasingly important area of regulation. If they have not already done so, firms should begin to carefully consider their data flows and think about how the new regulations are likely to impact their business. As noted above, the consequences for non-compliance could be severe.

20 GDPR article 45
21 Both MCCs and BCRs existed prior to the entry into force of the GDPR but will become relevant to EU-UK transfers of personal data post-Brexit.
22 GDPR recital 104
23 The ECJ is currently considering the validity of the Commission decision on which the MCCs are based; see the referral to the ECJ by the Irish High Court in *DPC v Facebook Ireland Limited and Maximillian Schrems* of 3 October 2017 (http://www.europe-v-facebook.org/sh2/ES.pdf).

2. Increased regulatory scrutiny of the asset management industry

There has been an observable shift in the focus of the regulator on asset managers, as seen by a number of the FCA's actions over the past year.

The FCA's final report (published on 28 June 2017) following its market study into the asset management industry set out a number of concerns in relation to competition and investor protection. This was closely followed by the FCA's market investigation reference in relation to investment consultancy and fiduciary management services, the first time that the FCA had used its powers to make a market investigation reference to the CMA. Shortly after, in November 2017, in another first for the FCA, the regulator issued a statement of objections to four asset management firms, alleging that they may have broken competition law by sharing information about their plans during the Initial Public Offering (IPO) or placing process when they should have been competing for shares.

The action taken by the regulator in the asset management space demonstrates both the focus and priority that it places on this area. The FCA is clearly increasing in both confidence and willingness to utilise its wider tool kit and the industry should prepare itself for further scrutiny.

1. FCA market study into the asset management industry

Set out below is a summary of the main concerns raised by the FCA following the market study:

Price Competition

The FCA found "weak price competition in a number of areas of the asset management industry,"[24] particularly in the context of retail active asset management services. This finding was based on the fact that there is considerable price clustering on the asset management charge for retail funds, the active charges have remained broadly stable, the profit margins of asset management firms are consistently high (on average, 36 per cent), and firms do not typically lower their prices to win new business.

Performance

The FCA looked at fund performance and the relationship between price and performance. The FCA found substantial variation in performance, both across asset classes and within them, but saw no clear relationship between charges and gross performance of retail active funds in the UK. The FCA noted that, since past performance is not a good indicator for future performance, it is very difficult for investors to predict which funds will perform well in the future.

24 Asset Management Market Study Final Report, MS15/2.3, June 2017

Clarity of Objectives and Charges

The FCA expressed concerns as to how asset managers communicate their objectives to clients and found that investors' awareness and focus on charges was mixed and often poor. Many retail investors were not aware that they were paying charges for their investment.

Investment Consulting and Other Intermediaries

The larger institutional investors were typically able to negotiate with asset managers and receive good value for money. However, many smaller investors, typically pension funds, found it harder to negotiate with asset managers and therefore often relied on investment consultants when making decisions.

The FCA identified various concerns in the investment consulting market, including relatively low switching levels, conflicts of interest, relatively high and stable market shares for the three largest providers, and a weak demand side.

Remedies

The FCA proposed a suite of remedies to address its main concerns, as follows:

a) To help provide protection for investors who are not well placed to find better value for money, the FCA proposes to:

- strengthen the duty on fund managers to act in the best interests of investors and bring individual focus and accountability to this
- require fund managers to appoint a minimum of two independent directors to their boards
- introduce technical changes to improve fairness around the management of share classes and the way in which fund managers profit from investors buying and selling their funds.

b) To drive competitive pressure on asset managers, the FCA will:

- support the disclosure of a single, all-in fee to investors
- support the consistent and standardised disclosure of costs and charges to institutional investors
- recommend that the Department for Work and Pensions remove barriers to pension scheme consolidation and pooling
- chair a working group to focus on how to make fund objectives more useful and consult on how benchmarks are used and performance reported.

c) To help improve the effectiveness of intermediaries, the FCA will:

- launch a market study into investment platforms
- recommend that HM Treasury considers bringing investment consultants into the FCA's regulatory perimeter.

2. Market investigation reference

The market investigation reference followed the findings made in the FCA's Asset Management Market Study, which expressed concerns in relation to investment consultancy and fiduciary management services, which play a significant role in advising pension fund trustees when they are procuring asset management services.

The FCA identified the following market features that, in its view, justified a reference to the CMA[25]:

Weak Demand Side

Trustees have a tendency to rely heavily on investment consultants, whom they perceive as having greater investment knowledge. Trustees often find it difficult to assess the quality of the advice provided by investment consultancies

25 https://www.fca.org.uk/publication/market-studies/final-decision-market-investigation-reference.pdf

and the services of fiduciary managers and therefore cannot assess whether a good investment result was due to the consultant's advice or other factors (e.g., luck). The FCA considered that the lack of available transparent and comparable data on the performance of investment consultant advice exacerbates the issue and is responsible for low switching levels.

Relatively High Levels of Concentration and Relatively Stable Market Share

The FCA found that the investment consultant market is highly concentrated, with three firms holding a combined market share of 50-80 per cent. The FCA considered that this may cause competition to work ineffectively.

Barriers to Expansion

Whereas barriers to entry are thought to be low, expanding in the market is considered to be challenging, especially for smaller firms. The FCA considered that this is likely caused by the fact that investors choose a consultant based on reputation and the fact that switching levels are low.

Vertically Integrated Business Models Create Conflicts of Interest

Many investment consultants have also developed their own product offerings (such as fiduciary management and fund-of-fund products). The FCA is concerned that investment consultants with their own product offering will often recommend their in-house propositions, even if there are better investment products offered elsewhere.

Scope of the CMA Investigation

The CMA announced that its investigation will focus on the following three areas of potential concern:

- whether difficulties in customers' ability to assess, compare and switch investment consultants mean that investment consultants have little incentive to compete for customers
- whether conflicts of interest on the part of investment consultants reduce the quality and/or value for money of services provided to customers
- whether barriers to entry and expansion mean that there are fewer challengers to put pressure on the established investment consultants to be competitive — which leads to worse outcomes for customers.

These are initial areas of potential concern that might be amended or expanded as a result of the responses submitted by interested parties and stakeholders. As John Wotton, chair of the newly appointed CMA Investigation Group, said:

"It is extremely important that the investment consultancy sector works effectively for its clients, which include many of the UK's biggest pension funds, and we want to ensure we are looking at the right issues. That is why we are urging people to get in touch if they have any evidence to share or views about whether these are the correct areas for us to be investigating."[26]

Although the CMA noted that it was at an early stage in thinking about remedies – assuming that it does identify a lack of competition as a problem – among its options, which are listed in its issues statement[27], are (a) requiring consultants to report on pension fund returns against agreed benchmarks, (b) the introduction of mandatory tendering, and (c) setting limits to or a ban on consultants receiving hospitality from asset managers.

3. FCA statement of objections to four asset management firms

On 29 November 2017, the FCA issued its first statement of objections to four asset management firms, alleging that they may have broken competition law.

The FCA believes that the four firms shared information by disclosing the price that they intended to pay, or accepting such information, or both, in relation to one or more of two IPOs and one placing, shortly before the share prices were set. The sharing generally occurred on a bilateral basis and allowed the firms to know the other's plans during the IPO or placing process when they should have been competing for shares.

26 CMA press release: "CMA sets out scope of investment consultancy market investigation"; 21 September 2017
27 https://assets.publishing.service.gov.uk/media/59c376f7ed915d408c10d131/investment-consultancy-market-investigation-issues-statement.pdf

The powers and processes (including publicity) that the FCA has and follows in relation to the Competition Act 1998 are separate and different from those it has and follows in relation to the Financial Services and Market Act 2000 (as amended) (FSMA). Competition Act cases may also be brought by the CMA. Firms can be fined up to 10 per cent of their annual worldwide group turnover for infringements.

The FCA has an overarching strategic objective of ensuring that the relevant markets function well. To support this, it has three operational objectives: to secure an appropriate degree of protection for consumers; to protect and enhance the integrity of the UK financial system; and to promote effective competition in the interests of the consumer. The asset management arena is an area of significantly increased focus for the FCA and, given the other recent related changes in law – for example, the broader scope of trading data that it will collect under MAR and MiFID II – such focus is only likely to intensify for firms.

3. The extension of the SMCR

Having successfully rolled out the SMCR to banks, building societies, credit unions and dual regulated investment firms in March 2016, the FCA is now preparing to extend the SMCR to all other financial services firms. It has issued a series of consultation papers on the proposed rules and transition to the new regime, and it anticipates finalising the rules in the course of 2018, with a view to implementation in 2019[28].

While the extended SMCR retains key elements of the regime as applicable to banking firms, the FCA has adopted a proportional approach to implementation for the rest of the industry.

Proportional Approach

The FCA's proportional approach to implementing the SMCR means that non-banking firms subject to the new regime are divided into three categories: "core regime," "limited scope" and "enhanced regime" firms[29]. The core requirements will apply to all firms, except the limited-scope firms. Enhanced regime firms will be subject to additional requirements, which are discussed further below.

The Core Regime

The "core regime" consists of three main elements: Senior Managers Regime; Certification Regime; and Conduct Rules.

28 CP17/25 Individual accountability – extending the SMCR to all FCA firms & CP17/40 Individual accountability – transitioning FCA firms and individuals to the SMCR
29 See, for example, CP17/25 page 9

Senior Managers Regime

An FCA-authorised firm will need to obtain prior approval by the FCA for the most senior staff members whose roles include the performance of "Senior Management Functions," such as:

- the Chairman function (SMF9)
- the Chief Executive function (SMF1)
- the Executive Director function (SMF3)
- the Partner function (SMF27)
- the Compliance Oversight function (SMF16)
- the Money Laundering Reporting Officer function (SMF17).

The Senior Managers Regime applies to anyone who performs a Senior Management Function, whether that person is in the UK or overseas:

- Statement of Responsibilities: Firms must prepare a Statement of Responsibilities with respect to each Senior Manager and provide this to the FCA when a Senior Manager applies to be approved and when there is a significant change to his responsibilities.
- Duty of Responsibility: Senior Managers will be subject to a duty of responsibility. This means that, if a firm is in breach of its obligations under the FCA's rules or principles, the Senior Manager for the area in which the breach took place could be held accountable.
- Prescribed Responsibilities: The FCA proposes seven "Prescribed Responsibilities" for core firms as follows:
  - PR1 – performance by the firm of its obligations under the Senior Managers Regime, including implementation and oversight
  - PR2 – performance by the firm of its obligations under the Certification Regime
  - PR3 – performance by the firm of its obligations in respect of notifications and training of the Conduct Rules
  - PR4 – responsibility for the firm's policies and procedures for countering the risk that the firm might be used to further financial crime
  - PR5 – responsibility for the firm's compliance with the Client Assets Sourcebook (CASS) (if applicable)
  - PR6 – responsibility for ensuring that the governing body is informed of its legal and regulatory obligations
  - PR7 – responsibility for an authorised fund manager's value for money assessments, independent director representation and acting in investors' best interests.

Firms will be required to assign each of the Prescribed Responsibilities to a Senior Manager. Each Prescribed Responsibility should be given to the Senior Manager who is the most senior person responsible for that area. Generally, a Prescribed Responsibility should be held by only one person.

Certification Regime

The Certification Regime will apply to employees who are not Senior Managers, but whose roles mean that it is possible for them to cause significant harm to the firm or its customers. The FCA will not approve certified staff, but firms will need to assess and certify the fitness and propriety of the certified staff to perform their roles.

Conduct Rules

The individual Conduct Rules will apply to all staff, except certain ancillary staff, such as receptionists, cleaners and catering staff.

The Conduct Rules are divided into two tiers, the first tier being applicable to all staff and the second tier being applicable to Senior Managers only.

The individual Conduct Rules applicable to all staff (save the specified exempt categories of staff) are:

- You must act with integrity.
- You must act with due care, skill and diligence.
- You must be open and cooperative with the FCA, the Prudential Regulation Authority (PRA) and other regulators.
- You must pay due regard to the interests of customers and treat them fairly.
- You must observe proper standards of market conduct.

The Senior Manager Conduct Rules applicable to Senior Managers only are:

- SC1 – You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
- SC2 – You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.
- SC3 – You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
- SC4 – You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

Fitness and Propriety

A key feature of the SMCR is to reinforce the obligation of firms to take responsibility for the fitness and propriety of staff to perform their professional duties.

The Enhanced Regime

The largest and most complex firms (fewer than 1 per cent of firms regulated by the FCA) will be subject to certain additional requirements under the Enhanced Regime.

Enhanced firms will need to apply all of the requirements under the Core Regime, as well as:

- Additional Senior Management Functions: The FCA proposes to apply six additional Senior Management Functions. These include the Chief Finance Function (SMF2), the Chief Risk Function (SMF4) and the Chief Operations Function (SMF24).
- Additional Prescribed Responsibilities: In addition to the seven core Prescribed Responsibilities, the FCA proposes to apply an additional seven Prescribed Responsibilities that must be allocated to Senior Managers in enhanced firms. These include “Compliance with the rules relating to the firm’s Responsibilities Map,” “Safeguarding and overseeing the independence and performance of the compliance function (in accordance with SYSC 6.1),” and “Developing and maintaining the firm’s business model.” Certain of these additional Prescribed Responsibilities should be allocated to Non-Executive Directors (NEDs).

- Overall Responsibility: There must be a Senior Manager with overall responsibility for every area, business activity and management function of the firm.
- Responsibilities Maps: Enhanced firms will need to have a single document that sets out the firm's management and governance arrangements. This includes how the Prescribed Responsibilities have been allocated, details as to who has overall responsibility for the firm's activities, and details of individuals' and committees' reporting lines.
- Handover Procedures: A person who is becoming a Senior Manager will need to be given all the information and material that they could reasonably expect in order to do their job. The FCA proposes that firms must have in place a policy explaining how they comply with this requirement, and maintain adequate records of the steps that they have taken.

Non-Executive Directors

Where a firm has a Chairman, this individual will be a Senior Manager (SMF9). However, the proportional implementation of the SMCR means that currently no other NED is required to be approved as a Senior Manager. Under the FCA's proposal, NEDs will be subject to all of the individual Conduct Rules, as well as SC4 (the requirement to disclose appropriately any information of which the regulator would reasonably expect notice). In addition, firms will be required to comply with the requirements for regulatory references, fitness and propriety, and criminal records checks.

The Legal Function

The Law Society published a response to the FCA's consultation on the extension of the SMCR[30]. It reiterated its position on the importance of excluding the legal function from the SMCR and welcomed the FCA's indication that it intends to issue a full consultation on the topic. Currently, the general counsel position within a firm is potentially "in scope" of the SMCR. The Law Society states that including the legal function within the regime raises significant risks for both clients and solicitors, including (i) erosion of legal professional privilege, (ii) in-house lawyers being placed in positions of conflict with their employers and (iii) the prospect of dual regulation for some lawyers.

Transitional Arrangements

The FCA published a separate consultation paper on the transitional arrangements for firms moving to the new regime at the end of 2017[31].

In overview, the FCA is proposing to automatically convert individuals from the Approved Persons Regime to the SMCR. This means that the majority of firms will not need to submit applications to convert approved persons to Senior Managers. Firms can instead focus on embedding the cultural changes that the new regime introduces and making sure that their staff receive appropriate training on the new regime. Responses to the consultation are required by 21 February 2018.

The FCA has recently sought to play down the effects of the extension of the SMCR and to alleviate fears among the 47,000 companies that will shortly be caught by the regime by telling them that the rules are "good for business."[32] While firms will need to invest appropriate resources to ensure that they comply with the new rules, it will be interesting to see how effective the SMCR is and how much appetite the regulator has to use it to hold senior individuals to account.

30 http://www.lawsociety.org.uk/policy-campaigns/consultation-responses/individual-accountability-extending-the-senior-managers-certification-regime-to-all-fca-firms-law-society-response/

31 https://www.fca.org.uk/publications/consultation-papers/cp17-40-individual-accountability-transitioning-fca-firms-and-individuals-senior-manager

32 FCA moves to calm concerns about new accountability regime, *Financial Times* 20 September 2017

4. Industry codes of conduct

In November 2017, the FCA issued a consultation paper[33] setting out its proposed approach to supervising adherence to proper standards of market conduct for unregulated markets and activities, including standards set out in industry-written codes of conduct. A discussion paper relating to a possible extension of the scope of Principle 5 to cover the unregulated activities of authorised firms was also issued. The consultation appears to be a welcome attempt by the regulator to clarify the scope of its powers and expectations in relation to the unregulated activities of authorised firms.

In the introduction to the consultation paper, the FCA states that firms and their staff should be clear about the FCA's expectations of good conduct. The FCA recognises, however, that for markets and activities not covered by regulatory rules and FCA Principles, its expectations may not be clear. CP17/37 makes the following proposals:

1) Adopting a new "general approach" to supervising and enforcing its SMCR rules (see above) for unregulated markets and activities, including those covered by industry-written codes of conduct. The FCA said that it expects firms and their senior management to consider market codes in determining the proper standard of market conduct as part of the SMCR requirements – for example, individual conduct rule 5, certification and regulatory referencing – and obligations, including in industries where the FCA does not have a framework of its own rules. The FCA will monitor adherence to the SMCR rules and noted that it may take enforcement action in cases of serious and egregious misconduct that leads to harm or potential harm.

2) To publicly recognise particular industry codes of conduct that, in the FCA's view, set out proper standards of market conduct for unregulated markets and activities. This proposed approach means that the FCA will review and assess industry codes against new criteria and then publicly state that it considers a particular code to be a helpful explanation of the proper standard of market conduct for a particular market/ activity. The FCA considers that this approach should encourage participants to adhere to the relevant code, although it notes that it does not intend to give any such code binding regulatory status.

Industry-led and internationally agreed codes of conduct published by the FCA should provide both clarity and reassurance to firms and individuals alike that they are following appropriate guidance. As with many amendments to regulation there are, however, possible pitfalls relating to such codes of conduct; for example, might firms be held to a higher standard of account than they otherwise might have been where an industry code "gold plates" certain standards?

CP17/37 also discusses the possibility of extending the application of Principle 5 of the FCA's Principles for Businesses (which requires firms to observe proper standards of market conduct) to unregulated activities.

The FCA states that an extension to Principle 5 would both help to clarify expectations of firms while at the same time giving it a greater ability to commence enforcement action for misconduct. In particular, the FCA notes that the proposed extension would help ensure that expectations of firms in respect of their market conduct relating to unregulated activities are brought to the equivalent standard as that expected of individuals (i.e., that action can be taken in respect of conduct relating to unregulated activities[34]).

Feedback on the consultation paper is required by 5 February 2018, following which the FCA expects to publish a policy statement.

33 CP17/37: Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5
34 See the FCA's Code of Conduct rule 2.1.5

5. EU regulatory developments

The following explores some of the key regulatory changes relevant for 2018, including the changes brought about by MiFID II; the changes arising from the EC's review of the Capital Markets Union in relation to the marketing of alternative investment funds; proposals for amendments to the Short Selling Regulation to make it more transparent, reduce risks and ensure common regulatory approach across member states; a legislative proposal to amend EMIR; introducing simpler and more proportionate rules on over-the-counter (OTC) derivatives that will reduce costs and burdens without compromising on financial stability; and preparedness for the reporting obligations under the Securities Financing Transactions Regulation (SFTR).

1. MiFID II — Key Areas Affecting Asset Managers

The revised Markets in Financial Instruments Directive (2014/65/EU) and the new Markets in Financial Instruments Regulation ((EU) 600/2014) (together with the secondary legislation issued pursuant to the same, MiFID II) came into force on 3 January 2018.

MiFID II replaced, and materially expanded, the earlier framework for the regulation of financial markets and the provision of investment services in the EU. The new regime will push the EU significantly closer to the goal of harmonised regulation of the operation of financial markets, and a number of the rules are directly applicable across the EU. In an effort to bring about harmonised regulatory practice in respect of MiFID II requirements, the European Securities and Markets Authority (ESMA) has issued substantial guidance on the proper interpretation of key provisions, which is reflected in the FCA rules.

However, a fully harmonised legal and regulatory framework has not been politically achievable. Consequently, the full impact of MiFID II implementation on firms will ultimately depend on the views and approach of their "home regulator". The full market impact of the new rules is expected to unfold in the course of this year (and beyond) as firms undertake a broad spectrum of approaches to their implementation of the new rules. Guidance is expected to continue to be provided by the regulators, which may result in adjustments to implementation by some firms. The following sets out a summary overview of the FCA's rules in some key areas of MiFID II generally affecting investment managers.

Inducements and Research[35]

MiFID II tightens the rules applicable to UK and other EU investment firms authorised under MiFID on incentives. The pre-MiFID market practice of research provided by brokers being effectively "paid" for through execution costs is prohibited under MiFID II. Instead, investment managers are required to pay "hard dollars" for investment research in accordance with the new rules.

In order to receive investment research under MiFID II, investment research has to be paid for out of the manager's

35 Articles 23 and 24 of Directive 2014/65/EU ("MiFID II") and Recitals 26 to 30 and Articles 11, 12 and 13 of the Commission Delegated Directive (EU) of 7.4.2016 C(2016) 2031 ("MiFID II Delegated Directive")

own resources or otherwise from a research payment account (RPA) controlled by the manager and funded through a specific research charge to the client based on a pre-agreed budget.

Where an RPA is used to pay for research, managers are required to (a) set and regularly assess a research budget, and agree a research charge with the board of the fund (or its general partner); (b) adopt detailed procedures for valuing research; (c) disclose the research budget and estimated research charge to existing and potential investors; and (d) provide annual disclosures of research charges to investors.

Most of the major asset managers have elected to absorb the cost of research. While, for the time being, the approach taken by the small and medium-sized managers has varied considerably, it is likely that greater investor pressure on research costs will ultimately result in an industry standard forming based on investor expectations. In any case, the practical implementation of the requirements on research unbundling will continue to evolve, reflecting the global nature of investment business.

Separately, the greater emphasis based on restricting the benefits received by managers and their staff members from brokers and service providers has caused some confusion as to where the limit should be drawn in terms of entertainment or hospitality received: What can properly be considered to constitute a minor non-monetary benefit that will not compromise the manager's ability to act in the best interests of its clients? Again, it is expected that there will be an impact on corporate hospitality but the precise boundaries of the new regime will likely be tested in the course of 2018.

Best Execution[36]

MiFID II requires investment managers to put in place more granular and instrument-specific best execution policies than previously. The focus will be on ensuring that managers have adequately considered how and whether best execution is achieved, monitoring of best execution processes and outcomes, and a dynamic compliance function that actively identifies issues and recommends improvements where necessary. For example, where executing orders or taking a decision to deal in OTC products, firms must assess whether the price quoted to clients is "fair" by developing systematic checks to undertake appropriate valuation and taking into account market data on comparable products (where available).[37] MiFID II aims to improve transparency of execution quality of different execution venues. In order to achieve this, firms are now required to publish data annually on their top five execution venues and/or brokers for each class of financial instrument, including trading volume.[38]

In addition, firms must publish specific information annually on the quality of execution obtained from their execution venues and brokers, including an analysis of specific factors that might affect the investment firm's execution behaviour (e.g., payments, discounts, rebates or non-monetary benefits made and received over the previous year).[39]

Furthermore, firms now cannot receive payments for order flow, since this would result in a conflict of interest and would amount to a banned inducement.[40]

Disclosure[41]

MiFID II stipulates enhanced disclosure requirements for firms carrying on investment business that is MiFID business (among other things, in relation to risks, conflicts, costs and charges).

With respect to costs, firms will be required to provide a client with full information on costs and associated charges, including, as applicable, the total price to be paid by the client in connection with the designated investment or the designated investment business, including all related fees, commissions, charges and expenses.

36 Article 27 of MiFID II
37 Article 64(4) of the MiFID II Commission Delegated Regulation of 25.4.2016 (MiFID II Delegated Regulation)
38 Article 27(6) of MiFID II, Article 65(6) of the MiFID II Delegated Regulation and Article 3 of Commission Delegated Regulation (EU) of 8.6.2016, C(2016) 3333 ("RTS 28")
39 Article 27(5) of MiFID II, Article 3(3) of RTS 28 and Article 65(6) of the MiFID II Delegated Regulation
40 Article 27(2) of MiFID II
41 MiFID II Article 24

Conflicts of Interest[42]

MiFID required firms to consider, prevent and manage conflicts of interest that potentially arise between firms and clients. MiFID II strengthens this basic framework by providing more detailed and prescriptive guidance for firms to deal with potential conflicts of interest. For example, firms are now required to consider all risks of a conflict of interest, rather than just "material risks" as was the case under MiFID. Also, firms will be required to maintain a conflicts-of-interest policy that specifies procedures to be followed and measures to be adopted in order to prevent, as well as manage, conflicts of interest.

MiFID II further requires firms to place more reliance on managing, rather than merely disclosing, potential conflicts of interest. Firms must ensure that disclosure to clients of conflicts is a "measure of last resort"[43] that can be used only when the firm's organisational and administrative arrangements cannot adequately manage conflicts.

Where disclosure is made, it is now subject to additional mandatory requirements.[44] Senior management at firms are required to receive written reports on a frequent basis, and at least annually, on the situations in which there is a conflict of interest entailing a risk of damage to the interests of one or more clients.

What next?

There is no question that MiFID II changes the regulatory landscape for firms and regulators alike. Firms will need to develop new ways of doing business, and they must continue to monitor regulatory publications closely as guidance continues to evolve and develop. As with the implementation of any new rules, unforeseen consequences can occur, and it will be interesting to see how the regulators respond to this and try to ensure that the objectives of MiFID II are met while still making sure that Europe and the UK continue to be, and are perceived to be, open for business.

2. Marketing of investment funds

In spring 2018, the EC is expected to publish a legislative initiative on reducing barriers to cross-border distribution of alternative investment funds and Undertakings for the Collective Investment of Transferable Securities (UCITS). The initiative forms parts of the EC's Capital Market Union action plan. The action plan envisages, among other things, improving the functioning of the single market for EU investment funds by reducing national regulatory barriers to the cross-border distribution of funds. The EC has identified these barriers to include differing marketing requirements/practices; the imposition of local agent; additional national disclosure requirements; differing and non-transparent regulatory fees; inefficient procedures for updating notifications; a lack of transparency regarding national requirements; and, more broadly, a lack of support for online and direct distribution.

The reduction of these barriers is expected to result in a more fully integrated European market for investment funds that will reduce market fragmentation, bring greater economies of scale and increase competition across the EU. It is expected that one of the outcomes of the action plan is that the EC will provide a harmonised definition for "pre-marketing" and reverse solicitation under the Alternative Investment Fund Managers Directive.

3. Short-selling regulation

ESMA has reviewed the Short Selling Regulation ((EU) 236/2012) (SSR) and has recommended various improvements for the SSR to the EC. The SSR lays down a common regulatory framework with regard to the requirements and powers relating to short selling of shares and sovereign debt (including the use of credit default swaps) and ensures greater coordination and consistency between Member States. The SSR aims to enhance transparency, reduce certain risks associated with short selling and ensure a common regulatory approach across member states.

The recommended improvements notably include:

- building a centralised notification and publication system across Europe

42 MiFID II Article 16(3), 23; MiFID II Delegated Regulation Section 3
43 MiFID II Delegated Regulation Preamble (48)
44 Article 34(4) and (5) of the MiFID II Delegated Regulation

- amending the market-making activities exemption to include various types of on-venue market-making activities described in MiFID II in the definition of market-making activities. In addition, ESMA proposes not requiring any membership requirement for OTC market-making activities and suggests introducing reporting obligations for market makers.

4. EMIR

The EC's proposals for amendments to EMIR are expected to progress through the legislative process during 2018 and be adopted by the end of the year. The amendments aim to introduce simpler and more proportionate rules on OTC derivatives that will reduce costs and burdens for market participants without compromising on financial stability. Currently, the clearing obligation and the risk mitigation obligations under EMIR apply to financial counterparties regardless of the size of their positions in derivative contracts, whereas the application to non-financial counterparties is predicated on the size of their positions in derivative contracts (calculated on a group basis).

The proposed amendments seek to redefine the scope of the clearing obligation for financial counterparties to ensure that all market counterparties who should properly be included in the scope are so included, while recognising that full compliance is likely to be excessively onerous for the smallest financial counterparties. The amendments extend the concept of differential application of EMIR on the basis of the aggregate position size that already applies to non-financial counterparties (which can be divided into NFC+ and NFC- categories) to financial counterparties. In addition, the proposed amendments should streamline the EMIR reporting requirements, making the application requirements more proportionate to the size, type and complexity of the counterparties by considerably reducing the administrative burden on the smallest financial counterparties. Finally, the amendments allow more time for pension funds to develop clearing solutions.

The EC has also introduced a further set of amendments to EMIR, which focus on harmonising the approach to the supervision of EU central counterparties (CCPs), to ensure further supervisory convergence and accelerate certain procedures.

The proposal also ensures closer cooperation between supervisory authorities and central banks responsible for EU currencies. To achieve this, a newly-created supervisory mechanism will be established within ESMA that will be responsible for ensuring a more coherent and consistent supervision of EU CCPs, as well as a more robust supervision of CCPs in non-EU countries, or 'third countries'. For non-EU CCPs, the proposal builds on the existing third-country provisions in EMIR and will make the process to recognise and supervise third-country CCPs more rigorous for those that are of key systemic importance for the EU. The aim is to address important challenges in derivatives clearing as its scale and importance grows and to take account of the role played by third-country CCPs in the clearing of financial instruments relevant to EU financial stability. The proposal introduces a new "two tier" system for classifying third-country CCPs. Non-systemically important CCPs will continue to be able to operate under the existing EMIR equivalence framework. However, systemically important CCPs (so-called Tier 2 CCPs) will be subject to stricter requirements.

5. Securities financing

Over the course of 2018, firms will need to take steps to prepare for the reporting obligation under the SFTR to report details of their SFT to an approved EU trade repository. The obligations largely replicate the EMIR reporting model and require the reporting of details regarding SFTs concluded by all market participants, whether they are financial or non-financial entities, including the composition of the collateral, whether the collateral is available for reuse or has been reused, the substitution of collateral at the end of the day and the haircuts applied.

Depending on the type of reporting counterparty (e.g., investment firms, central security depositories and UCITS), the SFT reporting obligations enter into force between 12 and 21 months after the EC approves the reporting obligation regulatory technical standards, which is expected to occur some time in the first quarter of 2018.

6. Enforcement action in relation to MiFID II

Firms need to be aware of the FCA's position on enforcement action in relation to the implementation of MiFID II[45].

The FCA has noted two key points in this context:

More Information Means Broader Reach

Wider information will be available to the FCA in relation to the data and information being collected under both MAR[46] and MiFID II. The FCA believes that this will shape its enforcement work for the better. For example, in addition to capturing transaction reporting data, the FCA is developing its capacity to collect and aggregate order book data from all venues using a cloud-based platform. This could allow it to read across venues and markets to enable it to gain a better view of wholesale markets.

The FCA Executive Director of Enforcement and Market Oversight, Mark Steward, has said:

"Our aim is to be able to collect this data on a daily basis from all venues and all cash markets, enabling us to segregate order flows by firms and trader, and given the additional data sets that we will collect under MiFID II, with the introduction of legal entity identifiers, by client also. We will also have plans to expand the scope of this collection to other markets in the future. It will be a powerful tool that will provide substantial regulatory benefit in the public interest."[47]

The FCA anticipates that these developments will enable it to make assessments (virtually in real time) and enable it to understand the markets with greater precision. It is also hoped that they will reduce false positives in data requests to firms and enable the FCA to detect serious misconduct earlier, especially in relation to suspected manipulation of the markets. The increased information will also shape FCA work in relation to supervision and policy assessments.

Proportional Approach

The FCA has noted that it will take a proportional approach in relation to firms' implementation of MiFID II by 3 January 2018. The FCA has said:

"We have no intention of taking enforcement action against firms for not meeting all requirements straight away where there is evidence they have taken sufficient steps to meet the new obligations by the start date;[48] however, the FCA cannot *"create a floor for compliance below the required MiFID II standards."*[49]

45 "A better view " (speech, Mark Steward, 20 September 2017)
46 Market Abuse Regulation (EU) No 596/2014
47 "A better view " (speech, Mark Steward, 20 September 2017)
48 "A better view " (speech, Mark Steward, 20 September 2017)
49 "A better view " (speech, Mark Steward, 20 September 2017)

It seems likely that the FCA will focus its resource towards those firms that are considered to have greater impact or higher risk in this area and/or are perceived as having deliberately flouted the requirements.

It will be interesting to see how effective the FCA is in utilising the additional information that it believes will be available to it and whether it has systems capable of synthesising the information in a manner that enables it to act quickly. Firms should certainly not assume that the information submitted is not likely to be reviewed and possibly relied on by the regulator in future enforcement action. Firms should also not be sanguine about having failed to achieve implementation by 3 January 2018 — there is no question that the FCA will consider enforcement action if there has been clear disregard of the due date.

7. Anti-money laundering developments

The FCA's focus on financial crime and AML has been a continuing theme for some years now, and was again emphasised in the FCA's 2017/18 Business Plan and in recent enforcement action[50]. Regulated firms are required to maintain robust and risk-focused AML systems and controls, and to promote a culture that supports these controls and that impresses on staff the importance of complying with them.

New Legislation

The key development in 2017 was the coming into force of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs), implementing the Fourth Money Laundering Directive[51]. The MLRs replace the Money Laundering Regulations 2007 and the Transfer of Funds (Information on the Payer) Regulations 2007. The MLRs seek to close certain gaps in the earlier legislation and require firms to adopt a more risk-based approach towards AML. Changes include:

- amendments to customer due diligence procedures; there is no longer an automatic entitlement to apply simplified due diligence for particular clients; firms will need to assess the risk in relation to each client and take a view as to whether simplified due diligence is appropriate
- the need for firms to prepare written risk assessments in relation to risk of money laundering and terrorist financing, keep them updated and make them available to the regulator on request
- the extension of the definition of "Politically Exposed Person" (PEP) to include domestic PEPs
- rather than having a list of "equivalent jurisdictions," the EC will identify high-risk, non-EU countries, with firms required to apply enhanced due diligence when dealing with people or entities associated with these countries.

50 See enforcement roundup
51 Directive (EU) 2015/849

New Technology

The FCA has been exploring ways for firms to embrace technology in their fight against financial crime. In August 2017, the FCA published the findings of a survey that it commissioned on emerging technologies with the potential for enhancing financial firms' work to detect and prevent money laundering.[52] The report's key findings included:

- On-boarding and maintenance: Many firms have considered or trialled new technologies, with utility technologies perceived as the most popular.
- Client screening: Firms were focussed on using analytics techniques and machine learning to increase the accuracy of screening rates to diminish the impact of false positives.
- Transaction monitoring: This was considered to be the area in which new technologies could be most influential, particularly in using data analytics, machine learning and natural language processing to enable firms to spot suspicious transactions and assess risk in real time.
- Reporting and management information: This could be enhanced through the use of data visualisation techniques to allow firms to gain insights into their customer base and better manage their AML operations.

The FCA report concluded, "It is clear that new and emerging technologies have genuine potential to have a transformative impact on AML compliance, both in helping to prevent money laundering and in reducing the cost of compliance. However, it is equally clear that substantial barriers to widespread adoption exist, which may well continue to limit the progress of ongoing innovation in AML compliance."[53]

Firms need to be alert to the risks of financial crime as it continues to evolve and innovate. It is clear that the FCA is open to firms considering new technology in order to make themselves as resilient as possible to criminals who are developing new techniques in their quest to launder the proceeds of crime, but this must be balanced against the regulatory requirements. This is a fast-moving area — both in terms of the crimes that can be committed and the technological solutions that are being developed to address them — and one hopes that the regulator can support firms to keep ahead.

FCA Outlines Lessons Learned in Year One of its Regulatory Sandbox

Given the FCA's focus on "technological change and resilience," it seems appropriate to reflect on the progress being made by the FCA's Regulatory Sandbox (Sandbox) approximately one year after its launch. The Sandbox enables firms to test innovative products, services or business models in a live user environment while ensuring that appropriate protections are in place. It was established to support the FCA's objective of promoting effective competition in the interests of consumers.

Since the Sandbox opened in June 2016, the FCA has received 146 Sandbox applications of which 50 were accepted and 41 progressed to testing[54]. The FCA considers that the key benefits of the Sandbox are the following:

- The Sandbox has helped reduce the time and cost of getting innovative ideas to market. Around 90 per cent of firms that completed testing in the first cohort have progressed toward a wider market launch.
- Testing in the Sandbox has helped facilitate access to finance for innovators. Such testing can help firms access funding by providing more certainty to prospective partners and investors; at least 40 per cent of firms that tested in the first cohort received investment, either during or following their Sandbox tests.
- The Sandbox has enabled products to be tested and introduced to the market. Firms have used Sandbox tests to assess commercial viability and how receptive consumers are to pricing strategies, communication channels, business models and the technologies themselves[55].

Additionally, the FCA's report highlights a number of the challenges faced by firms in conducting their tests within the Sandbox. These include accessing banking services and smaller firms struggling to acquire customers to take part in their tests.

52 New technologies and anti-money laundering compliance, FCA, 31 March 2017 (published 02/08/17)
53 New technologies and anti-money laundering compliance, FCA, 31 March 2017 (published 02/08/17)
54 https://www.fca.org.uk/news/press-releases/financial-conduct-authority-outlines-lessons-learned-year-one-its-regulatory-sandbox
55 https://www.fca.org.uk/news/press-releases/financial-conduct-authority-outlines-lessons-learned-year-one-its-regulatory-sandbox

The FCA seems to be generally satisfied with the progress of the Sandbox. Christopher Woolard, Executive Director of Strategy and Competition, FCA, said:

"The FCA's Regulatory Sandbox has been a first for regulators worldwide and we are pleased it has met a genuine demand from innovators. We have seen tests across the full range of sectors that we regulate and I'm pleased that the majority of firms that have tested products in the sandbox have gone on to take their innovation to market. It is important that we continue to evaluate the success of our interventions so that we can identify areas where improvements can be made to help both firms testing and ultimately the consumers they are serving."[56]

The regulator has, however, admitted that it has had limited success attracting investment firms to its campaign to drive innovation; most of the firms involved are fintech companies and banks working in cryptocurrencies and payment processing. Christopher Woolard, speaking a fortnight after the above press release was published, said that the Sandbox had received "relatively few applications from asset managers", despite the regulator being keen to accept them[57]. The FCA's plea for more asset managers to join the Sandbox comes as it faces criticism from some in the financial regulatory and technology world, who have questioned whether the FCA's intervention in the marketplace is making things better or worse. Although the FCA notes that it is too early to draw conclusions on the overall impact of the Sandbox, it does seem to demonstrate that the FCA is seeking to "keep up with the times" and, given that we are living in a world of constant technological development, its ambition in this area should be encouraged.

8. FCA investigations — a quiver full of arrows?

The FCA is taking a new approach to its investigations — it will not use investigations as a precursor to contemplated enforcement action when something has gone wrong, but rather as a tool for finding out what has happened[58].

The change in approach to investigations follows the Andrew Green QC Report on the enforcement actions following the failure of HBOS, in which the Financial Services Authority (FSA) (the predecessor to the FCA) was criticised for taking only those cases that it believed it could win. The report stated that:

"The FSA, when considering whether or not to conduct an investigation of an individual, would attempt to assess the likelihood of winning subsequent disciplinary proceedings against the individual, i.e., such disciplinary proceedings as would be brought after an investigation had been concluded. The problem with this approach was the difficulty in accurately evaluating the prospects of success in disciplinary proceedings before an investigation had even begun. This approach, therefore, had a tendency to discourage the FSA from starting investigations even though the threshold test for investigating was met and even though the public importance of investigating was high."[59]

56 https://www.fca.org.uk/news/press-releases/financial-conduct-authority-outlines-lessons-learned-year-one-its-regulatory-sandbox
57 *Financial News* – Setting the agenda for the City, 13 November 2017 p9
58 "Our investigations – the evolving approach" (speech by Jamie Symington, FCA Director of Investigations 15 June 2017)
59 Report into the FSA's enforcement actions following the failure of HBOS, by Andrew Green QC, November 2015

The FCA now sees its investigative assessment as one where, although not every case that technically crosses the threshold will lead to investigation, an analysis will be applied to assess the harm or potential harm to market users, and, in that context, it will make a decision as to whether it is appropriate to open an investigation.

The FCA has emphasised that it does not apply numerical thresholds and metrics, but assesses each case on its merit.

The FCA acknowledges that a necessary result of the change of approach is that more investigations will be open, and it has noted that there has been an approximate 75 per cent increase in investigations over the past year[60].

The FCA has said that:

"There must be rigour in ensuring that our resources are deployed most efficiently and effectively in progressing investigations to the point where we can decide what the regulatory response should be . . . secondly, there needs to be a recognition that it is likely that proportionately fewer of our investigations will progress to disciplinary enforcement action."[61]

The FCA has positioned its shift in approach as one that promotes fairness and transparency, and is focussed on finding out what happened when a problem arises. However, any investigation for a firm or an individual is unlikely ever to feel like a neutral, non-adversarial proceeding.

The FCA has limited resources, and the rise in investigations will increase pressure on existing staff, which has, anecdotally at least, led to delays in progressing investigations. The FCA has indicated that the lack of increased resources will not hamper it, but rather cause it to "become vastly more efficient, strategic and focused"[62]; however, this has yet to be seen.

More investigations will also mean additional pressure on resources for firms as they deal with the investigation process, which will likely require at least some document review and preparation, as well as attendance at interviews for key staff. Legal advice is also likely to be sought. The impact of an investigation on individuals can be severe, since they are often excluded from their workplace until the outcome of the investigation is known. If they are not supported by their firm, the financial costs of being involved in an investigation can be crippling.

The FCA may have changed its approach to investigations, but it will take some time for the industry perception of an FCA investigation to change. After all, few in the industry have yet had the experience of an FCA investigator whose "mind at the start of an investigation, should be a quiver of arrow-like questions rather than a disposition or view as to what the outcome needs to be."[63] Firms and individuals will need to be prepared for more investigations and resource themselves accordingly. While enforcement action following an investigation may not be seen as "inevitable," it will still remain a real risk.

60 "A Better View" (speech by Mark Steward, FCA Director of Enforcement 20 September 2017)
61 "Our investigations – the evolving approach" (speech by Jamie Symington, FCA Director of Investigations 15 June 2017)
62 "A Better View" (speech by Mark Steward, FCA Director of Enforcement 20 September 2017)
63 "A Better View" (speech by Mark Steward, FCA Director of Enforcement 20 September 2017)

9. Challenges to privilege

As firms have increasingly hired external law firms to conduct internal investigations, they have often assumed that any interviews conducted by the law firm with the firm's employees would attract privilege (particularly if these were investigations conducted after a notice of investigation had been received from the regulator). However, two recent cases have illustrated that the courts may take a narrower approach to privilege — particularly in relation to material relating to internal investigations. Firms should take careful note of this change in approach, since material once considered to be privileged may no longer be so protected.

Royal Bank of Scotland Rights Issue Litigation[64]

In the Royal Bank of Scotland (RBS) Rights Issue Litigation, the High Court held that lawyers' notes of interviews with the bank's employees were not privileged and protected from disclosure in litigation because the employees were not "clients," and the notes were not lawyers' working papers. The fact that the interview notes were prepared in the U.S. and may have been privileged under U.S. law did not matter, since the High Court held that the matter had to be determined according to English law.

As part of the RBS Rights Issue Litigation, the bank claimed privilege over notes and other records of 124 interviews with current and former bank employees by in-house and external lawyers, undertaken as part of two investigations. It was accepted that there was no litigation privilege, since litigation was not in contemplation at the time the notes were taken. RBS argued that the interview notes were protected because:

- They were subject to legal advice privilege.
- They were lawyers' privileged working papers.
- Under U.S. law, the interview notes were privileged.
- The court has discretion to withhold the documents on the basis that they were privileged under U.S. law.

Hildyard J followed the Court of Appeal decision in Three Rivers (No 5) [2003] QB 1556 and ruled against RBS. The key findings concerning the scope of legal advice privilege were the following:

- Legal advice privilege is confined to communications between lawyers and clients for the purposes of giving or receiving legal advice. The interview notes comprised information-gathering from employees preparatory to, and for the purpose of, enabling the bank to seek and receive legal advice. Additionally, the bank's employees and former employees were not the client for the purpose of legal advice privilege. Instead, they were providers of information (which was gathered by the lawyers). While a client is an individual capable of seeking and receiving legal advice, it should not be assumed that this extends to all of a company's management and employees, however senior.

64 [2016] EWHC 3161 (CH)

- The test in relation to lawyers' privileged working papers was whether the documents give a clue as to the trend of advice being given by a lawyer to his client. This should be distinguished from a note that merely records the substance of a conversation, even if this contains a lawyer's line of enquiry.
- While the court accepted that the interview notes would probably be protected by privilege under U.S. law, it was the approach of the English Court to apply the law of the forum to issues of privilege.
- Although it was accepted that the court retains discretion not to order disclosure or inspection of an otherwise disclosable document, the court declined to exercise such discretion in this instance. The court held that it would have required an exceptional concern (for example, that disclosure could lead to destruction of evidence) in order to exercise this discretion.

Serious Fraud Office v. Eurasian Natural Resources Corporation[65]

Shortly after the RBS Rights Issue Litigation, the Serious Fraud Office (SFO) case against Eurasian Natural Resources Corporation (ENRC) sought further clarification regarding the boundaries for privilege in the context of corporate internal investigations. In addition to legal advice privilege, and unlike the RBS case described above, the dispute also involved a claim of litigation privilege.

Following allegations of fraud, bribery and corruption, ENRC and the SFO engaged in dialogue over certain of ENRC's activities in Kazakhstan and Africa. Concerned about the allegations of criminal conduct, and during the period of dialogue, ENRC commenced its own internal investigations, employing solicitors and other professionals to conduct information-gathering exercises. The SFO then commenced a formal criminal investigation and used its powers to compel the production of documents. ENRC countered that certain categories of documents were protected from disclosure because they were privileged. The SFO applied for a declaration that these documents were not subject to legal professional privilege.

Mrs. Justice Andrews rejected all but one of ENRC's claims for privilege, holding that the claims for litigation privilege failed for a variety of reasons:

- Reasonable anticipation of a criminal investigation did not amount to reasonable anticipation of litigation. Criminal proceedings were not even a distinct possibility, let alone a real prospect, at the time the documents were created (although the court did, however, leave open the possibility that there may be cases in which an expectation of an investigation can be equated with a reasonable contemplation of prosecution).

65 [2017] EWHC 1017 (QB)

- Litigation privilege applies only to documents that are prepared for the sole or dominant purpose of conducting litigation (and not to documents produced with the purpose of enabling advice to be taken in connection with anticipated litigation or how to avoid contemplated litigation).
- The fact that ENRC had proposed to show to the SFO much of what it had done was detrimental, since litigation privilege could not attach to documents intended to be shown to a litigation adversary.

ENRC also argued that the lawyers' notes were covered by legal advice privilege. The court concluded that there was no evidence that any of the persons interviewed were authorised to seek and receive legal advice on behalf of ENRC. The Judge followed the approach of Hildyard J in the RBS Rights Issue Litigation and considered that Three Rivers set down a general test as to who could constitute the client for the purposes of legal advice privilege. Unlike Hildyard J, however, Mrs. Justice Andrews had little hesitation in applying the Three Rivers test, stating that an extension of the privilege to all employees would put a corporate client in a more protected, legally advantageous position than an individual. The fact that this area of law remains controversial was, however, recognised, and this was, no doubt, a factor in ENRC recently being granted leave for appeal.

The Law Society has confirmed in a press release[66] that it intends to seek permission to intervene in order to put forward arguments on behalf of solicitors because it considers that the judgment significantly narrows the scope of privilege as it applies to internal investigations once criminal proceedings are a prospect. The Law Society noted that it is impelled to act as it recognises the profound implications for when companies and their employees are protected by privilege. The Law Society president, Joe Egan, said:

“The case has profound implications for when and how companies and their employees are protected by privilege. Without the protection of legal professional privilege, firms may find it difficult to conduct effective internal investigations. If the ruling is upheld, it potentially has the perverse effect of discouraging firms from self-reporting for fear of the consequences.”

These decisions are of significance to all corporates involved in both domestic and cross-border investigations and litigation. It is clear that the courts are continuing to take a narrow approach in determining whether material may be privileged, particularly in criminal proceedings, and firms will therefore need to be alert to this. Blanket claims to privilege are likely to give rise to challenge. The fact that the Law Society has sought to intervene is welcome, although it remains to be seen whether this will have any impact. In the meantime, firms should give careful consideration to how interviews are managed and conducted, including the role of their lawyers in this process and how far privilege can truly be said to extend.

66 http://www.lawsociety.org.uk/news/press-releases/law-society-in-bid-to-intervene-in-landmark-privilege-case/

10. Key FCA enforcement cases in 2017

We have seen a number of developments in the way in which the FCA has approached enforcement in 2017. As noted in an earlier article, one of the key changes has been the shift in the FCA's approach to opening investigations. The FCA will now investigate where the statutory threshold is met and whether it is in the public interest, rather than also taking into account at the outset whether it is a case that it could win.

The FCA continues to focus on market abuse cases, stating that:

"High-profile enforcement cases have helped raise awareness of market abuse risks, and we have seen improvements in firms' conduct and culture. Participants in the equity markets generally have sophisticated systems and controls to manage market abuse. However, ensuring the positive tone from the top reaches all levels, and that clear accountability is in place, remains a challenge."[67] Notably, the FCA went on to say, "Within some institutions, we have identified weaknesses in systems and controls and governance arrangements to mitigate the risks of market abuse. Poor culture may be a driver of risk, particularly in areas where there has previously been limited or no oversight. Given the difficulty of monitoring, cross-venue manipulation is also a significant concern…"[68]

2017 saw the FCA place particular focus on market abuse cases involving capital markets. The Tesco case discussed below involved the FCA using its powers under s.384 of FSMA for the first time to require a listed company to pay compensation to investors for market abuse. The FCA also fined Tejoori Limited ("Tejoori") for failing to inform the market of inside information as required by Article 17(1) MAR. The cases against the individuals involved in the Worldspreads Limited matter show that the FCA will also hold individuals to account where they have been involved in disseminating false and misleading information relating to publicly listed companies. We can anticipate an increased number of cases against individuals as the SMCR beds down for banks and insurers, and is then rolled out to the wider financial services industry.

In addition to these key areas of regulatory focus (market abuse, investigations into senior individuals and financial crime), in this enforcement roundup, we consider the Supreme Court's judgment in respect of third-party rights; a breach of the FCA's disclosure and transparency rules; failing to comply with the FCA's Principles for Businesses (PRIN); a breach of reporting requirements under EMIR; systems and controls failings; the Court of Appeal's decision relating to Ms. Angela Burns; and complaints made against the FCA.

During the course of this year, we can expect more investigations, and more action against senior individuals, which is likely to lead to more cases being referred to the Upper Tribunal as individuals are less likely to settle cases with the regulator than firms. We also expect to see firms and individuals beginning to utilise the new options in

67 FCA sector views (April 2017): wholesale financial markets
68 FCA sector views (April 2017): Areas of focus: market abuse

the enforcement decision-making process (for example, the opportunity to "leap frog" the Regulatory Decisions Committee and proceed directly to the Upper Tribunal or contest only part of a decision through "focussed resolution agreements").

With the vast number of regulatory changes taking place in financial services with the introduction of MiFID II, GDPR and Brexit planning, it is important that firms do not lose sight of the continuing importance that the FCA places on culture and accountability, as well as firms' values. The FCA continues to consider culture at the heart of regulatory failings and will hold firms and individuals to account using enforcement action as a tool where required.

Market Abuse Remains a Top Priority for the FCA

Tesco plc and Tesco Stores Limited[69]

The FCA has, for the first time in its history, used its powers to order a listed company to compensate investors for market abuse failings. Tesco plc ("Tesco") and its subsidiary Tesco Stores Limited ("Tesco Stores") were found to have committed market abuse by giving a false or misleading impression about the value of publicly traded Tesco shares and bonds in a trading update. The firms were ordered to pay compensation to investors, anticipated to be in the region of £85 million plus interest.

The compensation scheme followed an announcement that Tesco Stores had entered into a deferred prosecution agreement (DPA) with the SFO relating to false accounting and, as a result, was required to pay a fine of £128,992,500. The FCA did not impose a financial penalty on Tesco Stores and does not propose to impose any additional sanction on it for market abuse.

Background

On 29 August 2014, Tesco published a trading update that stated, among other things, that it expected its trading profit for the six months ending 23 August 2014 to be approximately £1.1 billion ("August trading statement"). A month later, on 22 September 2014, Tesco published a further trading update ("September trading statement") in which it announced that it had identified an overstatement of its expected profit for the half year. This was said to be principally due to the accelerated recognition of commercial income and delayed accrual of costs, and was in the region of some £250 million. Having completed its investigation, the FCA found that the Tesco board relied on inaccurate accounting information provided to it by Tesco Stores. The FCA found that both Tesco and Tesco Stores knew, or could reasonably have been expected to have known, that the August trading statement was false or misleading.

The FCA concluded that the information in the August trading statement gave a false or misleading impression as to the value of Tesco's listed shares and bonds, leading to those shares and bonds trading at a higher price than they otherwise would have done. Following the September trading statement, the price returned to a level that was not substantially affected by the August trading statement. Therefore, in the period between the August and September trading statements, purchasers of Tesco shares and bonds suffered a loss (the overpayment they made for the shares or bonds, less any amount by which this loss was mitigated).

The FCA did not impose a financial penalty on the companies in acknowledgement of the cooperation shown in both the FCA and SFO investigations, the fact that Tesco Stores will pay a substantial penalty as part of the DPA and the steps taken by both companies to ensure that such misconduct would not occur in the future.

The FCA noted:

"The two companies have been proactive in the offering of information and have responded promptly and constructively to requests made of them. Furthermore, both refrained, at the FCA's request, from interviewing witnesses or taking statements; they disclosed voluntarily material which appeared to them to be significant to the FCA's enquiries; and they generally helped to facilitate a swift conclusion to the FCA's enquiries."[70]

69 FCA Final Notice 28 March 2017
70 FCA Final Notice 28 March 2017

This case is an example of the importance that the FCA is placing on investigating market abuse in capital markets, and it seems likely that the FCA will bring more cases of this nature in the future, with one example being the recent reports that the FCA is investigating the shockprofit warning issued by Mitie Group. This would certainly seem to indicate that the FCA has the appetite to pursue more of these matters as part of its overarching strategic objective to ensure that relevant markets function well.

Tejoori Limited[71]

The FCA imposed a fine of £70,000 on Tejoori, an AIM investment company, for failing to inform the market of inside information as required by Article 17(1) MAR.

Tejoori is a self-managed, closed-ended investment company whose shares were traded on AIM between 24 March 2006 and 5 December 2017. In December 2006, Tejoori acquired a 16.7 percent shareholding in BEKON Holding AG ("BEKON"), a renewable energy company based in Germany. The BEKON shareholders' agreement included a "drag-along" provision that could be used by majority shareholders to require other shareholders to sell their BEKON shares in the event of a takeover. Over time, Tejoori's holding in BEKON was diluted to 10.1 percent. Tejoori's interim results, published in February 2016 for the six months ending 31 December 2015, valued its investment in BEKON at US$3.35m.

On 12 July 2016, Tejoori was notified by BEKON about a compulsory acquisition of its shares by Eggersmann Gruppe GmbH & Co. KG ("Eggersmann"). The drag-along notice required Tejoori to sign a sale and purchase agreement (SPA) under which it would sell its BEKON shares to Eggersmann for no initial consideration, but with the possibility of receiving deferred consideration, depending on future projects. A spreadsheet prepared by BEKON suggested that, in the best case scenario, Tejoori might receive up to EUR 1.15m over five years. This was significantly less than Tejoori's valuation of its investment in BEKON. Tejoori's board mistakenly believed that it would not have to transfer the BEKON shares until it received the deferred consideration and that, as a result, the value of its investment would not change simply by entering into the SPA.

The information about the sale to Eggersmann was inside information and, under Article 17(1) MAR, Tejoori was required to disclose the information as soon as possible. Additionally, issuers must ensure that the inside information is made public in a manner that enables fast access and complete, correct and timely assessment of the information by the public.

Tejoori did not make an announcement on the transaction, although both BEKON and Eggersmann issued press releases announcing the acquisition on 11 August 2016. The press releases made no reference to Tejoori so the market was unaware of the terms. Without knowing these details, the market speculated, in online bulletin boards, about the amount that may have been paid to Tejoori. The bulletin board discussions regarded the sale as a positive development for Tejoori and its share price rose sharply on 22 and 23 August 2016, increasing 38 per cent over the two days.

The London Stock Exchange contacted Tejoori's nominated advisor (Nomad) on 23 August 2016 to query the sudden rise in price and Tejoori informed the Nomad that it did not hold any inside information and that it had not sold its shares in BEKON. This was based on a misunderstanding of the legal effect of the SPA. The Nomad only obtained clarification of the correct position when Tejoori's German legal adviser subsequently informed it that Tejoori had indeed sold its BEKON shares.

Tejoori ultimately released an announcement on 24 August 2016, which confirmed that it had sold its BEKON shares for no initial consideration and that it was unable to assess, at that time, whether it would receive any future consideration. Tejoori's share price closed 13 per cent down on the day of the announcement.

The FCA found that although on 12 July 2016 the draft "drag-along" notice and SPA had not been signed, Tejoori was, at that time, in possession of inside information regarding the shareholding in BEKON. Tejoori breached Article 17(1) MAR because it did not release an announcement about its shareholding in BEKON as soon as possible after

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becoming aware that there was a reasonable expectation that it would be required to sell its shares in BEKON for no initial consideration and with only a possibility of receiving deferred consideration that was materially lower than Tejoori's valuation of its investment. This was particularly so, given that this information materially differed from that in its last public announcement on 5 February 2016.

Mark Steward, FCA Executive Director of Enforcement and Market Oversight, said: "Tejoori's failure to promptly disclose inside information misled the market in Tejoori's shares and prevented investors from making fully informed investment decisions. This was a serious breach. Issuers must have regard to their disclosure obligations at all times and misunderstanding the commercial reality of a transaction is no excuse."

The amount of the fine took into account the mitigating factors that Tejoori had notified the FCA of its breach of Article 17(1) MAR and that it had provided an account of events and co-operated fully with the investigation. However, aggravating factors included that the board received a briefing on 5 June 2016 on its obligations under the AIM Rules, including that the board must notify the market without delay of any new developments that are not public knowledge that, if made public, would lead to a substantial movement in share price. Further, as the Tejoori case is the first action taken by the FCA under MAR, the regulator has sought to make a point about the consequences of such a mistake through the level of fine that it has imposed. Before adjustment for deterrence, the FCA had calculated that the appropriate level of penalty to impose was £8,617. This was increased to £100,000 to achieve credible deterrence, although Tejoori settled at an early stage of investigation to qualify for a 30 percent discount.

Christopher Niehaus[72]

The FCA has imposed a fine of £37,198 on Christopher Niehaus, a managing director at Jefferies International Limited ("Jefferies") for disclosing client confidential information over the informationsharing platform Whatsapp in order to impress a friend and another Jefferies client.

Mr. Niehaus was an experienced and senior employee of Jefferies, responsible for European Industrial groups in Jefferies' Investment Banking division. As part of his role, he had regular access to confidential information, including information regarding the forthcoming deals in which Jefferies' clients would be involved. The FCA found that, on a number of occasions between 24 January 2016 and 16 May 2016, Mr. Niehaus used Whatsapp to share confidential information regarding two of Jefferies' clients, with both a third Jefferies' client and a friend. The FCA also found that he had communicated confidential information during a social gathering.

The details of the information that Mr. Niehaus shared included the identity of the client, the details relating to the client mandate and the fee that Jefferies would charge for its involvement in the transaction. Mr. Niehaus also boasted about how he might be able to pay off his mortgage if one of the deals was successful.

Mr. Niehaus told the FCA that the purpose of these communications was simply to impress the recipients, and the FCA found that neither Mr. Niehaus' friend nor Jefferies' client, to whom disclosure was made, actually dealt in the

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securities about which Mr. Niehaus had provided information. The FCA also found that Mr. Niehaus had not expected them to deal in these securities when he disclosed the confidential information.

The FCA determined that Mr. Niehaus had acted without due skill care and diligence. The disclosure of information about one client's prospective rights issue to a competitor was considered to be particularly serious, since it might have provided the recipient with a unique commercial advantage and represented a failure to pay due regard to the interests of clients.

In terms of the penalty, the FCA considered Mr. Niehaus' misconduct to be at level three (applying the five-step framework) in terms of seriousness. The reasons for this included the fact that Mr. Niehaus acted deliberately and abused a position of trust, although this was countered by the lack of profit and unlikely impact on the integrity of the market. The FCA's starting figure was therefore 20 per cent of Mr. Niehaus' income over the previous 12 months. The FCA then reduced this figure by 15 per cent in recognition of Mr. Niehaus' continuous cooperation during the investigation, including his prompt and detailed answers during an interview under caution. Mr. Niehaus also agreed to settle during the Stage 1 settlement period, which meant that the resulting financial penalty was £37,198.

The case is an example of the FCA taking significant action against an individual where there was neither actual nor attempted market abuse or insider dealing. It also demonstrates the regulator's zero tolerance approach toward market abuse and the importance that the FCA attaches to individuals needing to act with the utmost integrity.

Wall Street Traders Using Encrypted Apps for Illicit Messages

On a similar note, concern is said to be growing in the Federal Bureau of Investigation that Wall Street traders are using encrypted apps to hide illicit communications from compliance programmes and regulators. This behaviour is illustrated in a recent complaint brought by the Securities and Exchange Commission (SEC) and a U.S. attorney in Manhattan against a former Bank of America IT worker, Daniel Rivas (and six others)[73]. Mr Rivas is said to have used a messaging app to pass encrypted, self-destructing messages to certain friends about corporate takeovers. Trading then took place on the basis of the inside information obtained.

It is clear that regulators are alert to shifting technologies as people seek to use communication channels that are more difficult to trace — the question is whether the regulators have the capacity to get ahead of these technologies, rather than simply reacting to them.

Niall O'Kelly[74] and Lukhvir Thind[75]

The FCA has fined former Worldspreads Limited ("WSL") Chief Financial Officer Niall O'Kelly £11,900 and former Financial Controller Lukhvir Thind £105,000 for engaging in market abuse and has permanently banned them both from performing any function related to regulated activity. WSL, which operated a spread betting business, collapsed in March 2012.

73 *Securities and Exchange Commission v. Daniel Rivas, et al.,* No. 17-cv-06192) (S.D.N.Y., filed August 16, 2017)
74 Final Notice 7 April 2017
75 Final Notice 7 April 2017

In August 2007, the holding company of WSL, Worldspreads Group ("WSG"), floated on the Alternative Investment Market of the London Stock Exchange. Mr. O'Kelly was closely involved in drafting and approving the admission documentation for the flotation, which contained materially misleading information and omitted key information that investors would have needed in order to make an informed decision about the company. The FCA also found that Mr. O'Kelly helped to manage an undisclosed "internal hedging" strategy at WSL by using fake client trading accounts and the unauthorised use of actual client trading accounts. By doing this, he artificially inflated assets on WSG's balance sheet.

In the Annual Accounts for 2010 and 2011, Mr. O'Kelly and Mr. Thind were said to have knowingly falsified critical financial information concerning WSL's client liabilities and its cash position, which was passed to the company's auditors. This meant that material shortfalls in WSL's client money position were concealed from investors. By 31 March 2011, these misstatements amounted to £15.9 million. WSL was unable to meet this client money liability, which ultimately led to its collapse in 2012.

Mr. O'Kelly's penalty was reduced significantly (from £468,756 to £11,900), since he was able to produce verifiable evidence that payment of the penalty proposed by the FCA would cause him serious financial hardship. Both individuals cooperated with the FCA's investigation and admitted market abuse.

Mark Steward, Executive Director of Enforcement and Market Oversight, said: "Mr. Thind and Mr. O'Kelly deliberately and repeatedly disseminated false and misleading information relating to a publicly listed company. Their actions amounted to serious market abuse, undermining the integrity of our markets and this will not be tolerated."

"It is to Mr. Thind's credit that he, eventually, raised concerns to the WSL Board and that both he and Mr. O'Kelly co-operated with our investigation and admitted market abuse."[76]

Investigations into Senior Individuals

The FCA continues to stress the importance that it attaches to individual responsibility and accountability; the clearest example of this in practice is through the extension of SMCR to the wider financial services industry, which we discuss above. The following case summary is in relation to a matter determined under the existing Approved Persons Regime, but is informative as to the FCA's approach to the responsibilities of senior individuals.

On 8 August 2017, the Upper Tribunal maintained the FCA's decision to ban Charles Palmer, former CEO of Financial Limited and Investments Limited (the "Firms"), from performing FCAsignificant influence functions[77]. The Tribunal also upheld the FCA's decision to impose a financial penalty of £86,691 on Mr. Palmer.

Mr. Palmer was the majority shareholder and CEO of Standard Financial Group Limited, and a director and de facto CEO of the Adviser Network, which comprised these Firms. The network operated nationally and, at its peak in March 2011, consisted of 397 appointed representatives (ARs) and 516 registered individuals (RIs). Between 24 February 2010 and 20 December 2012, the Firms' ARs and RIs collectively provided advice to approximately 40,000 customers.

The Upper Tribunal agreed with the FCA that Mr. Palmer failed to act with due skill, care and diligence (therefore breaching Principle 2 of the Statement of Principle for Approved Persons) in carrying out his role of director and de facto CEO of the Firms. The Upper Tribunal also agreed with the FCA that Mr. Palmer's failings were particularly serious in light of findings made against him by the FCA's predecessor, the FSA, in a Final Notice on 24 February 2010 and Mr. Palmer's failure to respond adequately to the failings found in that Notice.

Among other findings, the 2010 Notice found that Mr. Palmer had failed to take reasonable steps to ensure that Financial Limited's business was organised in such a way that it could be controlled effectively, both in relation to oversight and monitoring of its ARs and RIs and during a period of rapid expansion of Financial Limited's network of ARs and RIs under the business model that Mr. Palmer established.

76 https://www.fca.org.uk/news/press-releases/fca-bans-and-fines-two-individuals-market-abuse
77 *Charles Anthony Llewellen Palmer v The Financial Conduct Authority,* [2017] UKUT 0313 (TCC)

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

“Mr. Palmer’s conduct fell well below the standards the FCA would expect of a senior manager of an authorised firm. His conduct was made worse by the fact that he did not learn lessons from and address the failings highlighted to him in 2010.”[78]

What is particularly noteworthy about this decision is the way in which the Upper Tribunal analysed the failings of Mr. Palmer as an FCA-approved senior manager and how some common themes from recent FCA publications and speeches pervaded the judgment. For example, it was stated that there was insufficient challenge at board level; the number of nonexecutive directors was insufficient; while CEOs clearly need to delegate day-to-day responsibility for areas such as risk and compliance, they must retain a competent grasp of the regulatory requirements (which Mr. Palmer did not do); and the firm’s culture, as set from the top, was inappropriate. Many of these findings are key features of the recently introduced SMCR, and this decision is a timely reminder of the strict approach that the FCA is adopting in respect of individual accountability.

Failing to Comply with the FCA’s Principles for Businesses

The FCA publicly censured Capita Financial Managers Limited (CFM) on 10 November 2017[79]. While CFM was not ordered to pay a penalty, it will pay up to £66 million to investors who suffered a loss as a result of investing in a fund that was liquidated in late 2012.

The Guaranteed Low Risk Income Fund, Series 1 (which later became known as the Connaught Income Fund, Series 1) (the “Fund”) was an unregulated collective investment scheme (UCIS), which commenced operation in March 2008. Its aim was to provide short term bridging finance to commercial operators in the UK property market. CFM was the operator of the Fund until it resigned on 25 September 2009, approximately three years before the Fund went into liquidation (3 December 2012).

The FCA found that CFM breached PRIN 2 because it failed to act with the appropriate level of skill, care and diligence. In particular, CFM did not undertake adequate due diligence on the Fund prior to taking it on; allowed monies to be invested in the Fund despite its developing concerns that the Fund’s Information Memoranda (IM) were not clear, fair and not misleading; and failed to monitor the Fund adequately to ensure that the Fund’s contractual counterparties were operating in accordance with their contractual obligations.

In addition, CFM was found to have breached PRIN 7 because it failed to communicate with the Fund’s investors in a way that was clear, fair and not misleading. The FCA noted that CFM approved IMs which contained a number of inaccuracies, omissions, and unclear or potentially misleading statements, such as describing the Fund as “low risk” and “guaranteed” and naming a particular firm as auditor when that firm had not, in fact, been instructed.

Ordinarily, the FCA said, such failings would have resulted in the imposition of a financial penalty of £15 million. However, the regulator took account of the fact that CFM itself would not have been able to make a payment up to £66 million[80] for the benefit of the Fund’s investors if a financial penalty were also imposed. For this reason, the FCA decided that it would not be appropriate to require CFM to pay a financial penalty and, instead, issued a public censure only to CFM. The FCA said that a public censure and CFM’s payment for the benefit of the Fund’s investors supports the regulator’s operational objective of securing an appropriate degree of protection for consumers.

The FCA’s Executive Director of Enforcement and Market Oversight said: “Consumers are entitled to expect that authorised firms will carry out their responsibilities under our Principles for Businesses with care and diligence. These responsibilities are paramount and in this instance CFM failed badly. The aim of the payment announced today is to return the amount originally invested, placing investors as closely as possible back into the position they would have been in if they had never invested in the Fund.”

78 https://www.fca.org.uk/news/press-releases/upper-tribunal-upholds-fca-decision-fine-and-ban-charles-palmer-former-ceo
79 https://www.fca.org.uk/news/press-releases/capita-financial-managers-pay-66-million-benefit-investors-connaught-income-fund-series-1
80 In addition to an £18.5m settlement payment (with assistance from CFM’s parent, Capita plc) that was made to the Fund’s investors in January 2016

Breaches of Disclosure and Transparency Rules

On 17 October 2017, the FCA published its Final Notice against Rio Tinto plc ("Rio Tinto")[81] for breaching the Disclosure and Transparency (DTR) Rules. In addition to the £27,385,400 fine issued by the FCA, the firm and two former senior executives are facing fraud charges, filed by the SEC, in the United States.

The FCA found that Rio Tinto breached the DTR by failing to carry out an impairment test, and to recognise an impairment loss, on the value of mining assets based in the Republic of Mozambique when publishing its 2012 interim results. The firm acquired the assets in August 2011 for US$ 3.7 billion. Had Rio Tinto complied with its obligation to carry out the test, a material impairment would have been required to have been disclosed at the time of its 2012 half-year financial reporting. The FCA found that Rio Tinto's financial reporting was therefore inaccurate and misleading; this continued until 17 January 2013, when Rio Tinto announced an impairment of the Mozambique assets, writing off approximately 80 per cent of the value of the investment in the Mozambique mine.

When Rio Tinto acquired the Mozambique mine, its valuation was based on a plan to move rapidly into coal production. This plan assumed that Rio Tinto would be able to barge coal from the mines down the Zambezi River to the coast for export. Prior to half-year 2012, it became apparent that Rio Tinto would not be able to barge the coal to the coast as planned and that higher cost alternatives would be needed to transport coal for export. Rio Tinto began to carry out financial modelling of its mining business, which indicated that the value of the Mozambique assets, based on the best information available at that time, was negative.

Despite the modelling results, Rio Tinto decided that it would not carry out an impairment test as required by international accounting standards to assess whether an impairment was required to be recorded in its financial reporting of its 2012 half-year interim results. Instead, Rio Tinto decided that there was a lack of clarity around how it would develop the mines, which made it premature to revalue these assets. For this reason — and in the FCA's view — wrongly, Rio Tinto decided that it was appropriate to continue to value the mining assets at the acquisition price.

The FCA determined that this demonstrated a serious lack of judgment. There were indicators of impairment for the Mozambique assets, which meant that Rio Tinto was required to carry out an impairment test. Consequently, the FCA imposed a financial penalty on Rio Tinto in the amount of £27,385,400.

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

"The UK listing regime requires listed companies to adhere to high standards of disclosure and transparency. Rio Tinto should have been aware of its obligation to carry out the impairment test and the resulting material impairment should have been reported to the market at its half year results in 2012. Reflecting the size of the company, this is the largest fine imposed to date by the FCA for a breach of rules relating to a firm's official listing and demonstrates how vitally important high standards of disclosure and transparency are to ensuring our markets function fairly and effectively." [82]

81 Final Notice 17 October 2017

82 https://www.fca.org.uk/news/press-releases/rio-tinto-plc-fined-%C2%A327m-breaching-disclosure-and-transparency-rules

The firm agreed to settle at an early stage in the investigation and therefore qualified for a 30 per cent reduction in penalty. Were it not for this discount, the FCA would have imposed a financial penalty of £39,122,007. The FCA acknowledged the assistance from, and collaboration with, both the SEC and the Australian Securities and Investments Commission. The case is another example of an increasing trend of UK and overseas regulators working together to bring successful prosecutions with serious impact for firms.

Failing to Report Exchange Traded Derivative Transaction

In 2017, the FCA took its first enforcement action against a firm for failing to report details of trading in exchange-traded derivatives under EMIR, fining Merrill Lynch International (MLI) £34,524,000[83].

The FCA noted that reporting exchange-traded derivatives assists authorities in addressing and assessing risk inherent in financial systems caused by a lack of transparency. The reporting requirement was considered one of the key reforms introduced following the financial crisis to improve transparency within financial markets. MLI apparently failed to report 68.5 million exchange-traded derivative transactions between 12 February 2014 and 6 February 2016.

The FCA acknowledged that MLI was open and cooperative and assisted in the investigation, as well as taking quick steps to remediate the breach; however, it observed that MLI had been the subject of two earlier and related transaction reporting cases.

The FCA Executive Director of Enforcement and Market Oversight, Mark Steward, said, “It is vital that reporting firms ensure that their transaction reporting systems are tested as fit for purposes, adequately resourced, and perform properly. There needs to be a line in the sand. We will continue to take appropriate action against any firm that fails to meet the requirement.”[84]

Financial Crime Continues to Demand FCA Time and Resource

The recent enforcement action brought against Deutsche Bank AG (“Deutsche Bank”)[85] reinforces the FCA’s commitment to tackle cases of financial crime. As well as highlighting Deutsche Bank’s alleged failings, the Final Notice makes some useful practical suggestions on areas for firms to focus on in their quest to comply with the appropriate rules and regulations.

The FCA found that Deutsche Bank failed to maintain an adequate AML control framework from the beginning of 2012 to the end of 2015. The FCA fined the firm £163 million — the largest financial penalty ever imposed by the FCA for AML control failings.

83 Final Notice 18 October 2017
84 https://www.fca.org.uk/news/press-releases/fca-fines-merrill-lynch-failing-report-transactions
85 Final Notice 30 January 2017

The FCA alleged that Deutsche Bank failed to oversee properly the formation of new customer relationships and the booking of global business in the UK. As a consequence, Deutsche Bank was apparently used by unidentified customers to transfer approximately US$ 10 billion, of unknown origin, from Russia to offshore bank accounts. While it was not proven that Deutsche Bank's customers, or their underlying clients, were laundering the proceeds of crime, the way the trades were conducted, in addition to their scale and volume, was deemed to be highly suggestive of financial crime.

The FCA found deficiencies throughout Deutsche Bank's AML control framework. As a result of these failings, Deutsche Bank was said to have failed to obtain sufficient information about its customers to inform the risk assessment process and to provide a basis for transaction monitoring.

The failings allowed the front office of Deutsche Bank's Russia-based subsidiary ("DB Moscow") to execute more than 2,400 pairs of trades that mirrored each other ("mirror trades") between April 2012 and October 2014. The mirror trades involved the following arrangement:

- A Russian customer of DB Moscow bought liquid Russian securities from DB Moscow and paid in Roubles.
- A non-Russian customer of Deutsche Bank London, who had been on-boarded by DB Moscow, sold the same securities to Deutsche Bank London for U.S. dollars. Sometimes the trades would be booked on the same day.
- The trades in London were booked remotely by DB Moscow.

Trademarks of the transactions included customers trading on behalf of underlying clients; the entities being connected to each other, usually by common ownership; a frequent lack of commercial rationale for the trades; and the customers often losing money in fees.

The FCA said that customers could be on-boarded by overseas Deutsche Bank offices as clients of Deutsche Bank UK without the involvement or oversight of the UK's front office. Additionally, it was said to be common practice for trades to be executed into Deutsche Bank's trading book by traders not based in the UK, with the risk of leaving those trading activities outside the oversight and supervision of the UK entity.

The FCA held that Deutsche Bank had breached Principle 3 of the FCA's Principles for Businesses by failing to take reasonable steps to organise its affairs responsibly and effectively, with adequate risk management systems. Additionally, Deutsche Bank was said to have breached SYSC rules, which require a firm's AML control framework to be comprehensive and proportionate to the nature, scale and complexity of its activities and the firm's ability to identify, assess, monitor and manage its money laundering risk.

The FCA emphasised that Deutsche Bank had been extremely cooperative, had promptly notified it following the discovery of the mirror trades and had taken significant steps to assist the regulator in its investigation. The FCA also acknowledged that the firm was continuing to undertake remedial action and had committed significant resources to improving its AML control framework.

The action taken by the FCA reinforces the importance of multinational businesses ensuring that their policies and procedures are properly joined up. In particular, it highlights the following:

- Business units and individuals that are responsible for AML compliance must clearly understand their roles and responsibilities.
- Firms should take note of FCA action brought against other firms, as well as relevant guidance.
- Firms should rely on the customer due diligence of another firm only in the circumstances permitted by the relevant rules; allowing one office in one jurisdiction to on-board customers for another is, out of necessity, high-risk.
- Firms must ensure that their detailed policies properly address all elements of Know Your Client (KYC), not only to apply the right level of due diligence, but to understand the broader picture, especially around source of funds, beneficial owners and expected business patterns.
- IT systems must ensure that the whole picture on customers and transactions is available (and avoid separate repositories that do not interact with one another).

- There must be clear and allocated responsibilities for monitoring and flagging issues. In particular, where concerns or queries are raised, they must be properly followed through.
- Firms should be appropriately resourced.
- Systemic AML failings are not necessarily due to one person or one small group, but it is critical to impose appropriate responsibility so that it is clear who should be ensuring compliance.

Systems and Controls Failings

In December 2017, the FCA fined Bluefin Insurance Services Limited ("Bluefin") £4m for having inadequate systems and controls and failing to provide information to its customers about Bluefin's independence in a way that was clear, fair and not misleading[86].

Between 9 March 2011 and 31 December 2014, Bluefin, a large insurance broker that was wholly owned by the insurer AXA UK Plc during this time, held itself out to be "truly independent" in the advice that it provided and the insurers that it recommended to customers.

However, Bluefin failed to implement adequate systems and controls to manage the conflict that arose from Bluefin's ownership. Bluefin's independence was compromised by its culture which promoted business strategies, including a policy which focused on increasing the business placed with its parent company, over treating customers fairly.

Bluefin brokers did not disclose this policy, so customers risked being misled into believing that they were dealing with a broker who would conduct an unbiased search of the market.

Mark Steward, Executive Director of Enforcement and Market Oversight, said:

"Insurance brokers must promote a culture in which they act in their customers' best interests and provide them with the information they need to make an informed decision. This is central to the relationship between the industry and its customers.

It is also unacceptable that firms hold themselves out as independent when they are not."

The action taken by the FCA against Bluefin reflects one of the regulator's key messages that customers should be placed at the very heart of an authorised firm's business. Firms should heed this warning and review their policies and procedures to ensure that they consider what is best for the customer and do not act in a manner, or promote certain behaviours that could put this in jeopardy.

Third-Party Rights – A Judgment That Puts an End to the Ambiguity?

The long-running case between Achilles Macris and the FCA has finally ended with the Supreme Court[87] overturning the decisions of the Court of Appeal and Upper Tribunal; it was held that Mr. Macris had not been "identified" in certain enforcement notices and was therefore not entitled to third-party rights.

The case emerged from the FCA's action against JP Morgan Chase Bank NA (the "Firm") in respect of losses in its Synthetic Credit Portfolio arising from the so-called "London Whale" trades. The FCA fined the Firm £137 million and set out its detailed findings in decision and final notices issued to the Firm, which criticised the conduct of "CIO London Management."[88]

At the time, Mr. Macris was head of the Chief Investment Office International at the Firm and had regulatory oversight of the Synthetic Credit Portfolio. Mr. Macris complained that, although he had not been identified by name or job title in the notices, the FCA had prejudicially identified him by referring to "CIO London Management." Mr. Macris said that he was entitled to third-party rights under s.393 of the FSMA and therefore should have had the opportunity to make representations to the FCA in relation to the notice prior to publication.

86 https://www.fca.org.uk/publication/final-notices/bluefin-insurance-services-limited-2017.pdf
87 FCA v Macris [2017] UKSC 19
88 Final Notice 18 September 2013

The Upper Tribunal and Court of Appeal

The Upper Tribunal[89] found for Mr. Macris, holding that the references to "CIO London Management" would be taken by a reader with relevant experience to refer to the most senior individual involved. The Upper Tribunal formulated a two-part test whereby (i) it is necessary to determine whether the terms of the notice refer to a specific individual and, if so, (ii) could those references be seen to be referring to anyone other than that individual (which may also be ascertainable through "external material")? The Upper Tribunal noted that a number of the references in the notices were to an individual (for example, through conversations, attending meetings, sending emails and participating in calls).

The Court of Appeal[90] agreed that the notices had identified Mr. Macris, but based its reasoning on whether the relevant audience ("persons acquainted with Mr. Macris, or who operated in his area of the financial services industry") would have been able to identify him from publicly identifiable information, including a U.S. Senate Committee Report. The court concluded that individuals operating in Mr. Macris's field would reasonably have been able to identify him from statements made in the notices in conjunction with publicly available material. The FCA appealed the decision to the Supreme Court.

The Supreme Court

On 22 March 2017, the Supreme Court[91] found that Mr. Macris had not been identified in the notice.

In the majority judgment, Lord Sumption held that the test requires express identification by name or "synonym" — such as office or job title — provided that the synonym can refer to only one individual who is identifiable from the notice itself or publicly available information. Lord Neuberger expanded this test, stating that an individual will be identified in a document if (a) his position or office is mentioned, (b) he is the sole holder of that position or office, and (c) reference by members of the public to freely and publicly available sources of information would easily reveal the name of that individual by reference to his position or office. In relation to (c), Lord Neuberger said that any investigation should be "straightforward and simple" and not require "any detective work."

Lord Wilson, dissenting, argued for an "ordinary market operator" test that provided a greater balance between regulatory efficiency and protection of individual rights, which he said was the intention of s.393 FSMA. Lord Wilson's test proposed that an individual is identifiable if an ordinary operator in the same sector of the market, with access to information freely available in the public domain, would be able to identify an individual in a notice. He emphasised that the individual is likely to experience the greatest damage from FCA criticism in the market sector in which he works.

89 *Achilles Macris v. Financial Services Authority,* FS/2013/0010
90 *FCA v. Macris* [2015] EWCA Civ 490
91 *FCA v. Macris* [2017] UKSC 19

Practical implications

The Supreme Court's decision was welcomed by the regulators, who were potentially facing the task of making changes to their enforcement procedures, including rewording warning and decision notices if the Court of Appeal's ruling had been upheld. It is less welcome by those in industry, with many preferring the proposal put forward by Lord Wilson rather than that adopted by Lord Sumption. Given the split judgment, and the arguable remaining ambiguity, it will be interesting to see who may have future appetite to challenge the regulator's approach in this area.

Court of Appeal Affirms Upper Tribunal Decision and Awards Costs in Conflict of Interest Case

In *Burns v The Financial Conduct Authority*[92], the Court of Appeal dismissed the FCA's appeal against the Upper Tribunal's decision to award Ms. Burns costs of £100,000 plus VAT, despite Ms. Burns being unsuccessful in her proceedings overall and having been found guilty of serious misconduct.

The basis of the Upper Tribunal's award – upheld by the Court of Appeal – was that the FCA had acted unreasonably by pursuing against Ms. Burns the very serious allegation that she had made a demand for corrupt payments. The reinstatement of this allegation was said to have unreasonably increased the gravity of claims against Ms. Burns and contributed significantly to her legal costs. The Court of Appeal also upheld the Upper Tribunal's decision to fine Ms. Burns £20,000 and prohibit her from holding the CF2 (NED) controlled function (an already significantly better outcome for Ms. Burns than the original findings of a £154,800 fine and complete prohibition from performing regulated activities).

The Upper Tribunal made this award pursuant to rule 10(3)(d) of the Tribunal Procedure (Upper Tribunal) Rules 2008[93], which permits the Upper Tribunal to make an order in respect of costs "if it considers that a party or its representative has acted unreasonably in bringing, defending or conducting the proceedings". The Upper Tribunal considered the FCA's conduct to be unreasonable on the basis of it having reinstated an allegation, which had previously been considered and rejected by the Regulatory Decisions Committee, without sufficiently cogent supporting material capable of leading to a different outcome.

The basis of the regulator's initial case was that Ms. Burns had misused her positions as an NED to seek to advance her own commercial benefits while failing to disclose certain conflicts of interest. Ms. Burns was found by the Upper Tribunal, confirming the regulator's earlier decision, to have acted without integrity as a NED in breach of Statement of Principle 1 of the Statements of Principle for Approved Persons (APER) by failing to disclose a conflict of interest.

Ms. Burns appealed against the Upper Tribunal's decision on the basis that (i) it had failed to apply the correct standard of conduct in finding that she had breached the duties that she owed to the two mutual societies of which she was appointed a NED, and (ii) in reaching the decision that she lacked integrity and was not fit and proper to hold the CF2 position, it had wrongly taken into account matters that had not been pleaded by the regulator in its statement of case. The FCA also appealed against the costs order on the basis that it was extremely rare for costs to have been awarded to a losing party and one who had been found guilty of serious misconduct.

The Court of Appeal dismissed both appeals, upholding the Upper Tribunal's earlier decisions and the legal analysis on which they were based. The case serves as an example that challenging the regulator can be worthwhile in appropriate circumstances. Ms. Burns achieved a substantial reduction of both her financial penalty and the scope of her prohibition, together with a significant contribution towards her costs.

92 [2017] EWHC Civ 2140 (21 December 2017)
93 SI 2008 No. 2698

Complaints Against the FCA

There have been a number of instances this year where successful complaints have been brought against the FCA.

Not Answering the Question

The Complaints Commissioner found in favour of a member of the public who made a complaint regarding a suggestion made to the FCA in respect of implementing a new policy for obtaining quotations for car insurance[94].

The complainant was concerned that it took too long to obtain insurance quotations when making requests from more than one company. An alternative was suggested whereby a consumer would complete a written questionnaire, which could then be sent to insurance companies of their choice. The FCA's Customer Contact Centre provided a prompt response stating that it would pass the suggestion to the FCA Insurance Policy team, but noted that it would not be able to provide feedback on the suggestion. The individual was not content with this response, citing that, if the FCA would not accept the suggestion, then a reason should be given. The correspondence continued for some time, with the FCA also pointing out that it was unable to respond because of the restrictions — in relation to confidential information — under s.348 FSMA.

The Complaints Commissioner found in favour of the complainant. He summarised that this "was a simple matter which should never have become a complaint: you have effectively been forced to complain because the FCA would not answer a simple question." The Complaints Commissioner continued that the FCA failed to "apply some common sense and good customer service" and "repeatedly misled you about restrictions about what they could tell you in response to your suggestion." Perhaps most damningly of all, the FCA was told that, "For an organisation which says that it welcomes suggestions, and is committed to good complaints handling, this is not good enough." The Complaints Commissioner did, however, stop short of recommending that the FCA replace present management and "review all decisions they have made since their formation in 2013 'based on their erroneous interpretation of financial legislation,'" as requested by the complainant.

Skilled Persons and Communications About Compensation

On 11 September 2017, the Complaints Commissioner published its final decision in respect of a complaint made regarding the way in which compensation was offered to a firm's customers. The Complaints Commissioner did, however, reject the other complaints made against the FCA.

The decision suggests that the FCA approved the recommendation of a skilled person, appointed under s.166 FSMA, to send out letters to the firm's customers offering compensation. The FCA's intention was that the skilled person would devise a redress methodology, and then offers of compensation would be sent to the affected consumers. The firm had not given its final approval to the sending out of letters.

The Complaints Commissioner states that, "while the FCA has regulatory powers to compel a firm to pay compensation to its customers, this cannot be enforced through the terms of a s.166 Requirement Notice and contract with the

94 7 August 2017

skilled person. The skilled person can only commit a firm to pay compensation if the firm itself agrees to do so, which was clearly not the case here". The Complaints Commissioner concludes that the FCA was incorrect to assert that it was in the skilled person's remit to offer compensation and within the FCA's gift to approve it.

FCA Failings Regarding Potential Limitation Issues

On 2 October 2017, the Complaints Commissioner published two final decisions in which it upheld complaints against the FCA. The complaints related to the FCA's Enforcement team failing to raise with the Regulatory Decisions Committee, prior to Warning Notices being issued in February 2014, that certain documents had the potential to undermine the misconduct case made against the complainants due to reasons of limitation. When the limitation issue came to light (around July 2014), the FCA notified the complainants that it was no longer pursuing the case against them, solely for reasons of limitation.

In March 2017, the FCA partially upheld the complaints, on the basis that it had failed to give adequate consideration to the limitation period. The complainants, however, referred the matter to the Complaints Commissioner as "an independent and rigorous investigation into the non-disclosure of information by the Enforcement team" was sought.

In his conclusion, the Complaints Commissioner is critical of the FCA's "repeated failure to act on an issue of significance which had been flagged from the outset of its investigations." Additionally, he notes that, "On any reading of the facts, the FCA failed to meet its duty to ensure that its proceedings were managed competently and fairly." The Complaints Commissioner does, however, find that there was no bad faith on the part of the regulator, since there is "no evidence of an intention to mislead." The FCA apologised, accepting that mistakes had been made.

The cases are a reminder that firms and individuals should not take the FCA's procedures and conclusions for granted, and they should actively seek to challenge outcomes where it is appropriate to do so.

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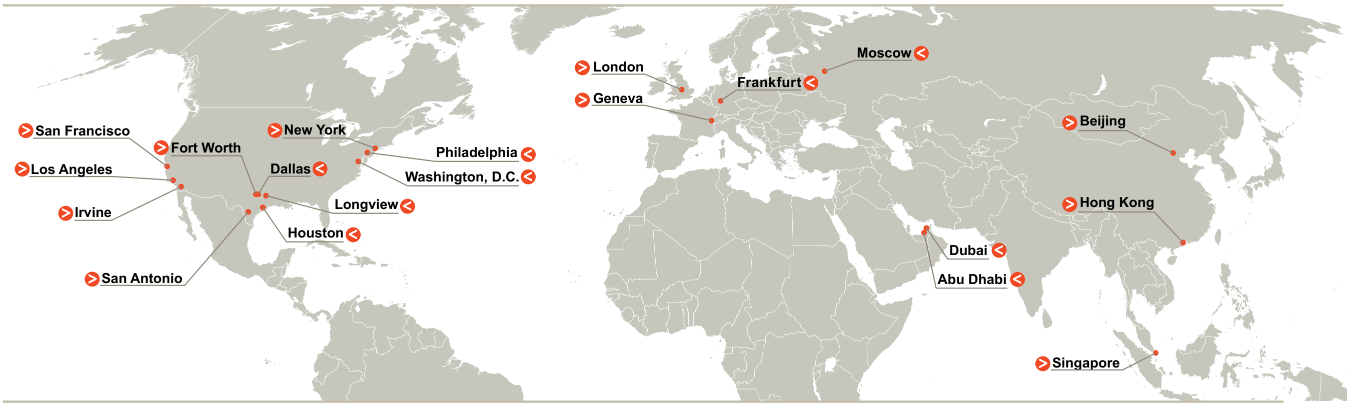

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