THE CITY LIBRARY

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# COMPLIANCE OFFICER BULLETIN

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

## ANNUAL REVIEW 2013

### 1. Introduction

2013 has been a year of regulatory consolidation. After the sound and fury of policy announcements this was the year in which structural change was implemented. The FSA was disbanded and the PRA and the FCA were created. In this issue of the *Compliance Officer Bulletin* we examine the extent to which the creation of the new regulatory bodies constitutes real change in the way that financial regulation will be exercised. It appears to us that there is a marked determination in the regulatory community to create a new form of regulation; acting in the interests of consumers rather than the industry, decisive, and, above all, interventionist.

However, as is well known, with power comes responsibility and the regulators will need to work hard and to be both prescient and lucky to prevent, as they seek to do, future failures (be they of institutions, products or ethics) in the financial services industry.

Notwithstanding our focus on the new regulatory bodies, we do not forget that the rules that they enforce are increasingly derived from European directives and regulation. Accordingly, we also look ahead to the key developments in European legislation that will mould financial services in the years ahead.

### 2. The creation of the FCA and the PRA: More than a structural change?

#### 2.1 Introduction

Prior to the creation of the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority ("PRA") (the FCA and the PRA, together the "Regulators") on April 1, 2013, the industry was eager to find out whether the new regulators would follow in the footsteps of the FSA or if they would forge a new path. "Journey to the FCA", a paper published in October 2012,[1] provided the first detailed insight into the role of the new

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regulators. The introduction, penned by Martin Wheatley (now chief executive of the FCA) set out the main objectives of the FCA.

The overarching strategic objective[2] of the FCA was described as "ensuring that the relevant markets function well". Journey to the FCA stated that the strategic objective would be supported by three operational objectives:[3]

- 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 consumers.

By contrast the PRA was intended to promote "the safety and soundness of deposit-taking firms, insurers and systemically important investment firms".[4] The PRA would be required to pursue this objective "primarily by seeking to avoid adverse effects on financial stability, and in particular seeking to minimise adverse effects resulting from disruption to the continuity of financial services that can be caused by the way firms run their business or upon their failure".[5]

Mr Wheatley suggested that the creation of the FCA was an "opportunity to reset conduct standards for the financial services industry"[6] and that the FCA would tolerate lower levels of risk and, when it identified problems that could harm consumers or the integrity of the market, would step in earlier and faster than the FSA had done.

Mr Wheatley has also set out his stall as to what constitutes good regulation, and how the FCA will approach its regulatory objectives going forward. On October 17, 2013, speaking at the British Bankers' Association ("BBA") Annual International Conference,[7] Mr Wheatley said:

> "What are the characteristics of effective regulation? For me, there are two key areas. First, and foremost, we need a regulatory structure that is firmly forward looking. That anticipates and tackles issues before they become multi-billion dollar problems ... The second key criterion for effective regulation is good judgment."

Mr Wheatley explained that the FCA would pursue this objective by scanning markets to see where the issues are:

> "... increasingly using thematic reviews and market studies to signpost direction. Over the last seven months, we have seen this work moved forward in several key banking-related areas, including: competition work on cash savings (so investigating issues like 'teaser' rates and consumer inertia) and our review into mobile banking."

In the second part of his address, Mr Wheatley noted that following the financial crisis of 2008 people began seriously to debate "... whether it was enough to only focus on compliance and rules—as opposed to pinning down broader expectations of behaviour in financial services". He went on to explain:

> "Rules and checklists are important but they do not guarantee good conduct. That is why the gestation period for cases like PPI, interest rate swaps and CPP all occur during an escalation in rules, with FSA guidance expanding by 27 per cent between 2005 and 2008. In preventing a repetition of these conditions, the first step for regulators has been to look beyond legal compliance. To exercise judgment more authoritatively."

There can be no doubt that the FCA is ambitious and has set itself difficult objectives, not least its desire to intervene before an issue becomes a "multi-billion pound problem". However, the question that must be asked is whether we have seen evidence of this new approach in the first eight months of the FCA and PRA's operation or, despite the change in name and structure, have things stayed the same?

## 2.2 The new regulator (and the new approach to regulation) in action

It has been clear throughout 2013 that the FCA wants to do more than talk the talk; there has been a noticeable change in the regulator's approach to industry issues. An interesting pattern has emerged throughout the year of the FCA engaging in discussions and negotiations with industry members to agree the terms of "voluntary" agreements and redress schemes. These schemes suggest a willingness on the part of the FCA to pursue enforcement action without necessarily following a formal "Handbook-led procedure". Indeed, the FCA itself considers that the schemes described below are evidence of a "more proactive, more interventionist, more creative and more judgment-based approach".[8]

### 2.2.1 The retry system

On June 7, 2013 the FCA announced that it had reached an agreement with seven of the UK's biggest high street banks on a new system for processing direct debits, standing orders and future dated bill payments. The new approach has been adopted as part of a series of initiatives designed to address everyday banking issues.[9] Previously the banks generally processed outgoing payments, such as direct debits, early in the morning; this meant that incoming payments, such as salary, made later in the day would sometimes arrive too late to cover the outgoings and the customer would incur a charge. The FCA has since agreed a "retry" system, a voluntary agreement between banks and the FCA, under which banks will retry any failed payments in the afternoon prior to finalising the transaction. This will allow deposits to clear and the outgoing payment to be completed. In addition, the FCA has also instructed banks that they need to make customers aware of the latest time they can deposit money and have it available to meet outgoing payments on the same day.

Clive Adamson, the FCA's director of supervision, commented:

> "We are committed to putting customer interests at the heart of everything the FCA does, and it's encouraging that the banks are also beginning to take this approach. There are no new rules here—this is an agreement with the industry; working together for the benefit of consumers can often be more effective than writing new rules, and it certainly delivers results more quickly. This is part of a wider focus by the FCA to ensure consumers get a better deal from everyday banking."

The government has announced that it plans to implement the major recommendations of a report published by the Parliamentary Commission on Banking Standards ("PCBS"), which include:[10]

> "Strengthening individual accountability by:
>
> - introducing a tough new Senior Persons regime governing the behaviour of senior bank staff;
> - introducing new banking standards rules to promote higher standards for all bank staff;
> - introducing a new criminal offence for reckless misconduct for senior bankers;
> - reversing the burden of proof so that bank bosses are held accountable for breaches within their areas of responsibility; and
> - working with the regulators to implement the Commission's proposals on pay. This will allow bonuses to be deferred for up to 10 years and enable 100 per cent clawback of bonuses where banks receive state aid."[11]

Current indications are that the regulators expect to be able to implement the new Senior Persons and Licensing Regime in 2015.[12]

### 2.2.2 Interest rate hedging products

In June 2012, the FSA announced that a review had revealed serious failings in the sale of interest rate hedging products to small and medium-sized businesses. The FSA detailed its main concerns: (i) inappropriate sales of more complex varieties of interest rate hedging products (such as structured collars); (ii) a number of poor sales practices used in selling other interest rate hedging products; and (iii) sales rewards and incentive schemes that could have exacerbated the risk of poor sales practice. The banks involved agreed to review their sales of interest rate hedging products made to customers; a pilot review of sales was subsequently carried out by the banks. The FSA published the key findings of the pilot review in January 2013 and the banks have since agreed to conduct their full reviews using the approach set out in the report.

The full review into the mis-selling of interest rate swaps began in May 2013; the full review includes a redress scheme for customers who were mis-sold interest rate hedging products.

The banks that signed up to the review and redress scheme have agreed to do the following:

- provide fair and reasonable redress to non-sophisticated customers who were sold structured collars;
- review sales of other interest rate hedging products (except caps or structured collars) for non-sophisticated customers; and
- review the sales of caps if a complaint is made by a non-sophisticated customer during the review.

The review exercise for each of the banks will be scrutinised by an independent reviewer and overseen by the FCA.

The redress element of the review has been criticised due to the fact that, as at September 4, 2013 the banks had paid out £500,000 in compensation to businesses who were mis-sold swaps out of a potential bill of £2.5 billion. However, Martin Wheatley, chief executive of the FCA, said that although the review had taken a long time to put into place he was confident that it would be an effective scheme: "With a process like this is was important to get things right and we have worked hard to ensure the scheme deals as fairly with people as possible."

Mr Wheatley also made the following comment: "In some cases the banks were selling more complicated products than they needed to because they made more profit from it. I think there was a particular period—and if we look at the period 2005–2008—where I think the moral compass was lost in banking." He also intimated that the FCA may consider fining banks after the redress scheme had closed: "There will be cases where we may need to take further action. We're not talking about that at the moment because we're focused on getting people their money back."

The FCA's focus on securing appropriate redress for consumers reinforces the regulator's commitment to meeting its operational outcome to ensure that consumers are sold products that meet their needs. In addition, in order to meet its strategic objective of ensuring that the relevant markets function well, the FCA must ensure that consumers are getting a fair deal. As such, the redress scheme for interest rate swap mis-selling evidences the fact that consumer protection will be a pervasive element of the FCA's role.

### 2.2.3 Card Protection Plan Ltd

On August 22, 2013 the FCA issued a press release[13] announcing the fact that Card Protection Plan Ltd ("CPP") and 13 high street banks and credit card issuers have agreed to take part in a voluntary redress scheme (the "Scheme") of up to £1.3 billion to compensate customers who were mis-sold CPP's card protection ("Card Protection Policy") and identity protection policies ("Identity Protection Policy" and together, the "Policies").

The Scheme comes in the wake of enforcement action taken against CPP; in November 2012 the FSA issued its joint largest retail fine of £10.5 million to CPP. The FSA considered the Policies to have been mis-sold on the basis that:

- the Card Protection Policy was sold by emphasising to customers that the product entitled them to up to £100,000 of insurance cover in the event that their credit or debit cards were stolen. This was unnecessary because customers' banks already provide this cover. As such, the Card Protection Policy did not have any substantive value for customers; and
- the Identity Protection Policy was sold by exaggerating the risks and consequences of identity theft. The FSA felt that the sales process focused on revenue and commercial objectives at the expense of treating customers fairly.

As well as CPP selling the Policies directly to customers, high street banks and credit card issuers introduced millions of customers to CPP. As such, those banks and credit card issuers who were involved in the mis-selling have agreed to be part of the Scheme and will provide the money needed to pay redress to customers.

The Scheme will involve around 7 million customers, who purchased around 23 million policies and will provide a simple and straightforward mechanism for customers to make a claim for redress. The Scheme was approved by the Court on October 7, 2013 and it is expected to begin making redress payments to customers in Q1 2014.

Martin Wheatley, chief executive of the FCA, made the following comments about the Scheme:

> "We have been encouraged that, working closely with the FCA and despite their different business needs, a large number of firms have voluntarily come together to create a redress scheme that will provide a fair outcome for customers. This kind of collaborative and responsible approach is a good example of how firms are taking more responsibility and helping—step by step—to rebuild trust. We believe that this will be a good outcome for customers who may have been mis-sold the card and identity protection policies. Subject to CPP's customers approving the scheme, these policy holders will be able to claim a full refund of premiums with interest. Doing it this way means customers will get redress via a simple and standardised process, so we are encouraging customers to approve the Scheme when they receive their voting letters in the Autumn."

Each of the industry agreements and redress schemes demonstrates a willingness on the part of the FCA to engage with industry and, using the threat of formal enforcement action, to negotiate settlement agreements and redress schemes. This does tend to indicate a more "assertive" regulator. However, to date there has been little resistance from an industry that is perhaps still a little embarrassed and less willing than before to fight its corner. It will be interesting to observe whether this cooperative attitude will persist, or will perhaps the FCA—with its new found confidence—be so assertive as to leave industry little choice but to fight back?

## 2.3 Thematic reviews

As indicated by Martin Wheatley and Tracey McDermott, the FCA is very focused on acting pre-emptively, taking action against firms before consumers suffer widespread harm. One of the ways in which the FCA aims to meet this objective is through continuing the FSA's practice of seeking to identify risks by carrying out thematic reviews of industry sectors.

### 2.3.1 Interest-only mortgages

The FSA began a thematic review of interest-only mortgages back in October 2012 in order to better understand them before making a decision on whether they should be banned. In May 2013, the FCA published a report setting out the findings from its predecessors' review. The thematic review had found that out of 2.6 million interest-only mortgages due for repayment over the next 30 years, around 260,000 did not have an associated repayment strategy and around 48 per cent of borrowers were found to be underestimating the financial challenge of the interest-only product they had signed up for.[14]

As a result of the issues flagged by the thematic review, the FCA has been able to work with the banking community in order to pre-empt what was set to be an incredibly damaging issue for some borrowers. Lenders worked with the FCA to put together a system to ensure that borrowers are contacted over the term of their mortgage and also more frequently towards the end of the mortgage loan term. One of the major elements of this process was the introduction of personalised, targeted communications with customers to ensure that customers are aware of the options available to them if they are unable to repay the principal amount outstanding on their mortgage by their loan-term end date. Martin Wheatley said that as a result of these communications from banks to borrowers: "This means that 600,000 borrowers, who could have been sleepwalking into a problem, will instead get a wake-up call to take action now." [15]

This action in relation to interest-only mortgages is an interesting indication of the FCA's new willingness to intervene in a market and to take pre-emptive action with a view to protecting the interests of consumers.

### 2.3.2 Add-on insurance

Another key area of focus for the FCA has been the way in which products are sold to consumers. The regulator is concerned with the sales process involved in marketing products to consumers, as well as whether or not the product is of any value to consumers.[16] As such, insurance has been the subject of detailed regulatory scrutiny and the FCA has published reviews on mobile phone insurance[17] and Motor Legal Expenses Insurance[18] ("MLEI"). Both reports found a number of issues in the way the products were sold. These issues created a gap between what consumers were led to expect and what firms actually deliver.

The £7,380,400[19] fine given to Swinton Group Ltd ("Swinton") on July 16, 2013 evidences the FCA's willingness to pursue enforcement action against firms where the FCA considers that they have failed to treat their customers fairly in the sale of add-on insurance products. Swinton, a general insurance intermediary, was found to have breached Principle 7 (Communications with clients). The FCA said that it had failed to treat its customers fairly by neglecting to disclose adequate information during the sales process. The FCA also said that inadequate staff training and an emphasis on sales incentive schemes had exacerbated the number of customers affected by mis-selling, which amounted to a breach of Principle 6 (Customers' interests).

We can expect to see further enforcement action in the add-on insurance sphere where firms fail to uphold their regulatory obligations and fail to take account of the FCA's findings in the mobile phone insurance and MLEI thematic reviews.

The leitmotif emerging from these (and other) thematic reviews is one of a regulator that will pursue a judgment-based approach to regulation, with a specific focus on ensuring good outcomes for consumers. In an October 2013 speech, Martin Wheatley, commented: "I know some people think this focus on business ethics is a regulatory 'phase'. I've heard it described as a 'cold breeze' that will pass through. But I want to make it clear today that the first 100 days of the FCA are a bellwether of things to come. It is lasting change—as opposed to the firework that peters out and falls to earth."[20]

We can expect to see the continued use of thematic reviews, as Martin Wheatley stated in a July 2013 address:

> "The important point here is that this is a new epoch in financial regulation. Thematic reviews, market studies, and the increased use of judgment, these are regulatory features that are here to stay. Like Icarus, financial services flew too close to the sun in the boom years. They pivoted too far towards commercial interests and too far away from consumer interests. Poor regulation provided an impetus for that fall and market failure ... it is in all our interests to correct the balance now. Good regulation is not a zero-sum game. It's not like a game of tennis or football, where for one side to win the other has to lose. We each have a vested interest in making markets work well for all participants."[21]

## 2.4 Re-enforcing credible deterrence

Notwithstanding the FCA's willingness to engage in innovative industry agreements and redress schemes, and its continued use of thematic reviews, it has continued to make determined use of its traditional enforcement powers in order to maintain its "credible deterrence". The FCA has successfully pursued a number of enforcement actions in respect of LIBOR, mis-selling, systems and controls and failure to be cooperative with regulators. We examine some of the more significant of these cases below.

### 2.4.1 LIBOR

The tough enforcement action and the hefty fines issued by the FCA in relation to the LIBOR rate-fixing scandal demonstrate the FCA's commitment to changing the culture of firms by pursuing a strategy of "credible deterrence".[22] In doing so, the FCA has publicly reinforced its commitment to pursuing its objectives of ensuring that the relevant markets function well and promoting and enhancing the integrity of the UK's financial system.

In fact, the implications for banks could even extend beyond regulatory fines. Barclays Bank Plc ("Barclays"), which was issued a fine of £59.5 million by the FSA on June 27, 2012,[23] has informed the FCA of the discovery of fresh documents relating to the London Interbank Offered Rate ("LIBOR") scandal which were not available to the regulators in advance of the June 2012 settlement. Legal representatives for Guardian Care Homes, which is challenging Barclays' attempt to dismiss the LIBOR element of its claim that the bank mis-sold it millions of pounds of interest rate derivatives, have commented that the new evidence shows "Barclays' misconduct goes further and wider than the regulatory findings". As such, given the FCA's public condemnation of the banks' behaviour in relation to LIBOR, it has been speculated that Barclays could face a fresh investigation as part of a subsequent LIBOR-rigging inquiry by the FCA.

**2.4.1.1 The Royal Bank of Scotland Plc**

On February 6, 2013 the FSA imposed a fine of £87.5[24] million on Royal Bank of Scotland Plc ("RBS") as a consequence of (among other things) what it considered to be the firm's breach of Principle 3 of the FSA's Principles for Businesses, in relation to LIBOR. Principle 3 states that a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.

The FSA found that RBS had established a business model that placed derivatives traders in close proximity to primary LIBOR submitters. The FSA found that the two groups were encouraged to communicate freely and traders were also allowed to act as substitute LIBOR submitters, despite what the FSA said was the obvious risk that traders would submit rates beneficial to RBS's derivative trading positions. The FSA said that RBS failed to identify and mitigate the risks in existence. Risk also existed because primary submitters' bonuses were linked in part to the profit and loss of their money market trading books.

The FSA found that RBS had breached Principle 3: (i) by failing to identify and manage all of the risks of inappropriate submissions until March 2012; (ii) by failing to have any submissions-related systems and controls until March 2011; (iii) by failing to have adequate transaction monitoring systems and controls to detect wash trades until March 2012; and (iv) through the failures of management oversight.

**2.4.1.2 ICAP Europe Ltd**

On September 25, 2013 the FCA issued a financial penalty of £14 million[25] to ICAP Europe Ltd ("IEL") for misconduct relating to LIBOR. The FCA found that IEL had breached Principles 5 and 3 of the FCA's Principles for Businesses in that a number of its employees sought to manipulate the Japanese Yen ("JPY") LIBOR submissions made by various banks that contributed to the calculation of published LIBOR rates ("Panel Banks"). The FCA said that IEL, through its brokers, had colluded with traders at UBS AG ("UBS") as part of a co-ordinated attempt to manipulate JPY LIBOR submissions made by Panel Banks. The FCA said that it had found evidence that IEL brokers were deliberately disseminating incorrect or misleading LIBOR submissions levels by emailing suggestions to some Panel Banks as to where they believed the published JPY LIBOR rate would set for the day and requesting certain Panel Banks to make specific JPY LIBOR submissions. The FCA found an instance where an IEL broker received corrupt bonus payments (of £5,000 per quarter) as a reward for his assistance in manipulating JPY LIBOR rates. As such, the FCA said that IEL brokers' misconduct risked undermining the integrity of the JPY LIBOR benchmark reference rate.

The FCA held that IEL had breached Principle 5 by failing to observe proper standards of market conduct. In addition, the FCA found that IEL breached Principle 3 by failing to have adequate risk management systems or effective controls in place to monitor and oversee its broking activity. In particular, the FCA investigation found that IEL had failed adequately to review its brokers' communications for compliance issues generally or place any compliance staff on broking floors. As such, the brokers' misconduct was exacerbated by a poor compliance culture within IEL which was a result of its heavy focus on revenue at the expense of regulatory requirements. Furthermore, the FCA found that IEL's inadequate systems, controls, supervision and monitoring meant that the brokers' misconduct went undetected and continued for several years.

Tracey McDermott, director of enforcement and financial crime, commented:

> "The misconduct in relation to LIBOR has cast a shadow over the financial services industry. The findings we publish today illustrate, once again, individuals within the industry acting with a cavalier disregard both for regulatory obligations and the interests of the markets. IEL's significant failings in culture and controls allowed that misconduct to flourish and fell far short of our expectations."

### 2.4.1.3 Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A.

On October 29, 2013 the FCA fined Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. ("Rabobank") £105 million[26] for serious, prolonged and widespread misconduct relating to LIBOR. The FCA cited Rabobank's poor internal controls as having encouraged "collusion between traders and LIBOR submitters and allowed systematic attempts at benchmark manipulation".[27] In addition, an FCA press release noted that Rabobank "did not fully address these failings until August 2012, despite assuring the FCA in March 2011 that suitable arrangements were in place".[28] The FCA considered that Rabobank had failed to act with due care, skill and diligence, failed to identify, manage or control the relevant risks and that it had failed to meet proper standards of market conduct. As such, the FCA found that Rabobank had breached Principles 2, 3 and 5 of the FCA's Principles for Businesses.

Tracey McDermott, made the following comments:

> "Rabobank's misconduct is among the most serious we have identified on LIBOR. Traders and submitters treated LIBOR submissions as a potential way to make money, with no regard for the integrity of the market. This is unacceptable. Rabobank's flawed assurances and failure to get a grip on what was going on in its business were extremely disappointing. Firms should be in no doubt that the spotlight will remain on wholesale conduct and we will hold them to account if they fail to meet our standards."[29]

### 2.4.2 Mis-selling

The plethora of retail cases brought by the FCA illustrates how seriously the regulator is taking its operational objective to secure an appropriate degree of protection for consumers. Tracey McDermott, the FCA's director of enforcement and financial crime has said that "influencing industry perceptions of what is acceptable is one of the regulator's key responsibilities".[30] As such, firms should pay close attention to the enforcement action taken by the regulator in the retail sphere as it serves as a bellwether for what the FCA considers to be unacceptable conduct.

### 2.4.2.1 UBS AG

On February 8, 2013 the FSA fined UBS AG ("UBS") £9.45 million[31] for failures in the way it sold the AIG Life Premier Access Bond, Enhanced Variable Rate Fund (the "Fund") and its subsequent handling of related complaints. The FSA considered UBS to have failed to take reasonable care to ensure the suitability of its advice to customers to invest in the Fund (in breach of Principle 9) and also that it had not paid due regard to the interests of its customers and, as such, had failed to treat them fairly (in breach of Principle 6).

One of the main criticisms levied at UBS by the FSA was that it had failed to carry out adequate due diligence on the Fund before selling it to customers so that, from the outset, UBS had an inadequate understanding of the risks associated with the Fund and it could not have been in a position to advise on whether the Fund was suitable for customers or to advise on the risks associated with the Fund. The FSA also said that advisers were recommending the Fund to customers when it did not provide the level of capital security that they sought. The FSA also noted that some advisers had incorrectly informed customers that the Fund was a cash fund that invested in money market instruments when, in fact, a significant proportion of the Fund was invested in other assets. The FSA said that UBS had also failed to make fair assessments of customer complaints relating to the Fund and, in addition, had not maintained adequate sales records.

Tracey McDermott said:

> "UBS's conduct fell far short of what its customers deserved and what the FSA requires. It failed to ensure it understood the product it was selling, failed to recommend it to the right customers and failed to take effective action in the financial crisis when the problems with the Fund came to the fore."

### 2.4.2.2 Sesame Ltd

On June 5, 2013 the FCA issued a financial penalty of £6,031,200[32] to Sesame Ltd ("Sesame") for breaches of Principles 3 and 9. The fine was made up of £5.8 million for systems and controls weaknesses in its investment business and £245,000 for advice in relation to Keydata products respectively. The FCA found that Sesame failed to take reasonable care to ensure the suitability of its advice for customers entitled to rely upon its judgment in breach of Principle 9 and various FCA rules. Furthermore, the FCA found that Sesame failed to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, in breach of Principle 3. In particular, the FCA said that Sesame failed to take sufficient steps to improve its systems and controls in relation to the oversight of its Appointed Representatives ("ARs") in that it failed to identify and monitor sales of products which were not suitable for most customers, and that file reviews and supervisor visits were not suitably robust. Tracey McDermott commented on the fine: "The weaknesses in Sesame's systems show there was an ongoing risk that unsuitable advice could be given by Sesame's ARs."

**2.4.2.3 AXA Wealth Services Ltd**

On September 12, 2013 AXA Wealth Services Ltd ("AXA") was fined £1,802,200.[33] The FCA issued this fine for what it considered to be AXA's failure to ensure it gave suitable investment advice to its customers. The FCA said that this failure had put a significant number of AXA's customers at risk of buying unsuitable products.

In the final notice, the FCA made the following comment: "It is of fundamental importance that firms providing investment advice take reasonable care to ensure that they give suitable advice to customers. AXA failed to do so." AXA was deemed to have failed to put in place an adequate process for establishing the level of risk its customers were willing and able to take with their investments. The firm also failed to ensure that its sales advisers were appropriately considering customers' individual circumstances before making recommendations. The FCA said that there was an unacceptable risk of sales advisers making inappropriate investment recommendations to customers in order to qualify for bonus payments.

AXA has since agreed with the FCA to contact all customers who may have been affected by its failings and a third party will oversee a review of any issues identified as a result of the review. AXA has also agreed that any customer who has suffered loss as a result of inappropriate investment advice will be fully compensated and will be able to switch or withdraw their investment.

Customers' losses due to AXA's alleged failings are currently low, however, the FCA has emphasised that in agreeing with AXA that it will contact customers to address any issues, it has pre-empted any future risk to customers by providing them with the opportunity to avoid potential losses during future stock market downturns.

This is an important decision, as it illustrates the FCA's commitment to a judgment-based and pre-emptive approach to supervision where the emphasis is on identifying and addressing problems before they cause harm.[34]

**2.4.2.4 Catalyst Investment Group and Alison Moran**

On September 30, 2013 the FCA issued Final Notices against Catalyst Investment Group ("Catalyst") and Catalyst's compliance officer Alison Moran ("AM"). The FCA stated that were it not for Catalyst's financial position, they would have imposed a financial penalty of £450,000 on the firm in respect of breaches of Principles 1 and 7 of the FCA's Principles for Businesses. AM was given a fine of £20,000 for breaches of Statement of Principle 6.

Catalyst was the primary distributor of bonds issued (in tranches) by Luxembourg-based ARM Asset Backed Securities SA ("ARM") between November 2009 and May 2010 (the "Relevant Period"). Catalyst promoted and distributed the ARM bonds to investment intermediaries and retail investors in the UK. The FCA said that by November 19, 2007, ARM had formed the view that, in accordance with Luxembourg law, it needed a licence from the Luxembourg regulator (the CSSF) to continue to issue the ARM bonds. The FCA found that ARM applied for a licence in July 2009 and the CSSF thereafter made a series of requests to ARM for further information; on November 20, 2009, the CSSF requested that ARM cease issuing bonds pending a decision on the licence application. The FCA said that Catalyst (which was aware of ARM's position) continued to accept funds from investors without disclosing ARM's position, or the risk that ARM could be liquidated if its licence application failed. The FCA considered that this should have been included in Catalyst's marketing material for the ARM bonds. In addition, the FCA said that Catalyst wrote to investors and IFAs on two separate occasions and both letters suggested that ARM's licence application was voluntary and failed to disclose the implications of the licence application being rejected. The FCA concluded that in continuing to receive funds from investors without disclosing ARM's regulatory position, Catalyst had showed a reckless disregard for the interests of investors and, as such, had failed to act with integrity in breach of Principle 1. The FCA also concluded that Catalyst had failed to communicate information to customers in a way which was clear, fair, and not misleading, in breach of Principle 7.

The FCA also took enforcement action against AM, fining her £20,000 for failing to act with due skill, care and diligence. The FCA said that AM was aware of the issues with ARM's licence in December 2009, but she failed to ensure that this was properly communicated to investors. The FCA considered this to be a clear breach of Principle 6. This demonstrates the seriousness with which the FCA treats regulatory breaches relating to retail customers and also evidences the FCA's willingness to take action against senior individuals within a firm.

The FCA also took enforcement action against Timothy Roberts ("TR"), chief executive of Catalyst (and a director of ARM from March 2007) and Andrew Wilkins ("AW"), a director at Catalyst between October 2007 and March 2010. TR and AW have both referred their cases to the Upper Tribunal which will reconsider each case and may uphold, vary, or cancel the FCA's decision.

UK retail investors have invested £54 million in ARM bonds, including £17.1 million in issues which are being disputed. Investors are at risk of losing a significant part of their investment. The extent of any loss is currently unknown.

Tracey McDermott commented on the case:

> "Catalyst showed a reckless disregard for investors' interests, exposing them to significant risk. We expect firms, and their senior managers, to put customers' needs first—and will take tough action against those who fall short of our standards."

#### 2.4.3 Systems and controls

The FCA's self-proclaimed role is "to create a culture of good conduct at every level of the industry".[35] In order to ensure that the right kind of culture is being instilled in firms, senior managers need to understand their businesses as a whole. This requires adequate systems and controls being put in place. Proper systems and controls allow senior managers to monitor their businesses for compliance issues, to assess potential areas of risk, and to ensure that minor issues are nipped in the bud. Ultimately, a comprehensive framework of systems and controls allows senior managers to address poor practice before it becomes ingrained in a firm's culture.

#### 2.4.3.1 Lamprell Plc

On March 18, 2013 the FSA issued a fine of £2,428,300[36] to Lamprell Plc ("Lamprell") for failings in its systems and controls which caused the firm to breach its obligations under the Disclosure and Transparency Rules, the Listing Rules, and the Model Code. The FSA found that Lamprell did not notify the market about the deterioration in its financial position in a timely manner and the FSA held that this breach was caused by Lamprell's inadequate systems and controls.

In particular, the FSA cited the fact that the firm's systems and controls had not increased in line with the firm's operational growth. This highlights the importance of ensuring that systems and controls are monitored on an ongoing basis to make sure they remain sufficiently robust to support a firm in the event that its circumstances change. The £2,428,300 fine indicates that the FSA considered Lamprell to have committed a serious breach. The fact that the UK Listing Authority had warned Lamprell about its systems and controls in 2011 was specifically cited by the FSA as resulting in a 10 per cent increase in the fine. The £2,428,300 fine also reflects a 30 per cent discount for early settlement.

#### 2.4.3.2 The Royal Bank of Scotland Plc and The Royal Bank of Scotland N.V.

On July 16, 2013 the FCA imposed a financial penalty of £5,620,300[37] on The Royal Bank of Scotland Plc ("PLC") and The Royal Bank of Scotland N.V. ("RBS N.V.") (together, "RBS"). The FCA issued the fine to RBS for incorrectly reporting transactions it made in wholesale markets and, in some instances, failing to report transactions at all.

The FCA found that RBS reported some 44.8 million transactions incorrectly, and had failed altogether to report a further 804,000 transactions between November 5, 2007 and February 1, 2012 (the "Relevant Period"). The breach represented failures in relation to 30 per cent of all transactions which were reportable by RBS during the Relevant Period.

Tracey McDermott said:

> "Effective market surveillance depends on accurate and timely reporting of transactions. We have set out clear guidance on transaction reporting, backed up by extensive market monitoring, and we expect firms to get it right. As well as a financial penalty, firms can expect to incur the cost of resubmitting historically incorrect reports. We will continue to take appropriate action against any firm that fails to meet our requirements."

Although the FCA noted that many of the systems and controls issues at RBS had arisen as a result of the takeover by PLC of ABN Amro Bank N.V. (now known as RBS N.V.), it nevertheless considered that the "considerable resources available to RBS" should have enabled it to overcome these challenges and ensure that adequate systems and controls were in place. One of the aggravating factors noted by the FCA was the fact that the FCA had provided significant guidance on reporting requirements and had also publicised a number of enforcement actions taken against other firms in similar circumstances.

**2.4.3.3 Aberdeen Asset Managers Ltd and Aberdeen Fund Management Ltd**

On September 2, 2013 the FCA issued a fine of £7,192,500[38] to Aberdeen Asset Managers Ltd and Aberdeen Fund Management Ltd (together, "Aberdeen"). The FCA said that the penalty was imposed on Aberdeen as a result of: (a) the firm's failure to recognise that the monies it placed in Money Market Deposits ("MMDs") with third-party banks on behalf of clients were governed by the Client Money Rules; and (b) the firm's subsequent failure properly to protect the client money by ensuring the trust status of the deposited monies in accordance with the Client Assets Sourcebook ("CASS") regime.

The FCA said that Aberdeen's approach to client money and, in particular, its failure to put in place trust letters in relation to MMD accounts created a presumption that Aberdeen was the legal owner of the accounts and uncertainty over the identity of the beneficial owner of the monies. The FCA considered that this introduced a risk to clients that, in the event of insolvency, the deposit banks might consider Aberdeen, rather than the client, to be the owner of the monies. The average daily balance of the MMDs was £685 million so there was a significant amount of money at risk.

The FCA considered Aberdeen to have had inadequate risk management systems in place, in breach of Principle 3, and also that it had failed to arrange adequate protection for certain of its clients' assets in breach of Principle 10.

Tracey McDermott said:

> "Proper handling of client money is essential in ensuring that markets function effectively. Where they fall short of our standards, firms should expect the FCA to step in and take action to avoid a poor outcome for their clients, and ultimately, consumers."

**2.4.3.4 JP Morgan Chase Bank, N.A. (the London Whale; Principles 2, 3, 5 and 11)**

On September 18, 2013 the FCA imposed on JP Morgan Chase Bank N.A. (the "Firm") a fine of £137,610,000.[39] At the time of writing, this is the second largest fine the city regulator has ever issued. The fine was the result of the 2012 "London Whale" trading scandal which saw the Firm's Chief Investment Office Synthetic Credit Portfolio (the "SCP") announce losses of US$5.8 billion in the first six months of 2012. By the end of 2012, the trading losses in the SCP amounted to US$6.2 billion and the scandal had rocked the financial markets.

The FCA considered that the regulatory breaches had permeated all levels of the Firm resulting in breaches of Principles 2, 3, 5 and 11 of the FCA's Principles for Businesses. The FCA found that the US$6.2 billion of losses occurred as a result of the Firm's high-risk trading strategy combined with weak management of that trading and an inadequate response to important information which should have alerted the Firm to the enormous risks present in the SCP.

The FCA said that the trading strategy for the SCP in 2012 resulted in a position so large that it risked substantial losses from even a small adverse market move. The FCA also said that the Firm's response to breaches of risk limits was to doubt the data indicating a breach and continually to approve temporary increases without regard to the root cause of the breach. The FCA found that flaws in the Firm's marking and valuation process meant that, as losses began to mount in early 2012, traders on the SCP were able to conceal these losses through mismarking the SCP's positions. The FCA said that this was clear evidence of systems and controls (Principle 3) failings. In addition, the FCA found that the Firm had failed to maintain an open and cooperative relationship with the FCA regarding the extent of its losses as well as the risk situation in the SCP.

Tracey McDermott, the FCA's director of enforcement and financial crime said:

> *"When the scale of the problems at JPMorgan became apparent, it sent a shock-wave through the markets. Maintaining the integrity of markets is a key part of our wholesale conduct agenda. We consider JPMorgan's failings to be extremely serious such as to undermine the trust and confidence in UK financial markets.*
>
> *This is yet another example of a firm failing to get a proper grip on the risks its business poses to the market. There were basic failings in the operation of fundamental controls over a high risk part of the business. Senior management failed to respond properly to warning signals that there were problems in the CIO. As things began to go wrong, the firm didn't wake up quickly enough to the size and the scale of the problems. What is worse, they compounded this by failing to be open and cooperative with us as their regulator.*
>
> *Firms must learn the lessons from this incident and ensure that they have business practices, values and culture to control the risks in their businesses."*

**2.4.4 Failure to cooperate with regulators**

The FCA expects, and Principle 11 of the FCA's Principles for Businesses requires, firms to deal with them in an open and cooperative manner. Where firms fail to adhere to this, and particularly where firms deliberately withhold information from the regulator, it is possible that enforcement action may be pursued.

**2.4.4.1 The Prudential Group**

On March 27, 2013 the FSA fined Prudential Plc and The Prudential Assurance Company Ltd £14 million and £16 million respectively, for various regulatory breaches. As such, the Prudential Group ("Prudential") was given a total fine of £30 million for various breaches of the FSA Principles and the UKLA Listing Principles. Specifically, the FSA said it issued the fines as a result of Prudential's failure to inform the FSA at the appropriate time that it was seeking to acquire AIA, the Asian subsidiary of AIG. The FSA considered Prudential to have breached Principle 11, which requires a firm to deal with its regulators in an open and cooperative way and to disclose to the appropriate regulator anything relating to the firm of which that regulator would reasonably expect notice. In this case, the FSA said that Prudential did not inform the FSA of the proposed acquisition of AIA until after it had been leaked to the media. The FSA said that Prudential failed to disclose the proposed transaction at a meeting with the FSA where it was asked detailed questions about its strategy for growth in Asia. The FSA considered that Prudential should have informed the FSA at the earliest opportunity in order to give the FSA time to decide whether to approve or reject the deal on regulatory grounds. The FSA said that the acquisition would have transformed Prudential's financial position and risk profile. It would have involved a rights issue of £14.5 billion which would have been the biggest ever in the UK. As such, the FSA found that this was a transaction which had the potential to impact greatly upon the UK's financial system. The FSA also censured Prudential's CEO, Tidjane Thiam, for being "knowingly concerned" in Prudential's breach of Principle 11.

The FSA subsequently said that it:

> "… expects to have an open and frank relationship with the firms it supervises and with listed companies. It is essential that firms give due consideration to their regulatory obligations at all times. In particular, timely and proactive communication with the FSA is of fundamental importance

to the functioning of the regulatory system and the integrity of the market … Firms should be in no doubt as to the importance of early communication with the regulator in respect of transformational transactions to avoid market and investor disruption."

## 2.5 Publishing information about enforcement warning notices

In Policy Statement 13/9[40] (published on October 15, 2013), the FCA provided details of how it will use its new power to publicise warning notices by publishing information about proposed enforcement action. The Financial Services Act 2012 contained amendments to FSMA s.391(1ZB) which granted the FCA the power to publish such information about the matter to which a warning notice relates as it considers appropriate. Previously, the regulator was only able to publish information about enforcement proceedings once it had decided to take enforcement action.

Following a period of consultation, the FCA has announced that information will be made public through a warning notice statement that will usually name the firm under investigation and, in certain circumstances, name an individual. However, the FCA has emphasised that, in accordance with FSMA s.391(6), they will not publish a warning notice statement if publication would be unfair to the person to whom the notice relates, prejudicial to the interests of consumers, or detrimental to the stability of the UK financial system.

At para.1.4 of Policy Statement 13/9, the FCA commented:

> "Our policy will, in particular, advance our consumer protection and integrity objectives. By publishing earlier information about our enforcement action both the financial services industry and consumers will be able to understand types of behaviour we consider unacceptable at an earlier stage. In turn, this will strengthen our continuing enforcement strategy of credible deterrence."

FCA Director of Enforcement, Tracey McDermott, also made the following remarks:

> "We listened carefully to views from inside and outside the industry. I believe we have got the balance right so we now have in place a regime that enables us to provide information to consumers, investors and firms earlier about the action we are taking to tackle misconduct to ensure markets work well and consumers get a fair deal. It is clear that the more transparent and open that we can make the regulatory process, the more confidence we can give people that we are acting in their best interest."

## 2.6 Client assets: Feeling the need for speed

In its 2013/2014 Business Plan (published in March 2013), the FCA stated that its supervisory work showed that a number of firms have inadequate records and ineffective segregation of client assets; a situation which would heighten the risk that any departure from the market could prove disorderly, causing harm to clients, creditors and counterparties, and the market as a whole. Accordingly, one of the FCA's key aims will be to increase firms' compliance and awareness of the client asset rules. The FCA proposes to do this through:

- increasing the supervision of firms holding client money and safe custody assets through more intrusive visits to firms, thematic projects and desk-based reviews, actions initiated through Client Asset and Money Return ("CMAR")/audit information and taking regulatory action where firm failings are identified; and
- embedding the FCA's risk assessment and prioritisation method, using the information provided by firms through CMAR audits, and combining this with firm intelligence.

In July 2013 the FCA then published CP13/5: Review of the Client Assets Regime for Investment Business (the "CP"). The CP is said to be driven by the FCA's desire to implement the lessons learned from the insolvency of firms such as Lehman Brothers International (Europe) Ltd and MF Global Holdings Ltd. The failure of these firms resulted in years of litigation and delayed the return of client money to clients. The FCA's proposed changes to CASS aim to enhance the client asset regime to achieve better results for consumers (both wholesale and retail) and to increase confidence in financial markets. The goal is to:

- improve the speed of return of client assets following the insolvency of an investment firm;

- achieve a greater return of client assets to clients following the insolvency of an investment firm (namely, lowering the shortfalls in the overall amount of money and assets returned to clients); and
- reduce the market impact of an insolvency of an investment firm that holds client assets (thereby creating greater market stability in the event of the failure of a large, complex and systemically important firm).

The CP proposes a number of changes to the CASS regime. However, one of the FCA's main proposals for change is to the client money distribution regime by enabling the insolvency practitioner of a firm that has begun insolvency proceedings to distribute client money based on the firm's records (rather than agreed claims of clients). This, it is suggested, would allow the distribution of client money to be undertaken within weeks of insolvency rather than the years or months it currently takes. Bearing in mind that the FCA has complained that a significant number of firms held inadequate records of client assets, a proposal for a distribution method which is reliant on those very records is an interesting one for the FCA to put forward.

The FCA's speed proposal seeks to introduce a client money distribution regime that permits an initial distribution of client money on the basis of a firm's records. This will involve a new two-stage distribution process:

- the formation and distribution of an 'initial' client money pool ("CMP") of client money held in client bank accounts or client transaction accounts to be made by an insolvency practitioner based on the failing firm's records ("CMP1"). Clients not appearing in the firm's records would not be eligible for a distribution from CMP1; and
- followed by the formation and distribution of a "residual" client money pool of any surplus in CMP1 and identifiable client money in the firm's house account ("CMP2"). Clients who believe they have an entitlement (but were not included in CMP1) will be able to make a claim in CMP2.

In circumstances where the firm is unable[41] to implement the two-stage distribution process the insolvency practitioner will need to form a single, notional combined CMP made up of all the client money from CMP1 and CMP2. The firm will then be required to perform a client money reconciliation which will involve a new calculation (rather than a repeat of any previously done by the firm) on the basis that the insolvency practitioner thinks is correct. This reconciliation would then be used to determine the clients' client money entitlements to the CMP. To validate these entitlements, and to provide an opportunity for clients to assert claims on the CMP, the firm would also be required to establish a claims process. Following this, the CMP must then be distributed rateably on the basis of the clients' client money entitlements.

The FCA highlights that there will be a greater responsibility on firms to ensure that their records are accurate (and on clients to check up as far as possible on their firms). It is not clear why there should be any greater responsibility on firms following any new changes to the distribution regime as surely compliance with the requirements of CASS and the maintenance of accurate records should already be a high priority for firms. However, the *impact* on clients whose firm does not have accurate records may of course be greater under the new speedy two-stage distribution process. Whilst the FCA acknowledges that it might be unfair on clients excluded from CMP1 owing to poor firm records, it believes that the overall outcome for the clients included in the firm's records is likely to be better. Further, it says that those clients who are ineligible to claim from CMP1 may not lose out entirely as they may be able to establish an entitlement in any CMP2. It is worth noting, however, that the outcome for such clients will depend on: (i) the amount of client money in CMP2; and (ii) the number of successful claimants to CMP2. In any event, the FCA has recognised that there will be greater pressure on it to supervise firms' compliance with requirements in this area.

Clearly the FCA's proposal for an increase in the speed at which distributions are made to clients must be balanced with the desire for accuracy of those distributions. Under the current regime, accuracy is prioritised, sometimes at the cost of delays in the return of money and assets to clients. The FCA considers that a faster return of client money following an insolvency is important to maintain confidence in financial markets and reduce the effect on other participants. Accuracy is a trade-off the FCA may be willing to accept, but will it be acceptable to clients? It would also be imprudent to assume that anyone missing out on a distribution will be picked up by the FSCS. Leaving aside issues of eligibility, certain clients who have lost out due to a shortfall in funds may be protected by the FSCS, but one who is absent from the firm's records (and accordingly whose claim cannot be verified) may not.

The FCA believes that the risks presented by a firm having materially poor records are mitigated to a degree by the fact that at the beginning of stage 1 of the speed proposal, when the insolvency practitioner repeats the firm's reconciliation, an assessment of whether the clients' client money entitlements can reasonably be determined from the reconciliation may be carried out. In the event that client entitlements cannot reasonably be determined, a distribution based on the firm's records does not take place. The combined pool is formed and the insolvency practitioner carries out a "correct" reconciliation and a lengthy claims process (i.e. effectively reverting to the current existing regime). It is obvious then that the success of any speedy distribution is entirely dependent on the accuracy of firms' records. Equally then, the delays currently experienced under the existing distribution regime could well be significantly reduced by improving the accuracy of firms' records and their compliance with obligations under CASS. This would, however, require greater supervision by the FCA.

As a fallback option, the FCA's alternative to the above speedy distribution proposals is to retain the existing distribution rules but to also codify some of the lessons learned from recent insolvencies. This would include:

- making it clear in the CASS rules what money constitutes the CMP;
- requiring a corrected reconciliation to be carried out at the primary pooling event; and
- clearly setting out the process to be followed to determine each client's entitlement in the CMP.

The desire for a speedy distribution of client money and assets, and the potential detriment to clients as a result of poor record keeping, should serve as a warning to firms that the FCA will pay more attention to firms' compliance with the CASS rules. To this end, the FCA has indicated in its 2013/2014 business plan that where it finds that firms do not have adequate systems and controls in place to ensure the safe segregation of client assets, it will consider taking enforcement action.

## 2.7 The PRA: A quieter start

The PRA has been less visible than the FCA in its first eight months of operation, although it is understood that it has been working hard, behind the scenes, in respect of the restructuring and recapitalisation of The Co-operative Bank. Nevertheless, it too has taken some interesting steps.

For instance, on October 15, 2013 the Chancellor, George Osborne, announced an agreement with China which would go some way towards making the City the main offshore centre for Chinese financial business. As part of an £8 billion scheme, London-based investors will be able to apply for a licence to use the Chinese RMB to invest in Chinese stocks and bonds. At present, investors are required to route their investments via Hong Kong. However, controversy was created by the second strand of the scheme; namely, the fact that Mr Osborne has brokered a deal between Chinese banks and the PRA to allow them to establish branches in the UK. The deal would see Chinese branches conducting wholesale activities (but crucially, not retail activities) in London with financial institutions and companies.

Critics have voiced concern over the fact that Chinese banks will be able to establish branches and not subsidiaries, citing the fact that branches of foreign banks are subject to relatively light touch regulation by the PRA. However, proponents of the deal have noted that branches have the benefit of the fact that if a branch runs into financial difficulties the cost of rescuing it would fall on the taxpayers of its country of origin. By contrast, the cost of rescuing a subsidiary would fall to UK taxpayers.

Some detractors have argued that the PRA is pursuing a special policy in respect of China and that its attitude towards Chinese branches is inconsistent with its wider regulatory approach. Andrew Bailey, chief executive of the PRA and deputy governor of the Bank of England, made the following comments in a speech[42] at the British Bankers' Association Annual International Banking Conference on October 17, 2013:

> "Earlier this week, it was announced that the PRA will be prepared to see Chinese banks open branches here (recognising that the Bank of China already has a branch in London). I want to describe how this change can come about, and in doing so it should be clear that this is not a special arrangement for China—rather it is part of a broader policy. Branches of foreign banks (both non-EEA and EEA) have a

> large presence here in the UK. Currently, they account for around one third of total UK resident banking assets. Supervision of branches has therefore always been an important issue for the UK authorities. In the run-up to the launch of the PRA, in April, we set out our approach to supervising subsidiaries and branches from overseas, and in this context the announcement on China is not a surprise."

At p.21 of the PRA's "approach to banking supervision" (the "Approach"), the PRA made the following statement in relation to branches of foreign firms:

> "Firms are able to operate in the United Kingdom as branches of overseas legal entities, meaning that there is no separate legal entity in the United Kingdom. Such branches can take one of two forms: those where the legal entity overseas is located within the EEA; and those located outside the EEA. Regardless of the corporate structure and location of the parent, the PRA expects all UK branches, like UK subsidiaries, to act responsibly in a manner that is consistent with safety and soundness. The PRA expects the branches to appoint a senior individual with authority to act as a primary contact with the PRA in relation to their affairs. This individual should also act as a channel for communication with the parent."[43]

Andrew Bailey's assertion that the PRA's stance on Chinese branches is consistent with the PRA's Approach appears correct, particularly due to the fact that a subsequent review of the Approach saw the PRA make the decision that:

> "We do not wish to see non-EEA branches undertaking critical retail banking functions (like taking deposits) beyond de minimis levels unless there is some good reason and importantly there is a very high level of assurance on resolution. In particular, we think that new non-EEA branches should stick to straightforward wholesale banking, of the type that supports world trade and capital flows."[44]

The fact that Chinese branches will only perform wholesale banking seems to support Andrew Bailey's argument that "it is a general policy, not a China policy, and it is consistent with promoting the benefits of an open world economy".[45]

### 2.8 An effective beginning: An interesting future

The objectives that have been set for the FCA, and the standards that it has set itself, are ambitious and difficult. The FCA has approached its new task with enthusiasm and a vigour that was sometimes missing in the FSA. In its first months of operation, the FCA has been innovative (particularly in its use of industry agreements) and rigorous (as can be seen in its use of its enforcement powers). It appears that the creation of the FCA and the PRA has indeed brought about more than structural change. It has ushered in a real change in the way in which the regulators pursue their functions and engage with industry. Nevertheless, the FCA faces a daunting task. It has promised to address issues before they become multi-billion pound problems. If it is to do this it will need to intervene aggressively and early (as it has shown a willingness to do). However, so far it has been dealing with a cooperative (and, perhaps still, embarrassed) industry. It will be interesting to observe, as the industry regains its confidence, whether the financial services sector will continue to be cooperative, or if it begins to challenge the FCA's new "judgement-based" approach and argue that such a large and complex industry requires regulatory certainty.

## 3. European legislation

2013 has seen the introduction of some very significant changes in the way the UK regulators are structured and the way in which they operate. The rules that the UK regulators enforce are increasingly derived from European legislation. In this section we consider some of the key developments in European financial services legislation.

### 3.1 Revision of the EU Markets in Financial Instruments Directive

Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments ("MiFID"), which provides one of the key legislative frameworks for financial services legislation across the EU, is in the process of being revised. Whilst the European Commission published its initial proposals to revise MiFID in the form of a draft directive ("MiFID II") and a draft regulation ("MiFIR") in October 2011, the final MiFID II and MiFIR texts have yet to be agreed and are currently subject to negotiation through trilogues held by the European Commission, the European Parliament and the Council of the European Union.

We expect political agreement to be reached on MiFID II and MiFIR by the end of 2013. We do not expect the date on which MiFIR will come into force, and the deadline for national implementation of MiFID II, to occur until at least 2015. However, firms should begin to assess whether the proposed changes are likely to impact their businesses.

Although MiFID II and MiFIR have yet to be finalised, the European Parliament and the Council of the European Union have each published their respective positions on the draft legislations for the purposes of the trilogue. We have described several of the major changes likely to be brought about by MiFID II and MiFIR below.

### 3.1.1 Organised trading facility

OTFs will be introduced as a new form of regulated trading venue (sitting alongside regulated markets and multilateral trading facilities) to regulate platforms which bring together third-party trading interests but which currently fall outside the characteristics of a regulated market or MTF (such as certain existing broker crossing networks and interdealer crossing systems).[46] Whilst a trading platform in which the operator may exercise an element of discretion in relation to the execution of trades cannot be categorised as a regulated market or MTF, such trading platforms will, under MiFID II and MiFIR, be categorised as an OTF which will be subject to similar transparency obligations as the other regulated trading venues and operators of OTFs will be prohibited from executing client orders on the OTF against its own proprietary capital (subject, potentially, to limited exceptions to be determined in the current trilogues).

It is currently unclear whether OTFs will be available for only non-equity financial instruments, or for both equity and non-equity financial instruments.

### 3.1.2 Investment services into EU by third country firms

MiFID II will require third country firms that intend to provide investment services to retail clients located in the EU to do so only through an authorised branch established within the EU.[47]

It is also possible that third country firms providing cross-border investment services to eligible counterparties and professional clients situated in the EU will only be permitted to do so with prior registration with ESMA (however, this matter is a key topic of debate in the current trilogues and therefore may not remain in the final rules).

Both authorisation of an EU branch established by, and registration of a third country firm, would be contingent upon (amongst other factors) the home jurisdiction of the non-EU firm having equivalent legal and supervisory measures in the relevant financial areas.

The introduction of these requirements would effectively preclude the UK from retaining its current financial services exemption for "overseas persons".[48]

### 3.1.3 Trading in clearing eligible derivatives and liquid financial instruments

Derivatives transactions conducted between "Financial Counterparties" and "Non-Financial Counterparties" (and equivalent third country firms where the transaction has a direct, substantial and foreseeable effect within the EU) that are subject to the clearing obligation under EMIR[49] will be required by MiFIR to be conducted on a regulated market, MTF, OTF or an equivalent third country trading venue.[50]

Furthermore, depending on the outcome of the trilogues, firms may be required to conduct all other transactions in financial instruments which are listed on a regulated market or traded on an MTF or OTF over a regulated trading venue or systematic internaliser (subject, potentially, to limited exceptions to be determined in the current trilogues, such as exemptions for intra-group transactions and transactions which are large in scale) to further reduce the overall number of OTC trades being conducted within the EU.

### 3.1.4 Commodity derivatives position limits/position reporting

Market participants of EU regulated trading venues will be subject to limits on the number of commodity derivatives contracts or positions which a participant can enter into or hold over a specified period of time (subject, potentially, to an exemption for positions entered into for hedging purposes).[51] It is to be decided within the trilogues whether such position limits are to be determined at a European level by ESMA, by national regulators, or by each trading venue.

Additionally, regulated trading venue participants will be required to report to their respective trading venues in as close to real time as practicable their commodity derivative and emission allowance positions which they hold in their proprietary capacity and, separately, any positions which they hold on behalf of their clients. Trading venues will, in turn, publish aggregated data on such commodity derivative and emission allowance positions on a weekly basis and, on request, provide participant or instrument specific data to national regulators.

### 3.1.5 Algorithmic trading

Firms which engage in algorithmic trading will be required to establish effective systems and controls to ensure the resilience of their trading systems to prevent trading which may create or contribute to a disorderly market.[52]

Where a firm is engaging in algorithmic trading in pursuit of a market making strategy the firm will be required continuously to provide quotes for at least a minimum duration to be specified by the final MiFID II text.

### 3.1.6 Complex financial products/investor protection

MiFIR will provide new powers for ESMA and national regulators to prohibit or restrict the sale of a particular (or category of) financial instrument(s), financial activities or financial practices which, in the opinion of the relevant regulator, raise investor protection concerns or pose a threat to the orderly functioning and stability of a particular market or the financial system as a whole.[53]

Additionally, in the interests of investor protection, MiFID II will no longer permit structured UCITS, shares in non-UCITS collective investment undertakings, and instruments with an embedded derivative to be categorised as "non-complex" financial instruments. Consequently, even where firms are providing execution services in respect of these products, a firm will be required to assess whether its services and/or products are appropriate for its clients.[54]

### 3.1.7 Corporate governance/nomination committee

MiFID II will require directors of firms to commit sufficient time to perform their duties. Accordingly MiFID II will impose limitations on the amount of non-intragroup directorships which each director may hold (e.g. an executive director of a firm may only hold up to two non-executive directorships of companies outside of that firm's group).[55]

Additionally, firms will be required to establish a nomination committee to assess and provide recommendations with regard to whether the management body possesses adequate collective knowledge, skills, and experience to understand the firm's activities and main risks, as well as to take account of diversity when selecting members to the management body.

### 3.1.8 Trade reporting

MiFIR will extend the existing trade transparency regime that is currently applicable only to shares which are listed on a regulated marketed or traded on an MTF. Additionally, MiFIR will require: (a) regulated trading venues (e.g. regulated markets, MTFs and OTFs) and systematic internalisers to publish quotes and post-trade data in respect of transactions conducted on its systems; and (b) firms to publish post-trade data in respect of transactions conducted OTC, in relation to "equity-like" instruments (e.g. depositary receipts, exchange traded funds and certificates) and non-equity instruments (e.g. bonds, structured products, emission allowances and derivatives) where such financial instruments are listed on a regulated marketed or traded on an MTF or OTF.

### 3.1.9 Approved publication arrangements/consolidated tape providers

Firms will be required to fulfil their post-trade reporting obligations in respect of OTC transactions through the newly conceived APA. APAs will effectively replace the current publication function performed by existing trade data monitors.

It is, however, still to be determined through the trilogues whether a regulated trading venue will be required to publish post-trade data for transactions conducted on its systems through an APA only or whether such trading venues may continue to publish post-trade data via their own publication systems.

Secondary to the accurate publication of post-trade data, APAs will also be required to facilitate the transfer of post-trade data to the newly introduced CTPs. CTPs shall consolidate in one place post-trade data originating from firms and regulated trading venues to allow market participants more effectively to compare trades taking place across the EU, thereby further promoting market transparency.

## 3.2 Revision of the Market Abuse Directive

Directive 2003/6/EC of the European Parliament and of the Council on Market Abuse ("MAD"), which came into force April 12, 2003 is also in the process of being revised. In order to further promote harmonisation of market abuse and insider dealing regimes across the EU, the European Commission published its legislative proposal to revise MAD in the form of a draft regulation ("MAR"), which shall be directly applicable in each of the European Member States without the need for national implementation when it eventually comes into force. Whilst MAR remains unfinalised, the European Parliament and the Council of Europe have reached political agreement on the contents of MAR. MAR can only be finalised once MiFID II and MiFIR have been finalised since MAR relies upon concepts to be introduced by MiFID II and MiFIR.

At the same time as the European Commission published its proposal for MAR in October 2011 the European Commission also published a draft directive to complement MAR by introducing minimum rules on criminal offences and criminal sanctions for market abuse ("CSMAD"). The UK, however, has the right under the Treaty of Lisbon to opt into or out of any European legislative policy that relates to matters of justice and home affairs. The UK has exercised its discretion to opt out of CSMAD on the basis that the UK already has an established criminal market abuse regime.

Based upon the political agreement reached on MAR on June 26, 2013 several of the major changes likely to be brought about by MAR are described below.

### 3.2.1 Financial instruments traded on an MTF or OTF

In addition to financial instruments admitted to trading on a regulated market, the market abuse regime will be extended by MAR to capture financial instruments which are traded on an MTF as well as those traded on an OTF (being a new type of regulated trading venue to be introduced by MiFID II and MiFIR).[56]

Like regulated markets, MTFs and OTFs will also be required by MAR to adopt adequate structural arrangements to be able to detect and potentially prevent market abusive practices.

### 3.2.2 Types of financial instruments captured by MAR

MAR will extend the offence of market manipulation to capture cross-market manipulation conducted in relation to: (i) spot commodity contracts,[57] where the transaction, order or behaviour has or is likely or intended to have an effect on the price of financial instruments that are traded on a regulated market, MTF or OTF; (ii) other financial instruments (e.g. derivatives), where the transaction, order, bid, or behaviour has, or is likely to have, an effect on the price of related spot commodity contracts;[58] (iii) emission allowances and other products auctioned pursuant to the Emissions Trading Regulations;[59] and (iv) financial benchmarks.[60]

### 3.2.3 Intermediate steps

Reflecting the ruling by the European Court of Justice in the Daimler case,[61] MAR clarifies that information relating to an intermediate step which is part of a protracted process may be precise information and therefore can, by itself, constitute inside information provided all other criteria of inside information as set out in MAR are satisfied.

### 3.2.4 Significant effect on price/reasonable investor test

MAR interprets information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments to mean "information a reasonable investor would be likely to use as part of the basis of his investment decision".[62] This aligns with the Upper Tribunal's interpretation of "significant effect on price" in the UK case of *FSA v Massey*.[63]

### 3.2.5 Presumption of use

The recitals of MAR state that a person in possession of inside information who carries out any transaction related to that inside information shall be presumed to have used that information, but this presumption may be rebutted if the person can establish that he did not use the inside information in carrying out the transaction. Whilst this presumption is not expressly set out in the main text of MAR, the main text of MAR does refer to situations where a person in possession of inside information shall not, in itself, be "deemed" to have engaged in insider dealing (e.g. where adequate and effective Chinese walls have been established). This aligns with the ruling by the European Court of Justice in the *Spector Photo* case.[64]

### 3.2.6 Attempted market abuse

MAR will extend the insider dealing and market manipulation offences also to include attempted abusive behaviour such as where a person attempts to commit insider dealing but the order is unsuccessful. It is, however, difficult to see how national regulators will be able to detect such attempted abusive behaviour in the absence of an actual effect to the markets.

### 3.2.7 Market soundings

One particular behaviour which MAR recognises as not constituting an improper disclosure of inside information is the performance of market soundings. In order to gauge the interest of potential investors in a possible transaction and the conditions relating to it (such as its potential size or pricing), issuers of financial instruments, secondary offerors of a financial instrument in such quantity or value that the transaction is distinct from ordinary trading, emission allowance market participants, and third-party agents acting on behalf of or on the account of such persons will be required by MAR specifically to consider whether the market sounding will involve the disclosure of inside information. The disclosing market participant will be required to make a written record of its conclusion and the reasons for that conclusion, both of which must be provided to a national regulator on request. MAR includes a presumption that a market sounding was made legitimately in the normal course of the exercise of a person's employment, profession, or duty where, in addition to the requirements already mentioned, if, before making the disclosure, the disclosing market participant:

- obtains the consent of the person receiving the market sounding to receive inside information;
- informs the person receiving the market sounding that he will be prohibited from using that information, or attempting to use that information, by acquiring or disposing of, for his own account or for the account of a third party, financial instruments relating to that information;
- informs the person receiving the market sounding that he will be prohibited from using that information, or attempting to use that information, by cancelling or amending an order which has already been placed concerning a financial instrument to which the information relates;
- informs the person receiving the market sounding that by agreeing to receive the information he is also agreeing to, and must, keep the information confidential;

and, after making the disclosure, the disclosing market participant:

- makes and maintains a record of all information given to the person receiving the market sounding, including the information given in accordance with the bullet points above, and the identity of the potential investors to whom the information has been disclosed, including but not limited to the legal persons and the natural persons acting on behalf of the potential investor, and the date and time of each disclosure.

The disclosing market participant must also inform a person who has received a market sounding once the information ceases to comprise inside information and keep a record of such correspondence. Although this is a useful clarification there is some doubt as to how this might work where firms involved in an offering of securities reach a different conclusion as to whether the information to be disclosed is inside information or not. In such situations some recipients of the information may find that they have agreed to restrict themselves from trading, whereas others have not. Further details are to be provided in secondary legislation to be drafted by ESMA.

### 3.2.8 Insider lists

Issuers of a financial instrument admitted to trading on a regulated market or traded on an MTF or OTF (with the exception of issues whose financial instruments are admitted to trading on an SME growth market), emission allowance market participants, emission allowance auction platforms, auctioneers and auction monitors, and any person acting on their behalf will be required to maintain, and keep updated, a list of employees who have access to inside information and to ensure that any person on the list acknowledges in writing the legal and regulatory duties entailed and is aware of the sanctions applicable to the misuse or improper disclosure of such information. MAR will require the list to at least include the following:

- the identity of any person having access to inside information;
- the reason for including that person in the list;
- the date and time at which such person obtained access to inside information; and
- the date at which the insider list was created.

Further details are to be provided in secondary legislation to be drafted by ESMA.

### 3.2.9 Managers' transactions

Issuers of financial instruments admitted to trading on a regulated market or traded on an MTF or OTF, emission allowance market participants, emission allowance auction platforms, auctioneers and auction monitors will be required to maintain a list of persons discharging managerial responsibilities within their company and persons closely associated with them.

Such persons discharging managerial responsibilities will be required to notify to the: (i) issuer, emission allowance market participant, emission allowance auction platform, auctioneer or auction monitor; and (ii) the relevant national regulator, about the existence of every transaction (including the pledging and lending of financial instruments) conducted on their own account relating to the shares or debt instruments of that issuer, or to derivatives or other financial instruments linked to them, or in emission allowances or related derivatives within three business days after the transaction once the total amount of such transactions by a particular individual has reached €5,000 within a calendar year (though national regulators have the discretion to increase this threshold to €20,000). The issuer, emission allowance auction platform, auctioneer or auction monitor will, in turn, be required to make such information public (unless national regulators implement alternative arrangements to make public such information themselves).

MAR will require the notification to include the following information:

- name of the person;
- reason for notification;
- name of the relevant issuer, emission allowance auction platform, auctioneer or auction monitor;
- description and identity of the financial instrument;
- nature of the transaction(s) (e.g. acquisition or disposal);
- date and place of the transaction(s); and
- price and volume of the transaction(s) (in the case of a pledge whose terms provide for its value to change, this should be disclosed together with its value at the date of the pledge).

### 3.2.10 Investigatory and supervisory powers of national regulators

MAR will require member states to designate a single regulator for the purposes of overseeing national compliance with the market abuse rules. In conformity with national law, MAR provides the relevant national regulator with wide-ranging supervisory and investigatory powers, which include (but are not limited to) the powers to:

- have access to any document and other data (in any form);
- require or demand information from any person;
- in relation to commodity derivatives, request information from market participants on related spot markets according to standardised formats, obtain reports on transactions, and have direct access to traders' systems;

- carry out on-site inspections, or investigations at sites other than the private residences of national persons;
- enter premises of natural and legal persons in order to seize documents and other data, or require existing data traffic records from a telecommunications operator, where there is a reasonable suspicion that such document, data or record may be relevant to prove a case of insider dealing or market manipulation;
- refer matters for criminal investigation;
- request the freezing and/or sequestration of assets;
- suspend trading of the financial instrument concerned;
- require the temporary cessation of any practice considered contrary to the market abuse rules;
- impose a temporary prohibition on the exercise of professional activity; and
- take all necessary measures to ensure that the public is correctly informed, including the correction of false or misleading disclosed information, including by requiring an issuer or other person who has published or disseminated false or misleading information to publish a corrective statement.

#### 3.2.11 Administrative sanctions

One of the key criticisms of the existing market abuse regime has been the significant variation in sanctions seen across the EU. For the first time, MAR establishes a framework for civil sanctions for market abuse. Companies convicted of market abuse could be fined up to 15 per cent of their annual turnover or, if greater, €15 million. Individual perpetrators could face fines of up to €5 million and a temporary, or in some cases permanent, ban on doing certain jobs within investment firms.

### 3.3 The Alternative Investment Fund Managers Directive

The deadline for EU Member States to transpose the European Union Alternative Investment Fund Managers Directive (the "AIFMD")[65] into their national laws passed on July 22, 2013.

The AIFMD regulates the hedge, private equity and alternative investment fund industry in Europe. It imposes organisational, management and systems requirements on alternative investment fund advisers that are either domiciled in the EU or that manage investment funds domiciled in the EU ("AIFM"). It also imposes minimum standards of pre- and post-sale disclosure and regulatory reporting for non-EU managers that actively market their funds to EU investors (the "Minimum AIFMD Marketing Requirements").

Whilst the large majority of EU Member States had transposed the AIFMD into their national laws by the July 22, 2013 deadline, several EU Member States (such as Finland, Italy and Spain) have yet to do so. The expectation is, however, that all EU Member States will have transposed the AIFMD into their national laws at some point during the first half of 2014.

With regard to implementation of the AIFMD requirements in the UK, this occurred through the combination of the introduction of the UK AIFMD Regulations (SI 2013/1773) (which came into effect on July 22, 2013), changes to the FCA Handbook rules (in particular, a new Investment Funds sourcebook ("FUND") has been introduced which applies to FCA authorised UK AIFMs and incoming EEA AIFM branches of a UK AIF), and the introduction of a new regulated activity of "managing an AIF" in the Financial Services and Markets 2000 (Regulated Activities) Order 2001 (SI 2001/544). There is further guidance in respect of "marketing" under the UK AIFMD Regulation contained in Ch.8.37 of the Perimeter Guidance Manual. The UK has provided for a transitional period in which UK AIFMs which had been managing an AIF prior to July 22, 2013 may continue to do so without authorisation until July 22, 2014, and non-EU AIFMs which had marketed any AIF into the EEA prior to July 22, 2013 may continue to market existing and new AIFs to prospective UK investors under the existing UK private placement regime (most, but not all EU countries, provided for a similar transitional period, although the precise conditions differ between countries). If the non-EU AIFM cannot avail itself of the UK transitional arrangements (or, after July 22, 2014), it would have to: (i) comply with the Minimum AIFMD Marketing Requirements;

(ii) comply with the existing UK private placement regime; and (iii) provide prior written notification to the FCA in which the Non-EEA AIFM confirms that the conditions of the Minimum AIFMD Marketing Requirements have been met.[66]

In respect of an AIFM which has its registered office in the UK (a "UK AIFM"), it would need to be authorised by the FCA to conduct the newly introduced regulated activity of "managing an AIF" unless it can be categorised as a Small AIFM (defined below); albeit that Small AIFMs are still required to be registered with the FCA.

A "Small AIFM" is an AIFM which has assets under management: (a) not exceeding €500 million in total where, in respect of the AIFs managed, no leverage is employed and investors are not given a right to redeem their investments within five years of the initial investment; or (b) not exceeding €100 million in total in all other cases.

As of July 22, 2013, UK AIFMs are required to obtain FCA authorisation to carry out the regulated activity of managing an AIF or, with regard to UK AIFMs already authorised by the FCA, to vary its permissions accordingly. However, a one-year transitional period is available for UK AIFMs which have been managing an AIF immediately before July 22, 2013. AIFMs eligible for this transitional period are required to obtain the requisite FCA authorisation or variation of permission by July 22, 2014. Since the FCA has three months within which to determine an application (which may be extended by a further three months should the FCA consider it necessary), the FCA advises AIFMs to apply for authorisation or a variation of permission by January 22, 2014 (to provide the FCA with a full six months to determine the application) and states that such applications should be submitted no later than April 22, 2014 in order for the applications to be determined before the July 22, 2014 deadline.

Once duly authorised, a UK AIFM will be fully subject to the obligations set out in the AIFMD, which have been transposed into FUND. Authorised UK AIFMs will therefore be required to (amongst other requirements):

- comply with investor disclosure requirements (FUND 3.2);
- produce AIFMD compliant annual reports for each AIF (FUND 3.3);
- comply with certain FCA reporting obligations (FUND 3.4);
- comply with certain limits in relation to securitised products (FUND 3.5);
- implement a liquidity management system (FUND 3.6);
- functionally and hierarchically separate the risk management function from the portfolio management function, and implement adequate risk management systems to identify, measure, manage and monitor appropriately all risks relevant to each AIF investment strategy and to which each AIF is or may be exposed (including setting a maximum amount of leverage which may be employed on behalf of the AIF) (FUND 3.7);
- exercise due skill, care and diligence in the selection and appointment of a prime broker (FUND 3.8);
- implement appropriate procedures for the valuation of the AIFs (FUND 3.9);
- comply with the AIFMD requirements relating to delegation (e.g. the entire delegation structure must be justifiable on objective reasons) (FUND 3.10); and
- appoint a depositary for each of its EEA AIFs, including (but not limited to) acting as the custodian of the AIF assets and to monitor the cash flows of the AIF (FUND 3.11).

Where an authorised UK AIFM wishes to market AIFs to investors domiciled in or with a registered office in the UK (a "UK Investor"), it would have to comply with the AIFMD marketing restrictions as set out in the UK AIFM Regulations as well as with the existing UK private placement regime (as discussed above). Under the UK AIFM Regulations, marketing of EEA AIFs to UK Investors would require prior approval by the FCA (the FCA has 20 working days in which to consider an application), whereas marketing of non-EEA AIFs to UK Investors would require the UK AIFM to provide prior notification to the FCA in which it confirms that the conditions prescribed in reg.57 of the UK AIFM Regulation have been met (i.e. the UK

AIFM is fully compliant with the AIFMD requirements, an appropriate cooperation agreement is in place between the FCA and the home regulator of the third country AIF, and the home jurisdiction of the AIF is not listed as a Non-Cooperative Country and Territory by the Financial Action Task Force).

An authorised UK AIFM may also passport its right to market EEA AIFs to professional investors in other EU Member States by notifying the FCA of its intention to do so. The FCA is obliged to send a copy of this notice of intention to the host state regulator within 20 workings days, upon the receipt of which the UK AIFM may commence marketing EEA AIFs in that territory. As a European passport is unavailable in respect of the marketing of non-EEA AIFs, marketing of non-EEA AIFs into an EU Member State other than the UK would be subject to the national private placement regime of that particular jurisdiction.

### 3.4 The European Market and Infrastructure Regulation

Regulation (EU) 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories ("EMIR") introduces new requirements on market participants to: (i) report all transactions in derivatives to a trade repository (including life-cycle events such as any modification and termination); (ii) clear certain derivatives through a central counterparty ("CCPs"); and (iii) employ risk-mitigation techniques for derivatives that are not cleared through a CCP.

Whilst EMIR came into force on August 16, 2012, the timing for particular rules to come into effect has been staggered.

Certain of the EMIR risk mitigation techniques for OTC derivative contracts not cleared by a CCP came into effect during 2013, such as the requirement for timely confirmation and daily valuation (which came into effect on March 15, 2013), and requirements relating to portfolio reconciliation, portfolio compression and dispute resolution (which came into effect on September 15, 2013).

It is currently expected that the derivatives trade reporting requirement, in respect of all types of derivatives, will come into effect on February 12, 2014 (being 90 days after ESMA authorised the first batch of trade repositories on November 14, 2013). Consequently:

- derivatives contracts entered into before August 16, 2012 and which were not outstanding on this date will not need to be reported;
- derivatives contracts which were outstanding on August 16, 2012 and are still outstanding on the February 12, 2014 will need to be reported by May 13, 2014 (being 90 days after February 12, 2014);
- derivatives contracts entered into before, on or after August 16, 2012 and which are not outstanding on the February 12, 2014 will need to be reported by February 12, 2017; and
- derivatives contracts entered into on or after February 12, 2014 must be reported to a trade repository on a T+1 basis.

There are, however, some outstanding issues (such as which party shall be responsible for generating the Unique Trade Identifier ("UTI")), on which we expect ESMA to publish guidance before February 12, 2014.

The mandatory derivatives clearing requirement is expected to come into effect during mid-2014 (provided the first authorisations of relevant CCPs under EMIR occur during Q1 2014).

### Notes

1 See http://www.fsa.gov.uk/pubs/other/journey-to-the-fca-standard.pdf [Accessed December 2, 2013].

2 Journey to the FCA p.12.

3 Journey to the FCA p.12.

4 Journey to the FCA p.1.

5 The Prudential Regulation Authority's approach to banking supervision p.7 (http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf.) [Accessed December 2, 2013.]

6 Journey to the FCA p.7.

7 See http://www.fca.org.uk/news/laying-myths-to-rest. [Accessed December 2, 2013.]

8 See http://www.fca.org.uk/news/speeches/financial-services-regulation-enforcement. [Accessed December 2, 2013.]

9 In the FCA's 2013/2014 Business Plan the regulator set out, at p.20, a series of initiatives to make everyday banking less frustrating (http://www.fca.org.uk/your-fca/documents/business-plan/bp-2013-14.) [Accessed December 2, 2013.]

10 The government's response to the Parliamentary Commission on Banking Standards report "Changing Banking for Good": https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211047/gov_response_to_the_parliamentary_commission_on_banking_standards.pdf. [Accessed December 2, 2013.]

11 Page 6 of the Government's response to the Parliamentary Commission on Banking Standards report "Changing Banking for Good": https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211047/gov_response_to_the_parliamentary_commission_on_banking_standards.pdf. [Accessed December 2, 2013.]

12 Timescale subject to change.

13 See http://www.fca.org.uk/news/consumer-redress-agreed-for-mis-sold-cpp-insurance. [Accessed December 2, 2013.]

14 The figures quoted are as per a speech by Martin Wheatley, chief executive of the FCA, at the British Bankers' Association Annual International Conference on October 17, 2013.

15 Martin Wheatley, speaking at the ABI Biennial Conference on July 9, 2013: (http://www.fca.org.uk/news/speeches/100-days-of-the-fca.) [Accessed December 2, 2013.]

16 The value of a product to consumers was considered in detail in relation to CPP, as discussed at 2.2.3 above.

17 Report published on June 27, 2013 (http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr13-2-mobile-phone-insurance.) [Accessed December 2, 2013.]

18 Report published June 7, 2013 (http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr13-1.) [Accessed December 2, 2013.]

19 Swinton agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount, the financial penalty would have been £10,543,500. The FCA noted that the fine would have been substantially higher if Swinton had not taken part in an FCA study which looked into how letters offering compensation could be written to ensure more customers respond. Credit was also given to Swinton for the swift action taken by the new management team to put things right after the problems were discovered.

20 Martin Wheatley, speaking at the ABI Biennial Conference on July 9, 2013 (http://www.fca.org.uk/news/speeches/100-days-of-the-fca. ) [Accessed December 2, 2013.]

21 Martin Wheatley, speaking at the ABI Biennial Conference on July 9, 2013: (http://www.fca.org.uk/news/speeches/100-days-of-the-fca.) [Accessed December 2, 2013.]

22 Tracey McDermott, speaking at the NERA Economic Consulting seminar on October 9, 2013.

23 See http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf. [Accessed December 2, 2013.]

24 RBS agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount the financial penalty would have been £125 million.

25 IEL agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount the financial penalty would have been £20 million.

26 Rabobank agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount the financial penalty would have been £150 million. At the time of writing, this is the third highest fine ever imposed by the FCA or its predecessor, the FSA.

27 See http://www.fca.org.uk/news/the-fca-fines-rabobank-105-million-for-serious-libor-related-misconduct. [Accessed December 2, 2013.]

28 See http://www.fca.org.uk/news/the-fca-fines-rabobank-105-million-for-serious-libor-related-misconduct. [Accessed December 2, 2013.]

29 See http://www.fca.org.uk/news/the-fca-fines-rabobank-105-million-for-serious-libor-related-misconduct. [Accessed December 2, 2013.]

30 Tracey McDermott, speaking at the NERA Economic Consulting seminar on October 9, 2013.

31 UBS agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount the financial penalty would have been £9.45 million.

32 Sesame agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount, the financial penalty would have been £8,616,000.

33 AXA agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount, the financial penalty would have been £2,574,595.

34 "Journey to the FCA" p.25.

35 Tracey McDermott speaking at the NERA Economic Consulting seminar on October 9, 2013.

36 Lamprell agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount the financial penalty would have been £3,469,125.

37 RBS agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount; were it not for this discount, the financial penalty would have been £8,029,100.

38 Aberdeen agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount. Were it not for this discount, the financial penalty would have been £10,275,000.

39 The Firm agreed to settle at an early stage and therefore qualified for a 30 per cent (stage 1) discount. Were it not for this discount, the financial penalty would have been £196,586,000.

40 See http://www.fca.org.uk/static/documents/policy-statements/ps13-9.pdf. [Accessed December 2, 2013.]

41 For example, where there is a systems failure or there is a difference of more than 10 per cent between the amount the failing firm should have been holding as client money and the amount actually segregated.

42 Andrew Bailey speaking at the British Bankers' Association Annual International Banking Conference on October 17, 2013 http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech687.pdf. [Accessed December 2, 2013.]

43 The Approach p.21: (http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf.) [Accessed December 2, 2013.]

44 Page 5 of Andrew Bailey's speech at the British Bankers' Association Annual International Banking Conference on October 17, 2013 http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech687.pdf. [Accessed December 2, 2013.]

45 Page 5 of Andrew Bailey's speech at the British Bankers' Association Annual International Banking Conference on October 17, 2013 http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech687.pdf. [Accessed December 2, 2013.]

46 See art.20 of the European Parliament's Report on MiFID II; see art.20 of the Council of Europe's General Approach on MiFID II.

47 See art.36 and art.41 of the European Parliament's Report on MiFID II; see art.41of the Council of Europe's General Approach on MiFID II.

48 See art.72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).

49 See art.4 of Regulation (EU) 648/2012 on OTC, Derivatives, Central Counterparties and Trade Repositories

50 See art.24 and art.2a of the European Parliament's Report on MiFIR; see art.24 and art.20c of the Council of Europe's General Approach on MiFIR.

51 See art.59 and art.60 of the European Parliament's Report on MiFID II; see art.59 and art.60 of the Council of Europe's General Approach on MiFID II.

52 See art.17 of the European Parliament's Report on MiFID II; see art.17 of the Council of Europe's General Approach on MiFID II.

53 See art.31 and art.32 of the European Parliament's Report on MiFIR; see art.31 and art.32 of the Council of Europe's General Approach on MiFIR.

54 See art.25 of the European Parliament's Report on MiFID II; see art.25 of the Council of Europe's General Approach on MiFID II.

55 See art.9 of the European Parliament's Report on MiFID II; see art.9 of the Council of Europe's General Approach on MiFID II.

56 See art.2(1) of the political agreement on MAR (July 5, 2013).

57 See art.2(3)(b) of the political agreement on MAR (July 5, 2013).

58 See art.2(3)(c) of the political agreement on MAR (July 5, 2013).

59 See art.2(1) of the political agreement on MAR (July 5, 2013).

60 See art.2(3a) of the political agreement on MAR (July 5, 2013).

61 *Markus Geltl v Daimler AG*, C-19/11.

62 See art.63 of the political agreement on MAR (July 5, 2013).

63 *Financial Services Authority v Massey* [2011] UKUT 49 (TCC).

64 *Spector Photo Group NV v Commissie voor het Bank, Financie-en Assurantiewezen*, C-45/08.

65 See Directive 2011/61/EU.

66 See reg.59 of the UK AIFMD Regulations (SI 2013/1773).

## Issue 113—Intellectual property and technology issues

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The financial services industry continues to spend billions of pounds globally on technology. The industry is also having to adapt to new procurement models for cloud services and open source software. This Bulletin is devoted to the area of financial services, technology and intellectual property. It includes a discussion of key technology issues for banks and financial services companies, including the hot topics of cloud computing and free and open source software (FOSS). Related to the use of technology and data, it also contains an update on key recent EU developments regarding data protection.

Coverage

- Introduction
- Protecting financial intellectual property
- Technology: key issues
- Implementing an IP policy

## COMPLIANCE OFFICER BULLETIN

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

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