

FINANCIAL REGULATORY UPDATE

# In Principle

10 THINGS YOU NEED TO KNOW FOR 2016  
NEW YEAR; NEW RULES; NEW EXPECTATIONS



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## IN PRINCIPLE: 10 THINGS YOU NEED TO KNOW FOR 2016—NEW YEAR; NEW RULES; NEW EXPECTATIONS

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Financial regulation is in a constant state of flux or, if you are feeling generous, evolution. In this publication, we focus on 10 key issues that we believe firms should be aware of going into 2016:

- increased regulatory scrutiny on asset managers
- culture for firms—a regulatory focus for 2016
- extension of the Senior Managers and Certification Regime
- MiFID II—a whistle-stop tour for investment managers
- compliance with transaction reporting requirements
- forthcoming changes to the market abuse regime
- the new Securities Financing Transactions Regulation
- contractual stays in financial contracts governed by third-country law
- tips for cooperating with the regulator (Principle 11)
- challenging decisions of the regulator.

We begin by assessing the regulatory environment for asset managers and analysing the key issues and upcoming developments that asset managers should be aware of going into 2016. We then address the most important of these and discuss the key issues that firms should be aware of as they consider how to operate within the fast-changing regulatory framework. In particular, we consider the extension of the Senior Managers and Certification Regime (SMCR) to all firms within the Financial Conduct Authority (FCA)'s regulatory perimeter, the key issues for investment managers flowing from the implementation of MiFID II, key regulatory requirements introduced by the new Securities Financing Transactions Regulation, forthcoming changes to the UK's market abuse regime and the impact the EU Bank Recovery and Resolution Directive will have on the financial arrangements of Prudential Regulation Authority (PRA)-authorised firms.

Further, we reflect on the key takeaways from enforcement matters involving the FCA in 2015. In particular, we discuss the FCA's message to industry about the importance of firm culture and the priority it places on this aspect of the regulatory framework. We also emphasise the importance of compliance in relation to transaction reporting. With the regulator imposing significant fines for breaches with a view to achieving credible deterrence in this area, we encourage firms to be sensitive to the regulator's thinking and to conduct regular reviews of their data and the robustness of their transaction reporting systems and controls.

However, it is not only regulated firms, but the regulator itself that is subject to the pressures of change. The FCA has been under intense scrutiny in 2015; it has had to deal with forceful criticism in both the Davis Review (relating to the mishandling of the launch of the 2014/2015 Business Plan) and from the Treasury Select Committee, as well as criticism in recent Tribunal cases. It is important for firms to be aware that it is open to them to challenge the FCA where this is appropriate – and that effective challenge can cause the FCA to change its position.

2016 will be a busy year for anyone working in the regulatory sector as the FCA seeks to address mistakes of the past and position itself as an effective conduct regulator for the future. The appointment of Andrew Bailey (previously of the PRA) as CEO of the FCA would seem to indicate that the government expects a shift in the FCA's priorities and approach and it will be interesting to see how the FCA gives effect to this.

We encourage firms to engage in dialogue with the regulator, but equally it is crucial that at these times of uncertainty firms seek advice and assistance to ensure that they are in the best position possible to manage the myriad of regulatory change coming their way and to ensure that they are meeting regulatory expectations.



## INCREASED REGULATORY SCRUTINY ON ASSET MANAGERS— WHAT YOU NEED TO KNOW

In this article, we outline the key issues on the regulatory agenda that asset management firms should be aware of as they enter a new year of business in 2016. Regulatory scrutiny of the asset management industry has increased over the past 18 months. In February 2015, the FCA published findings to its thematic review on market abuse controls in asset management firms. Shortly after, it announced that a new market study into the asset management industry will be launched to help the regulator consider whether competition is working effectively to enable investors to get value for money when purchasing asset management services. Tackling conflicts of interest issues continues to be a priority for the FCA. Further, significant regulatory reforms in 2016 are expected to create regulatory challenges for asset management firms. Firms should stay abreast of these developments and reflect on the adequacy of the systems and controls embedded in their business to ensure that they are in line with regulatory expectations.

### Market abuse issues in asset management firms

Combating market abuse continues to be a key priority for the FCA. In February 2015, the FCA published the findings of its thematic review on asset management firms and the risk of market abuse. The FCA found that more work was needed in a majority of firms, particularly in relation to controls aimed at identifying the receipt of inside information and post-trade surveillance<sup>1</sup>. Importantly, the FCA report provides examples of procedures and controls that it considers to be good and bad practice across the following themes:

- managing the risk that inside information could be received but not identified
- controlling access to inside information and managing the risk of improper disclosure
- pre-trade controls to prevent market manipulation and insider dealing
- post-trade surveillance
- personal account dealing policies
- training<sup>2</sup>.

Firms should consider the FCA's commentary in light of their own internal procedures and controls, since it can reflect the measure by which firms will be assessed in future market abuse enforcement cases brought by the regulator against asset management firms.

<sup>1</sup> TR15/1: Asset management firms and the risk of market abuse, at pages 1 and 2.

<sup>2</sup> TR15/1: Asset management firms and the risk of market abuse, Chapter 3.

Firms should also consider the extent to which the examples of good and poor practice in respect of the control of inside information set out in the FCA publication TR15/13<sup>3</sup> (which is addressed primarily to brokers) are relevant to their business.

## The FCA's asset management market study

It is clear that the FCA is taking a greater interest in the asset management industry more generally following the publication of its 2015/2016 Business Plan, which announced the regulator's intention to launch a new asset management market study<sup>4</sup>. The launch of this market study is a clear sign that the FCA's strategic focus is shifting beyond the banking sector. According to the terms of reference, which the FCA published in November 2015, the regulator aims to understand through the study whether competition is working effectively to enable investors to get value for money when purchasing asset management services<sup>5</sup>. To do this, the regulator will focus on exploring:

- how asset managers compete to deliver value
- whether asset managers are willing and able to control costs and quality along the value chain
- how investment consultants affect competition for institutional asset management<sup>6</sup>.

It will also consider whether there are any barriers to innovation or technological advances that have the effect of preventing new ways of doing business that could benefit investors<sup>7</sup>.

Although the study's final report is not expected until early 2017, the FCA has indicated that an interim report will be published in summer 2016 that will, among other things, set out the areas that have raised regulatory concern<sup>8</sup>. Asset management firms should be proactive in being informed of the issues identified in the interim report, because this will reflect the FCA's thinking and may signal the areas in which future guidance and regulatory intervention can be expected.

## Conflict of interest issues in asset management firms

Conflict of interest issues in asset management firms continue to be a focus for the FCA. In November 2012, the FCA's predecessor, the Financial Services Authority (FSA), published a report on conflicts of interest between asset managers and their customers<sup>9</sup>. In that report, the regulator reminded asset managers of their regulatory obligations to ensure that conflicts of interest are appropriately managed<sup>10</sup>. It found that many firms had failed to establish an adequate framework for identifying and managing conflicts of interest<sup>11</sup>. Further, it emphasised the importance of culture, noting that "the attitude towards customers established by senior management best

## EU/UK Financial Services Regulatory Practice

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

3 TR15/13: Flows of confidential and inside information.

4 2015/2016 Business Plan, at pages 11 and 44.

5 MS15/2.1 Asset management market study: Terms of reference, see Key Points in Chapters 2 and 4.

6 MS15/2.1 Asset management market study: Terms of reference, see Key Points in Chapter 4.

7 MS15/2.1 Asset management market study: Terms of reference, see Key Points in Chapter 4.

8 FCA press release: <http://www.fca.org.uk/news/asset-management-market-study>.

9 <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>

10 *Conflicts of interest between asset managers*, at page 4: <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>, see section 1.2.

11 *Conflicts of interest between asset managers*, at page 4: <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>, see section 1.3.

explained why some firms managed conflicts well and others badly<sup>12</sup> and that senior management often failed to show that it “understood and communicated this sense of duty to customers.”<sup>13</sup>

Firms should be cognisant of the FCA’s view that having adequate systems and controls to manage the conflicts of interest between a firm and its customers, and between the firm’s customers, is an important area of the regulatory framework, and the regulator will take seriously failures by firms to manage conflicts of interest fairly in accordance with Principle 8 of the FCA’s Principles for Businesses.

## **Key regulatory developments affecting asset management firms**

We expect that, over the course of 2016, there will be greater clarity around the expected impact of key regulatory developments on the asset management industry. In October 2015, the Treasury announced the extension of the SMCR to all Financial Services and Markets Act 2000 (FSMA) authorised persons (with an anticipated implementation date of 2018). Although the details of the extension are not yet known, asset managers should ensure that they are informed of the FCA’s proposals as and when they become available and be mindful of any issues that may surface following the implementation of the SMCR on banks, building societies, credit unions and PRA-regulated investment firms in March 2016<sup>14</sup>. With the commencement date of the EU Market Abuse Regulation (MAR) fast-approaching, asset managers should also consider whether changes to their systems and controls are needed in order to comply with MAR once it comes into effect<sup>15</sup>. Finally, notwithstanding that the effective date of MiFID II<sup>16</sup> is likely to be postponed, asset managers are advised to keep abreast of future developments relating to the implementation of MiFID II to ensure that they will be ready to work within the new regulatory framework once it comes into force.



## **CULTURE FOR FIRMS—A REGULATORY FOCUS FOR 2016**

The FCA has spent a considerable amount of time since its inception emphasising the importance of culture as a driving behaviour for firms, and its 2015/2016 Business Plan states that this continues to be an area of focus and scrutiny. The FCA has said that it will consider culture as part of its assessment of a firm in terms of its approach and behaviour. As such, in 2016, it will be important for firms to consider their existing firm culture and be prepared to articulate how they achieve and demonstrate a “top down”<sup>17</sup> positive culture that meets regulatory expectations. The FCA sees embedding cultural change as important for firms in order to regain the trust of consumers, as well as achieving FCA objectives.

<sup>12</sup> *Conflicts of interest between asset managers*, at page 4: <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>, see section 1.3.

<sup>13</sup> *Conflicts of interest between asset managers*, at page 4: <http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf>, see section 1.3.

<sup>14</sup> For further details on the SMCR, please refer to our article *Extension of the Senior Managers and Certification Regime*.

<sup>15</sup> For further details on MAR, please refer to our article *Forthcoming Changes to the Market Abuse Regime*.

<sup>16</sup> Comprising Directive 2014/65/EU and Regulation (EU) 600/2014.

<sup>17</sup> “Learning the lessons of the past as an industry” (FCA speech, Tracey McDermott, 2 December 2014).

“We continue to believe that a cultural shift within firms to celebrating good conduct that places consumer interests and market integrity at the heart of the financial sector will benefit all stakeholders. We continue to address conduct issues arising from failures in firm culture and are committed to ensuring this momentum is not lost.

Change in culture will only come when the tone at the top is right. However, it also requires staff throughout a business to understand and accept the values and practices the firm espouses. This means that firms must ensure that all of their processes support and reinforce the culture they want to promote. . . . We have a range of tools at our disposal to actively combat any poor conduct by firms and individuals.”

*(FCA Risk Outlook 2014/2015)*

The focus on culture arose following the financial crisis in the LIBOR and FX scandals. Clive Adamson, the then director of supervision at the FCA, said, “We accept that the FSA has not been as effective a conduct regulator as it could have been,”<sup>18</sup> but he then referred to the fact that it was felt that, when things went wrong (e.g., the misselling of PPI or manipulation of LIBOR), the cultural issue was at the heart of the problem.

The FCA has refused to expressly articulate what it means by culture, stating, “You should not. . . . need a rule book to determine right from wrong. Indeed, it would be impossible and frankly undesirable for any regulator to attempt to codify the limits of what is or is not morally acceptable.”<sup>19</sup> The FCA has warned that “Culture is notoriously difficult to measure and assess—let alone change.”<sup>20</sup> However, it has sought to try and communicate its expectations in this area to firms with references to getting firms to “do the right thing”<sup>21</sup> and emphasising compliance with the “spirit” of the rules, as well as the technical requirements. It has talked about firms putting customers “at the heart of the business.”

The FCA has also made particular reference to examples of poor culture within firms in final notices. For example, in a recent case where a major investment firm was criticised in relation to LIBOR- and EURIBOR-related misconduct and for apparently misleading the FCA in its investigation of these matters, the FCA commented:

“The Authority expects firms to promote a culture which requires staff to have regard to the impact of their behaviour on other market participants and the financial markets as a whole. This includes responding promptly, effectively and accurately to regulatory enquiries.”<sup>22</sup>

In an FX case involving a major bank, the FCA stated on the subject of culture that it expects firms to:

“identify, assess and manage appropriately the risks that their business poses to the markets in which they operate and to preserve market integrity, irrespective of whether or not those markets are regulated.”<sup>23</sup> Firms should also “promote a culture which requires their staff to have regard to the impact of their behaviour on clients, other participants in those markets and the financial markets as a whole.”<sup>24</sup>

The FCA has also outlined its position in relation to culture more generally. For example, the newly appointed FCA director of enforcement, Mark Steward, has referred to culture with reference to “an integrated ideal of good governance, regulatory compliance and fair process.”<sup>25</sup> To achieve this, he has said that firms<sup>26</sup> need to:

- understand the nature of their business in detail
- have effective systems and controls to ensure that the business is operating effectively and in accordance with conduct standards
- undertake risk-focussed counterfactual or counterintuitive audits of their systems and controls—systems and controls cannot be approached on a “set and forget” basis.

<sup>18</sup> “The importance of culture in driving behaviours of firms and how the FCA will assess this” (FCA speech, Clive Adamson, 19 April 2015).

<sup>19</sup> “The commercial importance of culture to industry” (FCA speech, Martin Wheatley, 2 December 2014).

<sup>20</sup> “The fairness challenge” (FCA speech, Martin Wheatley, 25 October 2013).

<sup>21</sup> “The fairness challenge” (FCA speech, Martin Wheatley, 25 October 2013).

<sup>22</sup> DeutscheBank Final Notice, 23 April 2015 paragraph 2.4.

<sup>23</sup> Barclays Final Notice, 20 May 2015 paragraph 2.3.

<sup>24</sup> Barclays Final Notice, 20 May 2015 paragraph 2.3.

<sup>25</sup> “Culture and Governance” (FCA speech Mark Steward 11 November 2015)

<sup>26</sup> “Culture and Governance” (FCA speech Mark Steward 11 November 2015).

He has further noted that one way of knowing when culture has failed is to consider<sup>27</sup>:

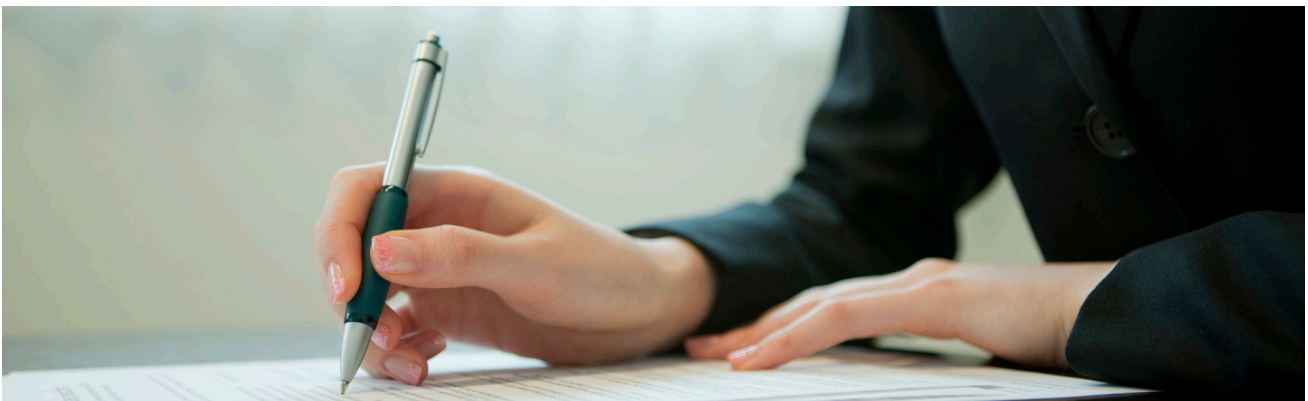
- how quickly it takes for problems to escalate to the right person or group of persons for effective decision making or action
- how many problems linger in the inbox or the draft box or the bottom drawer beyond their easily fixable date
- how difficult it is to fix things once they are detected.

Assessment of firm culture will be undertaken by the FCA through a range of different measures, such as observing how the firm responds to, and deals with, regulatory issues, customers' experience interacting with the firm, how the firm runs product approval processes, and considerations around that and the manner in which decisions are made or escalated. Board engagement with these issues will also be scrutinised.

The FCA had indicated that it would commence a thematic review of banking culture in 2015,<sup>28</sup> but it recently announced that this would no longer be pursued. The FCA has been at pains to emphasise that this should not be taken as any indication that culture is no longer a priority, with acting CEO Tracey McDermott stating, "We're not going soft on the banks, we're not being told what to do by the government. We have objectives which are set for us by parliament and statute and we are determined to deliver on these."<sup>29</sup>

The FCA's 2015/2016 Business Plan said that the FCA is particularly concerned in relation to the poor culture and controls that threaten market integrity, including conflicts of interest and poor culture and practice in consumer credit affordability assessments that result in unaffordable debt. Firms will need to be prepared to describe the culture that exists and the steps taken to embed a positive regulatory culture within their processes and people.

Fundamentally, firms should seek to achieve compliance with the FCA's regulatory requirements, but also take a commonsense view as to their approach and consider whether it could be perceived as doing the right thing by its customers and by the FCA. They need to focus on the objective of a regulation, as well as the technical compliance, looking broadly at their business and considering the key messages being communicated by the regulator in guidance and final notices. It is apparent that technical compliance alone will not be enough and that the FCA is not planning to back down on its expectations in relation to culture any time soon.



## EXTENSION OF THE SENIOR MANAGERS AND CERTIFICATION REGIME

On 15 October 2015, the Treasury announced that the government intends to extend the SMCR to all FSMA-authorized persons (with an anticipated implementation date of 2018)<sup>30</sup>. The intention is to replace the Approved Persons Regime (APR) that was subject to significant criticism following the financial crisis. Policy-makers hope that the extension of the SMCR will enhance personal responsibility for senior managers, as well as provide a more effective and proportionate means to raise standards of conduct of key staff more broadly.

<sup>27</sup> "Culture and Governance" (FCA speech Mark Steward 11 November 2015).

<sup>28</sup> FCA Business Plan 2015/2015 said this would commence in 2015, with start and end dates to be confirmed.

<sup>29</sup> BBC News "Financial Regulator FCA denies "going soft" on banks" (9 January 2016).

<sup>30</sup> HM Treasury policy paper *Senior Managers and Certification Regime: extension to all FSMA authorised persons*.



The key features of the extended SMCR are:

- an approval regime focused on senior management with requirements on firms to submit robust documentation defining the scope of these individuals' responsibilities
- a statutory requirement for senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility (this has replaced the reverse burden of proof for senior managers in relation to regulatory breaches in their areas of responsibility)
- a requirement on firms to certify as fit and proper any individual who performs a function that could cause significant harm to the firm or its customers both on recruitment and annually thereafter
- a power for the regulators to apply enforceable rules of conduct to any individual who can impact their respective statutory objectives.

The intention of the expansion of the SMCR across the industry is said to be "to enhance personal responsibility for senior managers, as well as providing a more effective and proportionate means to raise standards of conduct of key staff more broadly, with robust enforcement powers to the regulators."<sup>31</sup> It will also be significantly simpler for the regulators to administer one regime rather than two.

The proposed reforms follow the recommendations made in the Fair and Effective Markets Review,<sup>32</sup> which suggested that elements of the SMCR should be extended to cover firms active in fixed income, commodities and currency. Part of the reasoning given for extending the regime beyond the banking sector is to avoid regulatory arbitrage by ensuring that the same standards apply across banking, as well as other financial services.<sup>33</sup>

For more senior people, there will still be prior regulatory approval required for individual appointments, but, for less senior but nonetheless important positions, firms will have to take responsibility for ensuring that an individual is fit and proper on a regular basis, and formally confirm this at least once a year. This moves the administration of the regime from the regulator to the firm.

A significant issue in extending the regime beyond banking is the question of proportionality. Proposals that have been designed to fit banking firms will need to be applied to the diverse business models in the U.K. market. We can expect further consultation papers to be issued on the regulators' proposals.

The main impact for new firms being brought into the regime are expected to be:

- a substantial reduction in the number of appointments that are subject to prior regulatory approval (although firms will be required to undertake new tasks in terms of preparing statements of responsibility and other required information)
- the need to define (in detail) the scope of each senior manager's responsibilities and ensure that the regulatory requirements for both the firm and the senior manager are met
- firms will need to ensure that senior managers have sufficient and available resources to carry out their roles (this is something that senior managers should insist on, given the focus on their personal accountability)
- most current approved persons below senior management level are expected to become certified persons; in some roles, prior regulatory approval may not have been required, but these will still now become certified person roles
- firms are likely to incur additional costs from putting in place systems to ensure that employees are notified about, and receive suitable training in, the rules of conduct that apply to them.

The SMCR will come into operation for banks, building societies, credit unions and PRA-regulated investment firms on 7 March 2016. These firms have been given until 7 March 2017 to complete the certification of existing staff. The government intends that the implementation of the newly extended regime should come into operation for other financial services firms during 2018.

While it was always anticipated that the SMCR would be extended, it is notable to see the speed with which this has moved through. While the regulators have emphasised that this new regime will increase accountability and their

<sup>31</sup> HM Treasury policy paper *Senior Managers and Certification Regime: extension to all FSMA authorised persons*.

<sup>32</sup> *Fair and Effective Markets Review: Final Report* – June 2015.

<sup>33</sup> HM Treasury policy paper *Senior Managers and Certification Regime: extension to all FSMA authorised persons*.

ability to enforce against individuals, given the amount of responsibility that lies on the firm to approve and monitor, one cannot help but question what will really change. The regulator will be less involved in the process and will have a more limited gatekeeper function. The question will be whether the new regime will cure the ills of the APR – or whether it will simply present them in a different form.



## MIFID II—A WHISTLE-STOP TOUR FOR INVESTMENT MANAGERS

### Introduction

Over the past 12 months or so, the commentary regarding the second Markets in Financial Instruments Directive (“MiFID II”) has ranged from the gravely concerned to the welcoming when discussing the impending paradigm shift in the regulation of the European financial markets. However, notwithstanding the wide-ranging coverage on the subject matter, it is often unclear to legal and compliance personnel, let alone senior managers, traders and other front-of-office staff, what all the noise about MiFID II is about and, more importantly, what business impact the new rules in MiFID II will have.

The very short answer to the open question about business impact is that any business that involves the distribution and trading of shares, bonds or other financial instruments in the EU is highly likely to feel the impact of the changes introduced by MiFID II. While the specific impact will largely depend on a firm’s business model (for example, commodity derivatives and algorithmic traders being subject to specific rules), there are some common considerations for firms active in the sector generally. To better understand what this broad effect of MiFID II comprises, we will explore below some of the key topics in MiFID II generally concerning investment managers.

### Application

MiFID II/MiFIR will apply to investment firms, including investment managers, investment advisors, wealth managers and brokers; banks and other credit institutions when providing investment services and/or performing investment activities; operators of trading venues, including any pure market operator; financial counterparties (and certain nonfinancial counterparties) subject to the European Markets Infrastructure Regulation (EMIR); Central Counterparties (CCPs) and persons with proprietary rights to benchmarks; and non-EU firms who wish to provide investment services or activities in any EU member state.

### Objectives

The changes to the EU-wide financial regulatory framework introduced by MiFID II seek to bring about greater stability of the international financial system; to improve the symmetry of market information; and to achieve a more transparent and responsible financial system in the EU, countering market abusive trading practices in the financial markets and awarding greater protection to consumers.

## Structure

While MiFID I set out a framework for the regulation of the financial markets and the provision of investment services in the EU, since it was required to be separately implemented into national legislation in the different EU member states, in practice, MiFID amounted to a single set of rules applicable to EU investment firms, albeit subject to significant variation in the implementation of the regulatory requirements and oversight to which investment firms were subject.

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

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

In broad terms, the revised MiFID II Directive contains the rules that govern the operation of investment firms and operators of trading venues and other trading-related market infrastructures, which will be separately implemented into national legislation. By contrast, MiFIR will be directly applicable across the EU, and there will be no national divergence in the implementation of those rules.

By way of a high-level overview, the five headline issues affecting all investment managers arising from MiFID II are:

### 1. Use of dealing commissions to pay for research

MiFID II extends the rules applicable to investment firms on incentives. While firms under the existing MiFID rules are not permitted to accept inducements (i.e., “fees, commissions or any monetary or nonmonetary benefits paid or provided by any third party”) other than in limited circumstances, original, meaningful research is currently considered to be a permissible benefit as it falls within the limited circumstances permitted. MiFID II will effectively prohibit investment firms from receiving investment research from brokers pursuant to bundled commission arrangements, which is currently market practice. Investment managers may continue to receive research, provided that such research is paid for separately.

The key objective and effect is to sever any link between execution volumes and research spend. The shift is bound to have an impact on the quantity and quality of research acquired, and likely also on the scope of investments regarding which research is produced.

### 2. Best execution

Best execution was an investor protection concept introduced under MiFID, but its impact on the market and trading practices has been uneven. The central difficulty has been the objective measurement of best execution in most asset classes, with the exception of very liquid shares. MiFID II aims at enhancing this regime by requiring greater transparency of execution quality of different execution venues. Execution venues will be required to publish annually their execution quality data based on factors including price offered, execution costs, and speed and likelihood of execution.

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

### 3. Regulatory reporting and recording requirements

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

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

While delegation of transaction reporting will still be permitted, it is likely to be more complicated, since the investment manager would be required to capture and transmit all relevant information, including the trading decision/execution identifier. It is expected that, for the vast majority of investment managers, the preferred solution will be to undertake the transaction reporting in-house.

As a separate aspect of the enhanced transparency regime under MiFID II, the draft Regulatory Technical Standards concerning certain recordkeeping requirements introduced an EU-wide requirement for firms subject to MiFID II to record “relevant conversations.” The requirement applies to all conversations intended to result in a client transaction. This is in contrast to the existing position under MiFID that currently contains no mandatory requirement to record telephone calls. However, the UK (along with some other EU member states) mandates the recording of telephone calls that actually result in a client transaction. While, in the UK, the existing recording obligation is subject to an exemption allowing investment managers to rely on EU brokers to record the calls, MiFID II contains no such exemption. In addition, the retention period for such records will be extended from six months under the existing FCA rules to five years under MiFID II.

### 4. Transparency

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

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

### 5. Investor protection

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

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

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

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

### **Implementation—what next?**

MiFID II empowers ESMA to develop numerous technical standards (RTS) and draft implementing technical standards (ITS), and ESMA delivered these in September and December 2015, respectively. These technical standards contain much of the real substance of MiFID II and were submitted to the Commission for its endorsement. Once adopted by the Commission and published in the Official Journal, the EU member states will then be required to amend their existing legislation or implement new legislation to reflect the new requirements by 3 July 2016, and MiFID II is scheduled to come into force on 3 January 2017.

In terms of the directly effective legislation under MiFIR, it is nevertheless expected that there should be a national consultation process for the incorporation of the directly effective requirements into the national rules.

Although the European Parliament has formally stated that it is willing to accept a wholesale delay of the effective date of MiFID II by one year, at the time of writing, the amendment to the Level 1 provisions necessary to give effect to such a delay has not been made, and, hence, the implementation date of MiFID II remains uncertain. Therefore, investment managers should be working in the first instance to undertake a gap analysis to establish the key areas of change as applicable to their specific strategies and business models, to address operational issues and systems requiring updating or material improvement, and to identify both the threats and opportunities that MiFID II might present.

While the overall impact of MiFID II on investment managers will be significant, the changes are likely to belie opportunities, as well as challenges. Time for contemplation is short, and the sooner investment managers engage in action, the better.



## **COMPLIANCE WITH TRANSACTION REPORTING REQUIREMENTS**

Firms must continue to make adherence to FCA transaction reporting requirements a key priority for 2016, since the FCA is imposing increasing fines for non-compliance in this area. The issue is also relevant to the implementation of MiFIR, with ESMA currently consulting on its guidelines on transaction reporting, reference data, order recordkeeping and clock synchronisation.<sup>34</sup>

<sup>34</sup> ESMA consultation paper 23 December 2015 (ESMA/2015/1909). This guidance is intended to complement the technical standards and will be important to achieve consistent implementation of the upcoming MiFIR rules. The guidance is described as “*focused on the construction of transaction reports and of the order data records filed by field for various scenarios that can occur.*” The final guidance is expected to be published in the second half of 2016.

The FCA has emphasised the importance that it places on transaction reporting, stating:

*“Proper transaction reporting really matters . . . . Accurate and timely reporting of transactions is crucial for us to perform effective surveillance for insider trading and market manipulation in support of our objective to ensure that markets work well and with integrity.”<sup>35</sup>*

The FCA requirements for transaction reporting are set out in the Supervision Manual Chapter 17 (“SUP17”). Firms are required to submit data for a reportable transaction by close of business the day after a trade is executed. The reports are then reviewed by the FCA as part of its monitoring for market abuse and firm and market supervision. The FCA also exchanges certain transaction reports with other European Economic Area competent authorities.<sup>36</sup>

The FCA has made significant efforts to assist firms in understanding their reporting obligations under SUP17. These have included the publication of the FCA Transaction Reporting User Pack (TRUP), which is intended to be read with SUP17 and provide firms with sufficient guidance to make informed decisions about their FCA transaction reporting obligations.

The FCA has also established a page on its website that sets out its transaction reporting library.<sup>37</sup> This sets out useful links to help firms with common transaction reporting issues and queries. Extracts from the FCA publication Market Watch are included in the webpage detailing FCA commentary on specific aspects of transaction reporting. Firms are encouraged to monitor FCA communications to ensure that they stay up to date and review Market Watch newsletters.

The FCA Transaction Monitoring Unit (which monitors compliance with SUP17, as well as surveillance of markets for market abuse) is available to answer questions from firms about transaction reporting. It is also available to provide a sample of a firm’s transaction reports so that these can be checked against a firm’s internal data.

The FCA has sought to encourage discussion with industry by establishing a transaction reporting forum that provides an opportunity for FCA authorised firms and industry trade bodies to directly engage with the FCA Transaction Monitoring Unit on related developments and issues. The slides presented at the forum are made available on the FCA website.<sup>38</sup>

Despite the substantial level of guidance and support that the FCA has sought to make available, cases continue to be brought against firms for non-compliance in this area, with a number of high-profile firms receiving significant fines. The FCA appears to be increasingly frustrated that firms do not appear to be getting its message that transaction reporting matters.

The enforcement action taken against Merrill Lynch International (MLI) in 2015 for transaction reporting failures is an example of how seriously the regulator will take breaches in this area. MLI was fined £13,285,900, which is the largest fine ever imposed by the FCA for transaction reporting failures, and it was the first time the FCA applied a penalty of £1.50 per line of incorrect or nonreported data. The FCA considered that, although a penalty of £1 per line had been used in recent reporting transactions cases, fines that were calculated on this basis had not been high enough to achieve credible deterrence.

Between November 2007 and November 2014, MLI had failed to report 121,387 transactions and incorrectly reported 35,034,810 transactions to the FCA in breach of SUP17.1.4R and SUP17.4.1 EU/SUP17 Annex 1 EU. For example, some of MLI’s transaction reports contained inaccuracies, including incorrect details of the central counterparty and client, incorrect use of the Buy/Sell indicator, omission of the maturity dates of certain derivative transactions and the incorrect BIC code for certain transactions.

The FCA stated that “[a]ccurate and complete transaction reporting is essential to enable the Authority to meet its operational objective of protecting and enhancing the integrity of the United Kingdom financial system. The primary purpose for which the Authority uses transaction reports is to perform surveillance for and to inform investigations into market abuse, insider trading and market manipulation and related financial crime.”

<sup>35</sup> FCA press release 22 April 2015, “FCA fines Merrill Lynch International £13.2 million for transaction reporting failures.”

<sup>36</sup> *Through the Transaction Reporting Exchange Mechanism of the European Securities Markets Authority.*

<sup>37</sup> <http://www.fca.org.uk/firms/systems-reporting/transaction-reporting/transaction-reporting-library>.

<sup>38</sup> <http://www.fca.org.uk/firms/systems-reporting/transaction-reporting/transaction-reporting-forum>.

This decision is a strong signal that the FCA will take increasingly tough action against firms that are not compliant with their transaction reporting obligations. Georgina Philippou, the FCA's then acting director of enforcement and market oversight, commented:

“The size of the fine sends a clear message that we expect to be heard and understood across the industry.”

Firms should review their systems and controls to ensure that their transaction reporting is accurate and meets FCA expectations. The integrity of data used for transaction reporting should be regularly reviewed and any necessary amendments to transaction reporting processes initiated. Failure to do so can have severe consequences, since the FCA's patience appears to be wearing thin.



## FORTHCOMING CHANGES TO THE MARKET ABUSE REGIME

The new Market Abuse Regime (MAR)<sup>39</sup> comes into effect on 3 July 2016<sup>40</sup> and will be directly applicable in each of the European Member States without the need for national implementation. Below we outline the main changes that MAR will make to the UK's current market abuse regime.

### Increased scope (Article 2)

MAR will apply to a wider range of financial instruments and trading platforms than the currently applicable Market Abuse Directive (MAD)<sup>41</sup>. The current regime applies only to financial instruments traded on regulated markets and related financial instruments. The new regime extends to financial instruments traded on MTFs and Organised Trading Facilities (OTFs) and to financial instruments whose price depends on, or has an effect on, such financial instruments. The market manipulation provisions are also extended to related spot commodity contracts and to behaviour in relation to benchmarks. In addition, emission allowances are brought within scope.

<sup>39</sup> Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC.

<sup>40</sup> Although those requirements in MAR that refer to concepts that will be introduced by MiFID (e.g., requirements relating to Organised Trading Facilities) will not come into effect until 3 July 2017, when MiFID itself comes into effect.

<sup>41</sup> Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse).

## **Insider dealing and unlawful disclosure (Articles 7, 8, 9, 10 and 14)**

The definition of inside information is largely unchanged under the new regime; however, the definition in relation to commodity derivatives has been extended to cover price-sensitive information relating to spot commodity contracts and “information which is reasonably expected to be disclosed or required.” There is also a new definition of inside information in relation to emission allowances and auctioned products based on such emission allowances (this definition does not extend to information relating to issuers of such emission allowances or auctioned products). There are also new aspects to the definition of insider dealing (submitting, modifying or withdrawing a bid in relation to auctions of emission allowances and cancelling or amending prior orders after coming into possession of inside information, etc.).

## **Market soundings (Article 11)**

MAR provides a framework for disclosing inside information in the course of market soundings. Where market participants comply with certain requirements, they will be protected against the allegation of improper disclosure. These include (i) before the sounding, considering whether inside information will be disclosed; (ii) informing the proposed recipient of its obligations under the regime; and (iii) obtaining the proposed recipient’s consent to receiving the inside information. Market participants will be required to keep appropriate records in order to demonstrate their compliance with the requirements.

Further detail on this new protection will be set out in the more detailed “Level 2” measures (which are yet to be finalised) and is also set out in the technical standards (TS)<sup>42</sup> published by ESMA on 28 September 2015. These TS comment on other aspects of the new legislation and translate how the requirements will apply in practice to market participants, market infrastructures and national supervisors.

## **Changes to market manipulation (Articles 12 and 15)**

As discussed above, the scope of instruments to which the market manipulation provisions apply has been expanded under MAR. There is also a new offence of attempted market manipulation.

## **Suspicious transaction reporting (Article 16)**

The current suspicious transaction reporting regime is extended under MAR to include suspicious order reporting. Operators of trading venues and persons professionally arranging or executing transactions will be required to prevent, detect and report suspicious behaviour. ESMA’s TS published in September 2015 include its technical standards for reporting suspicious orders and transactions.

## **Disclosure obligations (Article 17)**

The current obligation on issuers to disclose “as soon as possible” remains under MAR; however, the obligation is now extended to include Emission Allowance Market Participants (EAMPs) with emissions above a certain threshold.<sup>43</sup> There are also possibilities now to delay disclosure in certain circumstances; for example, where disclosure would prejudice “legitimate interests,” the delay does not “mislead the public,” and the issuer/EAMP can ensure confidentiality.<sup>44</sup> In such circumstances, the competent authority must be notified of the delay and provided with a written explanation of how these conditions have been met as soon as the information is disclosed to the public. Alternatively, MAR allows for the issuer/EAMP to be required to give this explanation only if the relevant competent authority requests it. The latter option is currently the FCA’s and the Treasury’s preference, but the FCA is consulting on this issue.<sup>45</sup>

<sup>42</sup> Final Report: Draft technical standards on the Market Abuse Regulation—28 September 2015—ESMA/2015/1455.

<sup>43</sup> The Commission will adopt delegated acts that specify the relevant threshold. ESMA’s technical advice on this was published on 3 February 2015 (ESMA/2015/224).

<sup>44</sup> ESMA has said it will publish some guidelines to establish a nonexhaustive indicative list of what constitutes a “legitimate interest” and “misleading the public” (see paragraph 244 of the TS).

<sup>45</sup> FCA CP 15/35: Policy proposals and handbook changes related to the implementation of the Market Abuse Regulation (2014/596/EU)—November 2015 (“FCA CP 15/35”).



There is also a new provision in MAR for financial institutions to delay disclosure where it would entail a risk to financial stability, it is in the public's interest to do so, and confidentiality can be maintained. In these circumstances, the consent of the competent authority will be required beforehand.

ESMA's TS include the technical means for public disclosure of insider information and delays.

## **Insider lists (Article 18)**

The current requirement on issuers to have insider lists is extended under the new regime to EAMPs. The issuers/EAMPs will retain ultimate responsibility where their lists are maintained by a third party, and the lists will be required to be kept for five years. ESMA's TS set out the required format and template of the insider lists and the format for updating them.

## **Managers' transactions (Article 19)**

Persons with managerial responsibilities in an issuer (and persons connected to them) are already obliged to disclose their dealings in shares of the issuer, as well as derivatives or financial instruments relating to those shares.<sup>46</sup> This regime will now be extended to include issuers who trade on only MTFs and OTFs. Furthermore, persons discharging managerial responsibilities and closely associated persons will be required to notify the issuer/EAMP and the FCA of transactions in the issuer's/EAMP's specified financial instruments. The issuer/EAMP will then be required to make the information public. The time frame in which to do so is reduced under MAR to no later than three business days after the transaction. Notifications will be required once a EUR 5,000 per year threshold is reached.<sup>47</sup> Level 2 measures will specify the circumstances when trading during a closed period may be permitted, and the transactions covered. ESMA has provided its technical advice on this subject in the TS.

## **Investment recommendations (Article 20)**

The new regime will apply to any person producing or disseminating investment recommendations or other information recommending or suggesting an investment strategy (the current concept of "relevant persons" will no longer apply). Such information must be objectively presented, and persons must disclose or indicate conflicts of interest concerning the financial instruments to which the information relates. ESMA's TS discuss the arrangements for producing investment recommendations or other information recommending or suggesting an investment strategy.

## **Whistle-blowing (Article 32) and sanctions (Article 30)**

Under MAR, there is a requirement on competent authorities and firms to establish systems to encourage and enable whistle-blowing. The new regulation will also impose minimum levels for administrative sanctions. These requirements are already in place in the UK, but they are worth noting as they will drive up standards in the rest of the EU.

## **What next?**

The U.K. Treasury is currently preparing secondary legislation to repeal/modify existing domestic law that conflicts with MAR in order to meet the UK's obligations under the new regime. The FCA, meanwhile, published a consultation paper in November 2015, setting out its proposals for the changes to the handbook that would be required to implement the new regime.<sup>48</sup> In particular, s.118 of the FSMA, which sets out the existing market abuse regime, will be repealed. The FCA has made it clear, however, that the handbook should not be regarded as the source of all provisions relating to market abuse. After 3 July 2016, the handbook will provide guidance on matters governed by MAR, but it will not take the form of binding rules as it does currently. In addition, it will provide guidance only where the FCA decides that is appropriate.

<sup>46</sup> FCA Disclosure and transparency rule 3.1.

<sup>47</sup> Competent authorities are given discretion under MAR to increase this threshold to EUR 20,000. The FCA is proposing to adopt the default position of a EUR 5,000 threshold, but it is currently consulting on this in FCA CP 15/35.

<sup>48</sup> FCA CP 15/35.

The regulation itself is directly applicable, and July 2016 is fast approaching. Firms within scope should already be considering what changes they will need to make to their systems and controls during the next six months in order to be able to comply with MAR once it takes effect. They therefore need to be aware of all aspects of MAR that are applicable to them (including implementing measures) and any relevant ESMA guidelines. Firms should also be aware that the FCA has recently conducted thematic reviews on flows of confidential and inside information<sup>49</sup> and asset management firms and the risk of market abuse,<sup>50</sup> and should bear the regulator's findings in these reviews in mind when considering whether changes in systems and controls are needed to ensure that they will be able to comply with MAR.



## THE NEW SECURITIES FINANCING TRANSACTIONS REGULATION

The Securities Financing Transactions Regulation (SFTR), which imposes requirements on managers authorised under the EU Alternative Investment Fund Managers Directive (AIFMs) and the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS) to make certain investor disclosures to investors, was adopted by the European Council on 16 November 2015. Some of the investor disclosure obligations under the SFTR took effect when the SFTR entered into force in January 2016, while further investor disclosure requirements will apply from 2017, although funds established before January 2016 may defer compliance with investor disclosure obligations until 2017. In addition, the SFTR imposes certain other obligations in respect of securities lending transactions, repurchase agreements and other securities financing transactions, which will take effect later in 2016 and in 2017.

The SFTR is part of the EU's package of legislative measures aimed at addressing perceived issues with shadow banking.

### Key Requirements

The SFTR introduces new rules requiring:

1. AIFMs and UCITS management companies ("managers") to disclose in the offering documents of the funds that they manage whether those funds utilise securities financing transactions and total return swaps and to provide investors with periodic reports on the use of such transactions and swaps by the fund (the "investor disclosure

<sup>49</sup> <http://www.fca.org.uk/news/tr15-13-flows-of-confidential-and-inside-information>.

<sup>50</sup> <http://www.fca.org.uk/news/thematic-reviews/tr15-01-asset-management-firms-and-the-risk-of-market-abuse>.

obligation”); managers will be required to comply with the investor disclosure obligation from January 2016 with respect to the offering documents and 2017 with respect to the periodic investor reports

2. parties to “securities financing transactions” (including margin lending transactions, as well as securities and commodities lending or borrowing transactions, repurchase transactions, reverse repurchase transactions, and buy-sellback and sell-buyback transactions) to report the terms of those transactions to trade repositories (the “reporting obligation”); the reporting obligation will take effect in 2018 after the relevant secondary legislation (the regulatory technical standards, or RTS) has been finalised, subject to a number of different phase-in periods
3. the counterparty receiving collateral pursuant to any arrangement that permits the reuse of collateral to give certain information to the collateral provider regarding the effect of providing collateral with a right of reuse
4. the prior explicit consent (evidenced by a formally concluded written agreement or similar) of the collateral provider to such collateral arrangement (including granting the right of reuse of the collateral) (together with (3) above, the “collateral documentation requirements”); the collateral documentation requirements will take effect in mid-2016.

While the investor disclosure obligation relating to the offering documents takes effect in January 2016, a transitional period under the SFTR allows managers to postpone compliance until mid-2017 in respect of funds that were constituted before January 2016.

## **Impact**

### *Investor disclosure obligation*

The SFTR will require managers to include in the offering documents of their funds a general description of the securities financial transactions/total return swaps used by the fund, and the rationale for their use. Additional disclosures include overall data regarding the types of assets that can be subject to such transactions/swaps, criteria used to select counterparties and a description of acceptable collateral.

Separately, managers must disclose in the fund’s annual and semiannual investor reports information regarding the fund’s use of securities financing transactions and total return swaps. Information to be disclosed will include at least the following:

- global data regarding the amount of securities/commodities on loan as a proportion of total lendable assets, and the fund’s assets engaged in each type of transaction or swap
- concentration data, including the 10 largest collateral issuers across all transactions/swaps and the 10 largest counterparties of each type of transaction/swap (including counterparty name and gross volume of outstanding transactions)
- aggregate transaction data for each type of transaction/swap, including type of collateral and maturity tenor of the transaction/swap
- data on the reuse of collateral and regarding the safekeeping of collateral in the course of the transactions/swaps
- data on the return and cost for each type of transaction/swap.

While the challenge to managers will be to ensure that they have all of the data required for the disclosures, the overall effect on trading practices is not expected to be substantive. However, the granularity of the information to be provided to investors and prospective investors will be a change to some managers, and there may be concerns about potentially commercially sensitive data leaking to the market.

### *Reporting obligation*

The reporting obligation requires any counterparty to a securities financing transaction that is an undertaking established in the EU to make a report to an approved or recognised trade repository when the securities financing transaction is concluded, modified or terminated. The reporting obligation applies to securities financing transactions concluded on or after the reporting start date, and to certain securities financing transactions that remain outstanding

on the reporting start date. While the reporting obligation applies on an extraterritorial basis to a counterparty that is a non-EU undertaking, it is likely that it applies to such non-EU counterparty only if it is acting through a branch located in the EU.

The information to be reported to trade repositories will include at least the parties and beneficiaries, principal amount, currency, collateral details, lending fee and maturity date. Full details of the reportable data will be set out in the RTS.

The reporting obligation may be delegated to one of the counterparties, save in certain circumstances. Notably, if the counterparty subject to the reporting obligation is an AIF or a UCITS, the reporting obligation applies to the manager and cannot be delegated to the other counterparty. In practice, the reporting obligation will further expand the duties of the compliance functions, but should not cause material changes to trading practices.

*Collateral documentation requirements*

The collateral documentation and reuse requirements apply to all EU persons, not only regulated entities. The collateral documentation and reuse requirements will also have extraterritorial application to non-EU persons seeking to enter into, or continuing, securities financing transactions pursuant to collateral reuse arrangements with an EU person, or with an EU branch of a non-EU person.

The SFTR will impose the collateral documentation requirements on the reuse of collateral under all collateral arrangements and will apply retroactively to all collateral arrangements in place on the date the SFTR takes effect. Collateral documentation requirements are unlikely to have a significant impact on existing practices, especially in the UK, where the large prime brokers are already required to provide separate and extensive disclosure of the risks of rehypothecation.

While the SFTR will require changes to existing documentation, the changes are unlikely to be overly burdensome on the counterparties. It is likely that standard amendments to master agreements and, possibly, other market-standard, risk-warning language will be developed to allow for a consistent approach to meeting the SFTR requirements.

**Interaction with other EU rules**

The new rules overlap with a number of existing and planned EU and national requirements with respect to investor disclosure (including AIFMD) and to collateral arrangements (including the proposals under the revised MiFID II regarding the use of title transfer collateral arrangements by nonretail clients).



## CONTRACTUAL STAYS IN FINANCIAL CONTRACTS GOVERNED BY THIRD-COUNTRY LAW

A recent policy statement<sup>51</sup> from the PRA sets out final rules aimed at reducing the risk of contagion from the failure of a U.K. regulated bank (and insurance companies) and supporting its orderly resolution. The rules ensure that resolution action taken in relation to a firm would not immediately lead to the early termination of its financial arrangements (or those of its subsidiaries) governed by third-country law, while similar financial arrangements governed by the U.K. laws, or those of another European Economic Area jurisdiction, are stayed.

### What is the background to final rules?

In the summer of 2008, you would have been hard-pressed to find many people outside central banks, university economics departments and a small number of hedge fund managers with exceptional foresight who spent much time thinking about “financial contagion risk” or who even really understood what it meant. When Lehman Brothers collapsed in September of that year, the dominoes began to fall—the collapse triggered a series of contractual defaults and crossdefaults that quickly spread from Lehman through its counterparties and into the “real economy” — and, all of a sudden, the term was observed in action and was widely understood.

In the aftermath of the financial crisis, there has been a great deal of work—both within the UK and at an international level—to provide governments, central banks and financial regulators with an enhanced “toolkit” of powers that are intended to help them manage and mitigate the consequences of a significant financial institution suffering an insolvency event.

One of those tools is the EU Bank Recovery and Resolution Directive 2014/59/EU (BRRD), which establishes a harmonised framework for the recovery and resolution of credit institutions—or banks—and investment firms across the EU. As implemented in the UK through the amended Banking Act 2009, the BRRD provides the Bank of England with the power to temporarily suspend the rights of persons that are party to derivatives and other financial contracts (including repo, reverse repo, securities lending and other similar transactions subject to contractual stays and netting arrangements) with a PRA-authorized firm to terminate those contracts and to suspend the right of secured creditors of a PRA authorised firm to enforce their security. These powers are referred to as the “temporary stays.”

The BRRD also provides that a pre-resolution or resolution action by the Bank of England, PRA or FCA in respect of a PRA-authorized firm cannot give rise to any counterparty right under a contract with that firm to accelerate or terminate the contract or trigger rights over collateral. This is known as the “general stay.”

It is hoped that the temporary and general stays will prevent resolution action taken by the regulators in respect of a financial institution being the first domino to fall and trigger financial contagion. However, the effectiveness of the stays is limited by the fact that they apply to only contracts governed by the laws of the UK or other EEA member states.

Counterparties are currently able to put themselves into a better position relative to others by electing to contract under the laws of a non-EEA member state—this allows them to close out contracts in the event that the PRA-authorized firm enters into resolution and potentially undermines the resolution process. The rules set out in PS25/15<sup>52</sup> are intended to address this weakness by requiring a PRA-authorized firm to ensure that its relevant contractual arrangements include terms that prevent termination or acceleration of obligations in the event of resolution action by its regulators.

### What should businesses be particularly aware of in the final rules?

The rules set out in PS25/15 prohibit PRA-authorized firms from entering into financial arrangements (or materially amending existing arrangements) that would be subject to the temporary and general stays if they were governed

<sup>51</sup> 16 November 2015.

<sup>52</sup> Policy Statement PS1/15 Implementing the Bank Recovery and Resolution Directive—response to CP13/14.

by the laws of the UK, unless the counterparty to the arrangement agrees to enforceable contractual terms that have a similar contractual effect to the temporary and general stays in the event that the PRA-authorized firm enters resolution. The rules will come into effect on 1 June 2016 in respect of counterparties that are credit institutions or investment firms and on 1 January 2017 in respect of all other counterparties.

**Has the PRA dealt with industry concerns in the final rules, and are there any special issues of interest?**

Some industry participants felt that the objectives of the rules could be better achieved through a statutory cross-border recognition framework. The PRA accepted that this would be the better long-term solution and indicated that it would work toward it through international bodies, including the Financial Stability Board. However, such a framework does not yet exist, and, in the meantime, the PRA has decided to implement the rules.

**What action, if any, should firms take in light of the rules?**

PRA-authorized firms will need to ensure that the terms of their financial arrangements include the new limitations. This task will be made significantly easier by the development of standardised terms designed for this purpose, including the International Swaps and Derivatives Association resolution stay protocol. Perhaps the bigger impact will be on counterparties, in particular, non-EEA counterparties (including investment funds) that enter into relevant financial arrangements (e.g., derivatives) with U.K. banks and insurance companies and that will need to both accept that the contractual stays must be included within the contract and understand the impact of those terms on the risk profile of the transaction.



**TIPS FOR COOPERATING WITH THE REGULATOR (PRINCIPLE 11)**

Principle 11 of the FCA's Principles for Businesses requires that firms deal with their regulators in an open and cooperative way and disclose to the appropriate regulator anything related to the firm of which the regulator would reasonably expect notice. The FCA considers this the "minimum standard" of cooperation required by its rules<sup>53</sup> and has described the issue of cooperation as "vital."<sup>54</sup>

<sup>53</sup> <http://www.fca.org.uk/firms/being-regulated/enforcement/how-we-enforce-the-law/cooperating>.

<sup>54</sup> FCA Regulation round-up June 2015.

We expect the FCA's focus on cooperation and compliance with Principle 11 to continue over 2016 as the FCA looks at the way firms interact with it as part of their assessment of firm behaviour and whether their culture supports effective regulation. The FCA has demonstrated that it is willing to take enforcement action against firms and individuals in relation to breaches in this area.

For many firms, there can be some uncertainty as to what "cooperation" with the regulator means. The FCA has said that cooperation should mean "that firms tell us at the earliest opportunity if they identify any potential or actual misconduct, significant risks, or anything that might affect their ability to comply with rules and regulations. They should also ensure that they co-operate with us during our investigations, answer our requests for information in an open and timely fashion, and think about whether there is any useful information that they can volunteer to us even if we have not asked for it."<sup>55</sup>

The FCA has stated<sup>56</sup> that relevant considerations as to whether a firm has cooperated with the FCA may include:

- how quickly the firm/individual notified the regulator and whether it brought the issue to the attention of the regulator at the earliest opportunity
- the action taken once the problem had been identified and what the firm/individual did to investigate the nature/ source of the problem
- whether the firm/individual did everything that it could to fix the problem once it was found (for example, whether it instructed independent third parties to carry out a review)
- whether there is any likelihood of the conduct recurring
- what steps the firm/individual took to identify whether customers had been financially disadvantaged and how promptly it paid redress to consumers
- whether senior management actively and meaningfully participated in the efforts to address and remedy the issue
- whether the firm/individual quickly agreed the facts and actively sought to agree a basis on which enforcement action could be concluded
- whether the firm/individual responded promptly to FCA queries and requests for information
- whether the firm voluntarily provided material and/or information that the FCA did not directly request and of which it might otherwise not have been aware
- whether the firm/individual communicated the lessons learnt to the appropriate staff.

The FCA has observed that "A firm/individual knows its business better than anyone else" and so will give credit to those who help it "unravel potential misconduct, and help conduct enquiries quickly and efficiently." While this is a useful indicator from the FCA, it is important that firms are careful in preparing responses or notifications to the regulator; they should take advice if the issue is sensitive or has the potential to raise FCA concern. Firms should feel able to ask questions of the regulator and engage in a constructive dialogue, particularly in relation to an investigation, without this being perceived as behaving in an uncooperative manner.

### **Bank of Beirut (UK) Ltd<sup>57</sup>**

The recent action taken by the FCA against Bank of Beirut (UK) Ltd (the "Bank") provides an interesting example of Principle 11 breaches that resulted in action against both the firm and the individuals involved.

In 2010 and 2011, the FCA became concerned that the Bank had failed to give sufficient consideration to the risk that it could be used for financial crime. As a result, it required the Bank to implement a remediation plan, which included steps to remediate customer files, resolve internal audit issues, develop and implement an adequate compliance monitoring program, and review the implementation of the plan.

<sup>55</sup> FCA Regulation round-up June 2015.

<sup>56</sup> <http://www.fca.org.uk/firms/being-regulated/enforcement/how-we-enforce-the-law/cooperating>.

<sup>57</sup> Final Notice 4 March 2015.

Although the Bank had failed to complete these steps, it repeatedly provided inaccurate information to the FCA to suggest that it had done so. This led the FCA to find that the Bank had breached Principle 11 (relations with regulators). Similarly, it found that the compliance officer, Mr Wills (who was responsible for addressing some of the remediation steps and had handled most of the Bank's communications with the FCA), and internal auditor, Mr Allin (who was responsible for reviewing whether the Bank had undertaken the remediation steps), had breached APER Statement of Principle 4 (open and cooperative dealings with the regulator).

Georgina Philippou, the acting director of enforcement and market oversight, said that providing misleading information to the regulator is a serious breach of the responsibilities applicable to approved persons. She commented:

“[the FCA is] reliant on compliance officers and internal audit to act as an important line of defence, to support effective regulation at firms and to show backbone even when challenged by their colleagues.”

Firms need to walk a careful line to ensure that they are being sufficiently cooperative with the FCA whilst not unduly prejudicing their position. Information provided to the FCA should be accurate and supplied without delay. It is crucial that firms avoid any suggestion that they have misled the regulator, and it is important that thought and time is given to how communications with the regulator are framed. Firms should, where possible, seek to engage in early dialogue with the regulator and provide proactive updates if further work or enquiry needs to be undertaken. We would encourage firms to take advice on these issues as they arise so as to position themselves with the regulator as best as possible.



## CHALLENGING DECISIONS OF THE REGULATOR

Firms and individuals are often wary of referring an FCA decision notice to the Upper Tribunal or otherwise challenging the approach taken by the FCA out of concern that such steps will be unlikely to cause the FCA to change its view or to potentially result in a worse outcome.

However, recent cases before the Upper Tribunal and the Complaints Commissioner have demonstrated that, in appropriate circumstances, such challenges are worth pursuing and may result in a change in the FCA's approach. This is a factor that all regulated firms and individuals should bear in mind for 2016. The Tribunal has been particularly robust in its comments on the importance of the FCA following its own processes and has held it to account. We set



out below an outline of three 2015 cases where the FCA was successfully challenged and/or its approach has been the subject of criticism.

## **Andrew Wilkins**

The FCA was forced to back down from its attempt to prohibit Andrew Wilkins, a former Director of Catalyst Investment Group Limited (“Catalyst”), following the Upper Tribunal issuing additional reasons clarifying its decision of 6 August 2015.<sup>58</sup>

In August 2013, the FCA issued a censure to Catalyst and published Decision Notices against Timothy Roberts (who was a director and the chief executive of Catalyst) and Andrew Wilkins. The notices set out the FCA’s intention to fine them £450,000 and £100,000, respectively, and prohibit them for recklessly misleading investors when promoting bonds offered by ARM Asset-Backed Securities SA between November 2009 and May 2010. The individuals referred the Decision Notices to the Tribunal.

The Tribunal upheld the FCA’s finding that Mr Roberts and Mr Wilkins had acted without due care, skill and diligence and that Mr Roberts’ conduct demonstrated a reckless disregard for the interests of investors and a lack of integrity. However, the Tribunal rejected the FCA’s allegation that Mr Wilkins had acted recklessly and without integrity. The FCA pleaded that, even if the Tribunal did not accept that Mr Wilkins did not lack integrity, it was open to the Tribunal to conclude that he was nonetheless not fit and proper (for example, on the basis of his competence and capability).

The Tribunal Decision referred in its conclusion to both the issues of integrity and competence and stated that it did not consider that Mr Wilkins’ failings to be such that they justified a finding that he was not fit and proper. In the Decision, the Tribunal reduced the fine on Mr Wilkins to £50,000 and remitted the matter of his prohibition back to the FCA to reconsider in the light of its findings of fact, noting that, although Mr Wilkins had made certain errors, it did not consider that he had acted with a lack of integrity or with a reckless disregard to investors’ interests. The Decision stated, “As noted above, we do not consider that Mr Wilkins is not fit and proper as alleged by the Authority.”<sup>59</sup>

The FCA believed that it was still open to it to prohibit Mr Wilkins on the basis that he lacked competence, and it made the decision to do so. The FCA considered that it could take this position, since it was of the view that, despite its comments, the Tribunal did not make an overall finding that Mr Wilkins was fit and proper.

It was left to Mr Wilkins to seek additional reasons from the Tribunal, which were issued on 8 September 2015. The Tribunal said that its Decision needed to be read as a whole, and it dismissed the allegation that Mr Wilkins was not fit and proper, including the allegation of lack of competence.

The FCA was left to reconsider the matter and decided that it was not appropriate to prohibit Mr Wilkins after all.<sup>60</sup>

## **Clive Rosier**

On 21 May 2015, the Upper Tribunal upheld the FCA’s decision to impose a £10,000 fine and a prohibition order (preventing the performance of significant influence functions) on Clive Rosier, the sole director and approved person of Bayliss & Co (Financial Services) Limited. The Tribunal upheld all but one of the FCA’s findings in relation to breaches of Statements of Principle 2 (due skill, care and diligence) and 7 (ensure compliance with regulatory standards), but the decision is notable for the heavy criticism the Tribunal made of the FCA’s handling of the case, including the submission of late evidence and the FCA’s approach to publicity of its Decision Notice, which the Tribunal described as “deeply disappointing and troubling.”

The FCA submitted a witness statement just 10 days before the hearing without first seeking permission from the Tribunal. Further, new documents that were referenced in this statement were inserted into the trial bundle without permission from the Tribunal. The Tribunal thought that the FCA’s introduction of material in this way showed “an unacceptable degree of arrogance.” It also said that following the proper course for introducing material is important where the applicants represented themselves and may be less familiar with the Tribunal’s rules and procedures.

<sup>58</sup> Upper Tribunal Additional Reasons for Determination, 8 September 2015.

<sup>59</sup> Upper Tribunal Decision at paragraph 286.

<sup>60</sup> FCA Final Notice, paragraph 2.3.

The Tribunal was highly critical of the FCA's approach to the publicity of the Decision Notice. The FCA had emailed a press release, together with a link to the Decision Notice (which was mistakenly described as a Final Notice), to selected media outlets. The press release referred to the provisional nature of the FCA's decision in only the last paragraph and, in the Tribunal's view, did not accurately reflect the content of the Decision Notice. The Tribunal said that these actions "demonstrate a standard of care in drafting and approving an important public communication . . . which fell well below the standard the Authority would find acceptable on the part of the firms it regulates in relation to the approval of financial promotions." It also said that references to Mr Rosier by his surname only were "unnecessarily disrespectful." The Tribunal also criticised the FCA's handling of Mr Rosier's complaint in relation to the press release, noting the lack of a "swift recognition of a mistake and a clear commitment to put it right" on the part of the FCA. These failures led the Tribunal to conclude that the FCA's procedures in relation to publicity for Decision Notices should be strengthened.

### **Change in control applications**

On 23 October 2015, the Office of the Complaints Commissioner ("Complaints Commissioner") published a final decision in which it criticised the FCA's handling of the complainant's change in control application.

A complaint was made to the Complaints Commissioner regarding the FCA's handling of a change-in-control application. One of the issues raised was that the FCA had set extremely short deadlines for the complainant to respond to issues that the FCA had raised about the application. Under FSMA, the FCA has 60 working days to assess a change in control application. The FCA can pause the assessment period once and so extend the time that it has to consider an application (a process referred to as "stopping the clock"). In this case, the FCA accidentally removed the ability to stop the clock on the complainant's application by requesting supplemental information early on in its assessment process. As a result, the FCA was bound by the 60-day statutory period. This led the FCA to set very short time frames for the complainant to respond to its requests for further information.

The Complaints Commissioner thought that the FCA's request for information was "ill-considered." It criticised the FCA for failing to recognise the error earlier and for failing to provide a candid explanation of the resulting time frames to the complainant. It also criticised the rushed process for considering the application that resulted from the FCA's error. This led the Complaints Commissioner to recommend that the FCA make a compensation payment of £750. It saw a need for the FCA to review its procedures for handling change-of-control applications to ensure that FCA staff are properly focused upon the management and purpose of the process, are trained to understand when deadlines should be adjusted in order to avoid unnecessary stress and potential unfairness, and are fully aware of how and when the FCA can stop the clock to allow firms to provide further information.

All three cases demonstrate that, where the FCA has acted unreasonably, it can be held to account. Going into 2016, firms should not be wary of challenging the regulator in this context, since there is a real prospect that such challenges could cause the FCA to amend or review its approach.

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