FINANCIAL REGULATION
EMERGING THEMES IN 2016

FEATURED CONTENT

BLP BERWIN LEIGHTON PAISNER

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READING BETWEEN THE LINES

Welcome to our 2016 publication, in which members of our team read between the lines of financial regulation and share their personal views on the impact of key developments that are taking shape in the coming year.

A quick flick through these pages will show that the pace of change in financial regulation is as fast as ever, yet we are also sensing a shift in the dynamic between the regulator and government. There is more talk in government circles of the importance of promoting the competitiveness of the UK as a financial market, an objective that was roundly rejected by the Treasury in the aftermath to the 2008 crisis. It is a little too early to say whether this marks a change in the direction of the regulatory pendulum, which for a long period has swung in favour of giving greater powers to regulators and encouraging ever more punitive disciplinary action. However, the signs to date have been positive.

This mood change has also been reflected in the approach of the Upper Tribunal and the Court of Appeal, who provide the only independent check on how the PRA and FCA use their wide-ranging powers. Although the potential downsides of referring cases for an independent hearing remain so much heavier than they ought to be, it is heartening to see the Upper Tribunal and Court of Appeal dismissing cases, significantly reducing the level of sanctions and even awarding costs against the regulators where they have overstepped the mark.

I hope that you find these articles as engaging and stimulating as I did when I read them. If you have views or comments on any of the topics covered then we would be delighted if you share them with us.

Nathan Willmott

Nathan Willmott
Head of Financial Regulation

CONDUCT

INSURANCE ACT 2015

EMPOWERING THE PURCHASER

Lawmakers and regulators continue to jostle for position when it comes to protecting the rights of policyholders. Jonathan Sacher and Polly James examine whether the new Insurance Act will make a difference and shift the balance of power.

Striking the right balance

We have discussed in previous editions of 'Emerging Themes' the slow pace of change in insurance law, as compared to insurance regulation, when it comes to protecting the rights of insurance policyholders.

This imbalance was redressed in part by the Consumer Insurance (Disclosure and Representations) Act 2012, which changed the law to increase the rights of consumers purchasing personal insurance. At the same time, however, the Financial Conduct Authority came into existence. It trumpeted its new mantra about making firms "put the customer at the heart of everything that they do" and spoke about "ensuring that consumers, whether retail or wholesale, enjoy an appropriate degree of protection," forcing the lawmakers into the shadows in the policyholder champions' arena.

The lawmakers are now back in the running. There are significant changes for business customers of insurance in the Insurance Act 2015, which will become law on 12 August 2016, and the Enterprise Bill, published in September 2015, which will allow damages for late payment of insurance and reinsurance claims.

Who will pay the price?

The Insurance Act 2015 contains several important changes for business insureds which will apply to Insurance, Reinsurance and Retrocession. Summarising these very briefly:

1. **Modernisation of utmost good faith**
   The duty of utmost good faith, which required a policyholder to disclose all matters that may be relevant to the risk, failing which the insurer could avoid the contract and pay nothing, is being replaced by the "duty of fair presentation". Apart from the duty to disclose all material facts, the insured can discharge their duty of fair presentation by putting an underwriter on notice of enquiry and, if the underwriter fails to ask more, the insured will be deemed to have complied. This modernisation of the ancient duty of utmost good faith may redress the balance of power significantly in favour of the policyholder.

2. **New proportionate remedies following a breach**
   Remedies for the breach of the duty of fair presentation are very different from the old law. Under the Marine Insurance Act 1906, the consequence of a breach was that the underwriter could avoid the contract. There were no options. The new Act has introduced a range of proportionate options ranging from avoidance (if the reasonable underwriter would not have written that risk) to a variation of the contract (the underwriter would have written the risk but on different terms) or even an adjustment of premium – by way of reduction in the value of the claim to reflect the premium the underwriter would have charged.

3. **Breach of warranty no longer terminates a policy**
   The new Act converts warranties into suspensive conditions. The consequence is that a warranty no longer has the effect of causing the contract to cease but, instead, can be remedied. Claims made before the breach of warranty and those after the breach has been remedied, are now payable. In addition and most importantly, claims unconnected with a warranty breach are recoverable.

The Enterprise Bill proposes to introduce the concept of damages payable by an insurer if a claim is paid late. These must be damages actually suffered rather than the equivalent of bad faith or punitive damages in the United States. There are tests as to whether the insurer's behaviour was reasonable or not.

Although it will be legally permissible for business insureds and insurers to contract out of both the Insurance Act 2015 and these provisions of the Enterprise Bill if enacted, in a soft market we consider it highly unlikely that significant contracting out will be commercially possible for insurers.

The power of the purchaser

What this new legislation will do is to give business insureds, for the first time, a statutory cause of action against an insurer in circumstances where the insurer has behaved unfairly.

Consumers purchasing insurance have long had the right to bring action against insurers for breach of statutory duty under Section 138D of the Financial Services and Market Act 2000, where they can show that the insurer has breached an actionable provision of ICOBS. Business insureds have always had less legal protection (on the basis that their bargaining power was more equal to that of the insurer), but that is about to change.

The power of the purchaser, whether an individual or a business insured, now has both the law and the regulatory system on its side.

Jonathan Sacher
Head of Insurance

Polly James
Senior Associate,
Financial Regulation

PLEVIN V PARAGON PERSONAL FINANCE LTD

ROGUE DECISION OR GAME-CHANGER FOR RETAIL FINANCIAL SERVICES?

The judgment in the closely watched Supreme Court appeal of *Plevin v Paragon Personal Finance Limited* sent a shiver down the spine of the financial services industry. A lender's failure to disclose to its customer that large commissions had been paid out of her PPI premium was ruled unfair under the Consumer Credit Act 1974, even though no regulatory duties were breached. Joanna Harris explains why regulator and regulated alike are now struggling to quantify the scope and impact of this decision …and what could happen next.

Key facts of the *Plevin* case

Mrs Plevin purchased a single-premium PPI policy in 2006 in connection with a loan and was charged a premium of £5,780 payable at the outset. Of this premium, 71.8% was taken in commission, £1,870 by the independent credit broker, LLP Processing (UK) Ltd, and £2,280 by the lender, Paragon Financing Ltd. In January 2009, Mrs Plevin brought proceedings against LLP on the basis that it was in breach of its fiduciary duties as her fiduciary agents. The case settled in 2010. However, Mrs Plevin's claim against Paragon proceeded to trial. The complex issues were narrowed over the course of the trial to the question of whether Mrs Plevin's relationship with Paragon was unfair within the meaning of 140A(1)(c) of the CCA 1974, because of something "done (or not done) by, or on behalf of, the creditor".

Legal test applied

Pursuant to section 140A of CCA 1974, a court may reopen a credit agreement between a creditor and an individual debtor where the relationship arising from the agreement (or related agreement) is unfair, and can order an appropriate remedy.

The leading authority before *Plevin* was the Court of Appeal's decision in *Harrison v Black Horse Ltd [2012] Lloyd's Rep IR 521*. In that case, despite finding the 87% commission taken by the lender "quite startling", Tomlinson LJ found that it would be "an anomalous result" if a lender was obliged to disclose a commission under the Act, in circumstances where it was not obliged to disclose it under the regulatory regime.

Joanna Harris
Associate,
Financial Regulation

However, in his sole judgment in *Plevin* (with which the other Justices residing agreed), Lord Sumption decided that the test for breach of regulatory duty is manifestly different to the test for fairness under section 140A. Whereas the regulatory rules (in this case, ICOBS) imposed a "minimum standard of conduct", section 140A introduced a broader test of fairness, the application of which required a "large element of forensic judgment" by the court.

Applying the broader test of fairness, Lord Sumption concluded that the agreement fell short of the required standard. Commenting on the 71.8% commission, Lord Sumption concluded that "…at some point commission may become so large that the relationship cannot be regarded as fair if the customer is kept in ignorance. At what point it is difficult to say, but wherever the tipping point may lie the commissions in this case are a long way beyond it." The court did not make a factual finding as to whether Mrs Plevin would have bought PPI, had she known of the commission. However, Lord Sumption's conclusion (which is difficult to argue with) was that any reasonable person hearing that two-thirds of the premium they were being charged for a financial product constituted commission would have thought twice about entering into it. This was particularly the case given that Mrs Plevin's needs had not been properly assessed and she did not need to take out a PPI policy at all. Further, it was Paragon's responsibility to disclose the commissions as the only party who knew the level of both.

Implications

Plevin therefore represents a real movement of the legal goal posts. Firms have been left to grapple with the implications of the courts holding them to a different standard of behaviour than that required by the FCA.

In addition to looking at current practices of calculating and disclosing commission to ensure that they are *Plevin*-compliant, the industry is concerned that *Plevin* may expose firms to even more complaints in relation to PPI sold in the past, and potentially even to complaints about other financial products sold to individuals in relation to credit agreements which are caught by CCA 1974. Firms have therefore been forced to ask the question – how much commission is unfair? This could be a multi-billion dollar question, with some analysts recently suggesting that banks could face a £33bn bill if the *Plevin* judgment was extended to other financial products.

What will the FCA do with *Plevin*?

The FCA has confirmed that it will give guidance on where Lord Sumption's "tipping point" lies in the context of PPI commission. In November 2015, the FCA released a consultation (open until 26 February 2016) on new rules and guidance on handling PPI complaints, which includes guidance on the application of *Plevin*. The proposed rules contain a rebuttable presumption that, when a firm is assessing a PPI complaint in which the credit agreement covered by the PPI falls within the scope of section 140A–B CCA 1974, a failure to disclose a commission of 50% or more gives rise to an unfair relationship (and conversely that a commission of less than 50% does not). The FCA is also consulting on proposed examples of circumstances in which the presumptions can be rebutted.

In an attempt to allay the fears of investors, the FCA has proposed that the rules and guidance will not require firms to proactively review their PPI sales in the context of section 140A, or to re-open previously rejected complaints (although complainants who did not previously raise an undisclosed commission as an issue with the lender would still be free to do so). And, as a final lifeline to firms, the FCA is consulting on a 2018 deadline for consumers to bring PPI mis-selling complaints, including complaints brought on a *Plevin* basis. Many banks saw their share prices rise after the FCA's original announcement of the consultation in October 2015.

A law of unforeseen consequences?

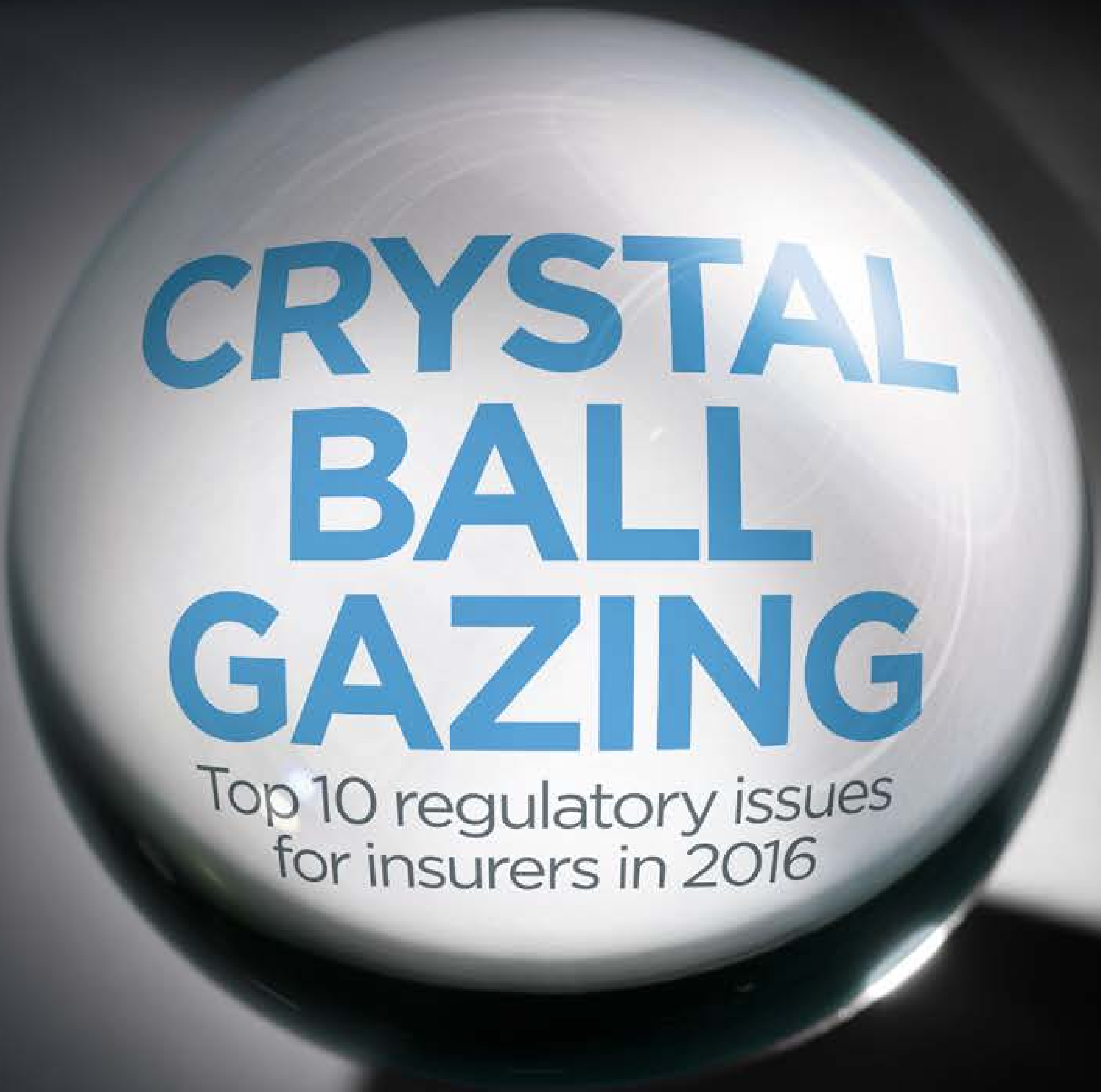
The proposed new FCA rules do not require redress to be paid in respect of products other than PPI, however this will not affect the rights of consumers to bring *Plevin*-style actions in the courts. In our view, it is highly likely that claims will be brought seeking to apply the principles in *Plevin* to other retail financial services products within the scope of CCA 1974.

Silver lining?

On a more positive note, *Plevin* has drawn a helpful line on the allocation of responsibility between LLP and Paragon for the purposes of complying with CCA 1974. Mrs Plevin argued that the unfairness of the PPI agreement arose not only from the non-disclosure of the commission and its recipients, but also from the failure to assess the suitability of the PPI policy to her needs. The Supreme Court decided that, while the non-disclosure of commission was the responsibility of the lender, the failure to assess suitability was not: ICOBS imposed a duty to assess and advise on suitability, but expressly assigned this duty to LLP as the entity dealing directly with the customer. It could therefore not reasonably be expected that Paragon would perform the function. Lord Sumption distinguished this from the question of disclosure of commission, in relation to which ICOBS did not impose a duty on anyone. Following this finding, it was left to Lord Sumption to determine whether LLP's failure to assess was a failure "by, or on behalf of" Paragon, and therefore made Mrs Plevin's relationship with Paragon unfair. Lord Sumption found that it was not. In doing so, he confirmed that the words "by, or on behalf of" must be taken in their natural meaning, a welcome clarification of the legal position.

Practical steps to take now

As a practical matter, firms providing and/or distributing financial products to retail consumers in relation to credit agreements that fall within the scope of section 140A should urgently review their policies on commission disclosure. Based upon the *Plevin* judgment, a sensible starting point would be that if knowledge of the level of a commission would be likely to cause a consumer to shop around, or simply not to purchase the product at all, then that commission should be disclosed to the consumer in order to prevent the risk that the transaction may later be overturned on *Plevin* principles.



CRYSTAL BALL GAZING

Top 10 regulatory issues for insurers in 2016

The Senior Insurance Managers Regime is not the only regulatory issue set to need insurers' attention in 2016. Adam Jamieson sets out the top ten regulatory issues that insurers can expect to be engaged with in the coming year.

1

Outsourcing arrangements and delegating authority

Outsourcing continues to be one of the main 'conduct risks' for insurers operating in the general insurance market. In June 2015, the FCA published the findings of its long-awaited thematic review (TR 15/07) into insurers' outsourcing of under-writing authority, claims handling authority and certain other elements of insurance product provision (including complaints handling). The FCA concluded that some firms had not adequately considered or recog-nised their regulatory obligations.

Following TR 15/07 the FCA expects all insurers and intermediaries to:

- consider the extent to which the issues identified in the review impact their businesses;
- assess what changes might be necessary to existing arrangements; and
- ensure any new arrangements are designed with the review's outcome in mind.

2

Oversight of appointed representatives

Announced in its 2015/16 business plan, the FCA launched a review into the role appointed representatives (ARs) play in distributing general insurance products. The principal must have robust systems, controls and resources in order to be in a position to select and oversee ARs effectively. The findings of the review are expected in 2016.

3

Claims handling for Small and Medium-sized Enterprises (SMEs)

In May 2015 the FCA published the findings of its thematic review (TR 15/6) into how promptly and fairly insurers were handling claims made by SMEs. The FCA found failings around claims handling for these customers and noted its intention to engage with firms, senior figures in the industry and relevant trade bodies to discuss the findings of the review. Firms with SME customers should note carefully the findings of TR 15/6 and implement the changes necessary to improve communication and ensure a more customer-centric claims handling process.

4

General insurance products sold as add-ons

Following a market study conducted in 2014 into general insurance add-ons, the FCA consulted on a range of possible remedies to tackle the issues arising, before publishing final rules (PS 15/22) in September 2015. In summary:

- From 1 April 2016, FCA rules will no longer permit the opt-out sale of add-on products to customers. The effect of this is that customers will no longer be defaulted into add-on products for which they will be charged.
- Firms must ensure their appointed representatives comply with the new rules.
- Free add-ons will continue to be allowed, unless the firm seeks to charge for them at renewal.
- Non-binding guidance in relation to the provision of information about add-on products to customers should be reflected in firms' sales practices by September 2016.

5 Measuring the value of insurance products

In its market study into general insurance add-ons, the FCA found that customers were paying too much for some products that offered poor value. The FCA explored this issue in a discussion paper (DP 15/4) in June 2015, which considered various options for requiring insurers to report information that would allow consumers to assess and compare the value of insurance products more effectively. Options for the appropriate value measures include:

- using the claims ratio as a standalone measure;
- using the claims ratio coupled with claims acceptance rates; or
- using a package of measures comprising claims frequencies, claims acceptance rates and average claim payouts.

The FCA was originally expected to publish a formal consultation on the preferred measures towards the end of 2015, however this is now expected in 2016. The new measures will be included in a new regulatory return to be completed by general insurers on a regular basis.

6 Cybercrime and data security

Reliance on web-based front-end channels poses a risk of increased cybercrime. These channels increase the risk of personal data and consumer funds being compromised. Similarly, insurance firms providing cover for cybercrime risks are themselves collecting large volumes of data that could be vulnerable to cyber-attacks. The FCA sees this as a key area of risk as set out in the FCA's 'Risk Outlook' for 2015/16 (included in the FCA's most recent business plan). Firms should be aware that traditional security controls firms used around data may not be sufficient to withstand the breadth of sources of cyber-attacks.

The FCA's Financial Crime Guide (published in April 2015) contains useful guidance for firms on data security, including examples of good and bad practice in respect of systems and controls.

In November 2015, the FCA published Consultation Guidance (15/6) on the requirements for firms when outsourcing to the 'cloud' and other third-party IT services (please see Marcus Pearl and Laura Jenkins' article, "How to use the FCA's Procurement Guidance", on pages 90 – 93 for more information on the guidance). The guidance is intended to help all firms to oversee effectively all aspects of the life-cycle of their outsourcing arrangements: from making the decision to outsource, selecting an outsource provider, and monitoring outsourced activities on an ongoing basis, through to exit. The final guidance will be published following the consultation period (which will end on 12 February 2016).

7 Big Data

The use of 'Big Data', such as web analytics and behavioural data tools, is increasing across financial services and particularly in the general insurance sector. For the FCA, there is a balance to be struck between allowing innovation while preventing poor consumer outcomes. In its 2015/16 business plan, the FCA committed to undertake a thematic review, to gain more understanding both of how insurers use Big Data and how this might evolve in the future. At the end of November 2015 it published a call for inputs to the review, focusing on three key questions:

1. Does Big Data affect consumer outcomes?
2. Does Big Data foster or constrain competition?
3. Does the FCA's regulatory framework affect developments in Big Data in retail general insurance?

The call for inputs closed on 8 January 2016. The outcome from the call for inputs may feed into one of several possible next steps. The FCA will use the findings from the call for inputs to determine whether to conduct a market study or make adjustments to existing policy and/or guidance.

8 Insurance premium financing

The FCA published the findings from its thematic review of premium finance for retail customers in May 2015. In our view, there is plenty more work for the FCA to do in this area, particularly in the light of the new CONC rules relating to the provision of premium finance.

9 Whistleblowing

In October 2015, the FCA and the PRA published final rules and guidance requiring firms to put in place formalised whistleblowing procedures. The rules will apply to insurance and reinsurance firms within the scope of Solvency II and Lloyd's managing agents. For other firms, the rules should be treated as guidance. In particular, the rules require firms to:

- appoint a non-executive director to be the "Whistleblowers' champion" (a role which aligns with the prescribed responsibility for whistleblowing procedures under the new SIMR regime);
- put in place appropriate and effective internal procedures for the disclosure of reportable concerns;
- provide adequate training and information for staff about the firm's internal whistleblowing arrangements and the FCA and PRA whistleblowing services;
- require their appointed representatives and tied agents to tell their UK-based employees about the FCA whistleblowing service;
- include text explaining employees' legal rights in respect of making protected disclosures in any new settlement/compromise agreements;
- ensure that nothing in any employment contract or settlement agreement prevents or discourages an employee from making a protected disclosure to the PRA/FCA;
- put in place "reasonable measures" to ensure that whistleblowers are not victimised;
- inform the FCA if they lose an employment tribunal case brought by a whistleblower; and
- present a report on whistleblowing to the board at least annually.

Insurers have until 7 March 2016 to assign responsibilities to a whistleblowers' champion and until 7 September 2016 to comply with the new rules.

10 General insurance renewal

In December 2015 the FCA published CP15/41 following a large scale research project, which looked at over 300,000 customers from one home insurance and two motor insurance providers. The aim of that project was to assess whether improved disclosure can help consumers become more engaged at renewal. The FCA's consultation proposals, which follow on from the research project and other FCA work, include:

- rules that require firms to disclose last year's premium on renewal notices;
- rules that require additional disclosure when customers have renewed the same product four times or more;
- guidance on how firms can improve their processes around renewals; and
- guidance about records that firms maintain to demonstrate compliance, including a record of premiums.

The consultation closes on 4 March 2016 and a Policy Statement and final rules are expected in mid-2016. Firms should consider increasing their focus on renewal pricing, and consider their obligations to Treat Customers Fairly when developing their overall approach to renewal pricing and in their treatment of long-standing customers.

Adam Jamieson
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DON'T SIT ON THE SIDELINE

GET INVOLVED IN THE FCA'S 2016 MARKET STUDIES

The FCA has announced plans to investigate the asset management, insurance and mortgage sectors in 2016, and will continue its market study into investment and corporate banking. Sarah Ward considers how firms can get involved.

New scrutiny of Big Data in insurance, asset management and mortgages
On 18 November 2015, the FCA launched a market study into asset management and may, within the next twelve months, launch a further market study into the use of Big Data in the insurance market. A market study into the UK mortgage sector may also be launched by Q2 2016, following the FCA's October 2015 call for inputs on competition in the sector.

The review of the use of Big Data in the insurance market was announced in the FCA's 2015/16 business plan, and was followed by a call for inputs in November 2015. For the FCA, 'Big Data' includes web analytics and behavioural data tools (including the increasing use of social media) as well as other unconventional data sources. The FCA is keen to identify potential risks and benefits for consumers, including whether the use of Big Data creates barriers to access products or services. It will also examine whether the regulatory regime unduly constrains beneficial innovation in this area. It says it expects to publish a Feedback Statement detailing the findings from the call for inputs and its next steps in mid-2016.

The Terms of Reference for the asset management study indicate that the three issues the FCA will explore are:

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

The FCA will issue information requests to stakeholders, including asset managers and investors, in the coming months and anticipates publishing interim findings in the summer of 2016. A final report is expected by Q1 2017.

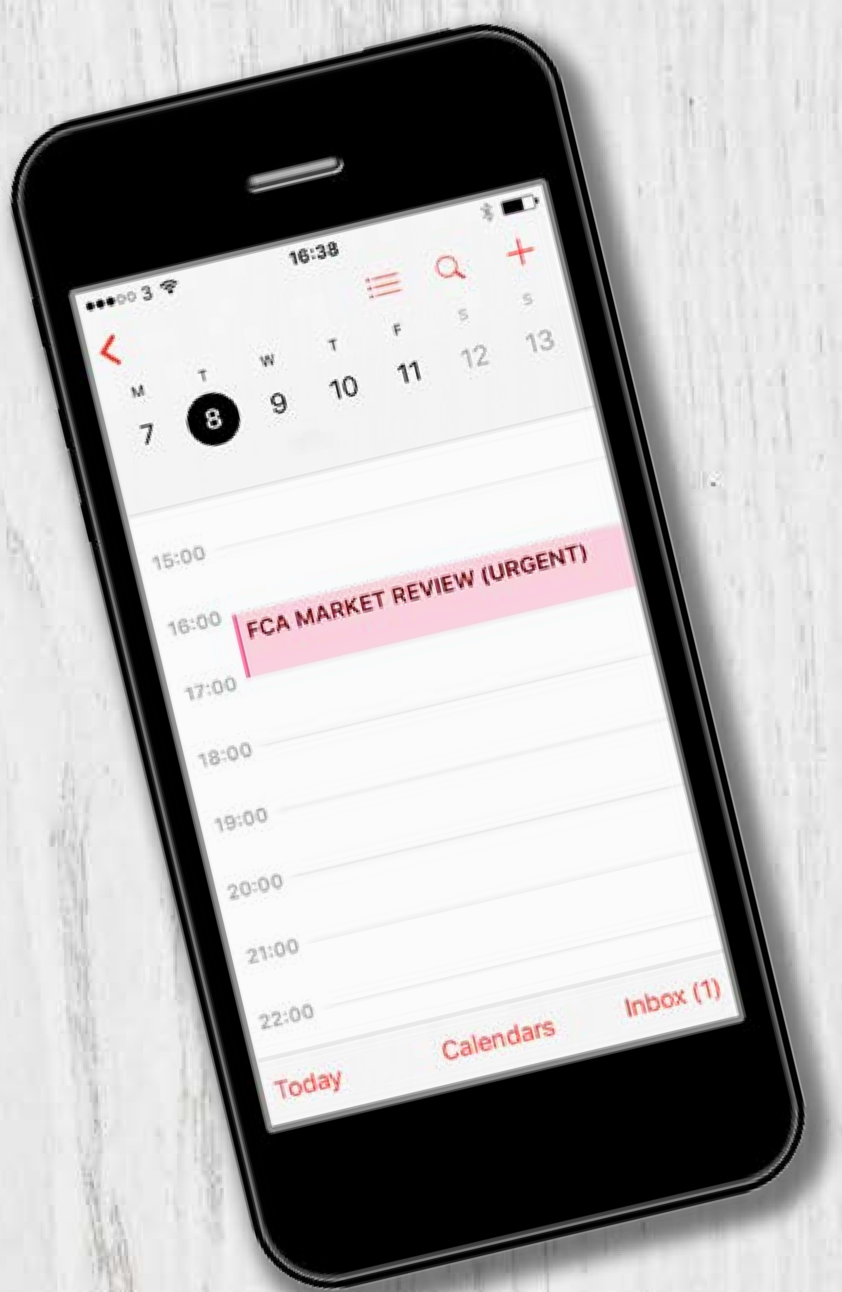
The FCA's call for inputs on competition in the mortgage sector covered all loans against any property, whether by retail consumers or businesses, and included lifetime mortgages, shared ownership, buy-to-let, second charge mortgages and bridging loans. The FCA plans to publish, in the first quarter of 2016, a Feedback Statement summarising its analysis of the responses received and setting out any further action.

In the coming year, the FCA will continue its market study into investment and corporate banking, which it launched in May 2015. A final report is expected in spring 2016.

What this means for affected firms
As any recipient of a recent market study questionnaire from the regulator will know, an FCA market study can be burdensome for affected firms, even for those who choose to provide the minimum information and data requested. The FCA has considerable powers to require information to be produced, and administrative and criminal sanctions can apply if a firm fails to comply with its obligations.

The stakes are also high. The FCA can make significant interventions into a market it finds is not functioning well, including:

- market-wide remedies, including rule-making, publishing general guidance and proposing enhanced industry self-regulation;
- firm-specific remedies, including the FCA using its own-initiative variation powers or own-initiative requirement powers, cancelling permissions, public censure, imposing financial penalties, as well as filing for injunction orders or restitution orders; and
- making a market investigation reference to the Competition and Markets Authority (CMA), or accepting undertakings in lieu of a reference. The CMA has a wide range of remedies it may seek to address any adverse effects on competition that it identifies during a subsequent investigation, including requiring divestment of a business or assets.



Remedies imposed by the FCA can also extend beyond the scope of the initial market study. The FCA's general insurance add-ons market study, for example, recently led the FCA to introduce rules to ban "opt-out selling" across all financial services sectors, not just those covered by the market study, from 1 April 2016.

Engagement strategy
When the FCA launches a market study, all stakeholders are given the opportunity to provide relevant information and data to the FCA. The FCA will also send detailed questionnaires to relevant firms. Responses may be requested on an informal basis, but the FCA states in its guidance that it expects regulated firms to assist with such requests, in line with their duty of cooperation and disclosure under Principle 11 of the FCA's Principles for Businesses. The FCA also has considerable powers to require any (regulated or unregulated) firm to provide it with information or data.

Firms likely to be affected by the FCA's upcoming market studies should therefore shape their engagement around both the outcomes they would like to see from the market study, and those they would prefer to avoid or limit. Firms who choose not to engage pro-actively with the authority should be aware that the information-gathering stage of a FCA market study can still be burdensome for affected firms, and is likely to involve periods of intense information gathering. Care should always be taken to ensure that information provided to the authority is accurate and complete, and that it does not inadvertently draw any regulatory or competition law issues to the FCA's attention.

Sarah Ward
Senior Associate,
Antitrust & Competition

A POWERFUL COMBINATION

HOW COMPETITION LAW & FSMA INTERACT

Equipped with a greater range of concurrent competition powers the FCA is pursuing an objective to promote effective competition on behalf of consumers. How will it utilise its powers and what are the ramifications for regulated firms?

Concurrency so far

The FCA has focused on using its new market study powers as a means of ensuring market structures promote rather than hinder effective competition.

On 1 April 2015, the FCA obtained concurrent competition powers, allowing it to enforce UK and EU prohibitions on anti-competitive agreements and abuse of dominance. The FCA also gained enhanced market investigation powers, including the ability to refer markets to the Competition and Markets Authority ("CMA") for an in-depth investigation. As a consequence of these new powers, every single financial sector firm is potentially subject to FCA competition enforcement.

Furthermore, the Payment Systems Regulator ("PSR") was simultaneously given concurrent competition powers for certain UK retail payment systems.

When enforcing, the FCA and PSR must use competition law in preference to Financial Services and Markets Act 2000 ("FSMA") regulatory powers where it is appropriate to do so. Both regulators risk losing their concurrent powers if they do not use them effectively. The stakes are high and the FCA has over 100 competition enforcement specialists at the ready.

"Mix and match" powers

The FCA now has a uniquely powerful toolkit as a result of its combined competition law and regulatory functions. The regulator is able to "mix and match" FSMA and competition investigation powers when investigating infringements or conducting market studies, providing the FCA with significant time and process flexibility when it comes to carrying out its duties.

Self-Reporting Suspected Infringements: What does it mean for you?

The SUP 15.3.32 requirement that a "...firm must notify the FCA if it has or may have committed a significant infringement of any applicable competition law" creates particular complexity.

"Significant" is judged on factors including actual or potential effect on competition and consumer detriment. However, what constitutes a "significant infringement" remains, in practice, unclear. Furthermore, there is no geographic limit to the self-reporting requirement, meaning a firm could infringe competition law in an unrelated jurisdiction, and may still have to confess to the FCA.

Regulated firms are left with little choice if they find evidence of a suspected competition law breach. Unlike businesses in other industries, FCA regulated firms must self-report suspected infringements. However, in cases where competition leniency may be available for the particular breach of competition law, firms will still need to decide whether or not to seek antitrust immunity or leniency from the relevant regulator at the same time as reporting to the FCA.

I have outlined some key developments below. The FCA has not yet launched an individual competition law investigation.

FCA Market Studies: In-progress and planned

The FCA's investment and banking market study was launched in May 2015. It followed the wholesale sector review which identified potential competition concerns in relation to customer choice, lack of transparency and product bundling in the equity and debt capital, mergers and acquisitions, and acquisition financing sectors. The first round of questionnaires were burdensome, and additional information requests remain a possibility. If the FCA identifies significant concerns it may require the CMA to conduct an in-depth market investigation. If so, the CMA can order significant remedies to address any competition issues it finds.

On 18 November 2015 the FCA launched its long-awaited market study into asset management. This review will focus on the balance of choice, cost and value in the industry, assessing asset management for both retail and institutional investors. The FCA will also examine the related markets for distribution and advice to the extent that they affect client choice and competition between asset managers.

While responding to market studies can be onerous, firms do have the opportunity to engage proactively with the regulator to help shape the future regulatory regime.

The Mortgage Sector: A call for evidence

Although not a full market study, the FCA launched a call for inputs on competition in the mortgage sector in October 2015. Notably, the FCA scope extends beyond mortgage suppliers to upstream finance, along with related industries such as valuation and estate agents. The call for inputs closed on 18 December 2015 and a report is expected in Spring 2016.

How does the PSR differ?

Whilst the PSR's guidance closely follows the FCA approach, there are notable departures. For example, the PSR's self-reporting obligation is narrower in scope – it relates only to issues that could "materially adversely impact" advancement of the PSR's statutory objectives and duties. Furthermore, the PSR does not require parties wishing to settle to waive their appeal rights, unlike the FCA.

The PSR has also launched two market reviews, relating to indirect access to payment systems and ownership and competitiveness of payments infrastructure. The final report for each review is expected in Summer 2016.

What next for the FCA, PSR and your firm?

The FCA and PSR continue to focus on using their concurrent powers at a market level rather than through individual competition investigations. However, this balance is likely to tip in due course.

As well as responding to market studies if required, firms should continue to ensure that they have adequate competition compliance procedures in place. The FCA in particular will not shy away from investigating suspected competition law breaches wherever it can.

James Marshall
Partner, Antitrust & Competition

IS A PICTURE WORTH A THOUSAND WORDS?

FCA CALLS FOR CLEARER CONSUMER COMMUNICATIONS

On 25 June 2015, during those lazy summer days, the FCA issued a Discussion Paper called "Smarter Consumer Communications". The closing date for initial responses was September, so the paper perhaps did not receive quite the attention it deserved. Peter Richards-Carpenter explains why the impact of the underlying initiative could be explosive and argues that its intentions are entirely worthwhile.

"Smarter Consumer Communications" asks the industry to take a long, hard look at the way it communicates with consumers and to come up with new ideas and proposals for making those communications clearer, more impactful and straightforward. It cites examples of new practices that it likes, almost all of them screen-based, and highlights the likes of cartoon usage, pop-ups and Q&A sessions to bring dry material to life and grab the attention of a retail readership. For certain types of material, there is much to be said for these approaches. It is axiomatic that a picture can be worth a thousand words in aiding comprehension, but the industry still has a long way to go in this area.

Pithier, clearer, shorter

It is worth noting that the Discussion Paper covers both general communications and promotional material on the one hand and formal, legal documentation on the other. Many of the concepts outlined in the paper are doubtless constructive and helpful, so far as general communications and promotional material are concerned – and this is no small point. The essential features and risks involved in a retail product or service can be buried from consumers under heaps of detail. This may lead the consumer to ignore or misunderstand important facets.

Most of us need as much help as possible if we are to master the detailed features of a financial product or service, and these are features that we really ought to consider before investing. This is nothing to do with questions of misleading information. We have had rules governing misleading information in promotional material and general communications for over 25 years. The Discussion Paper points out very effectively that too much information can "bury" other information that may be significant from a consumer standpoint. Any damage may be unintentional but it is nonetheless potentially harmful.

The plea to make communications pithier, clearer, shorter and more relevant strikes a chord in principle, even though the approach is far too simplistic. There are references to difficulties and barriers caused by regulatory requirements, and a commitment at least to consider whether some of these barriers can be removed by the regulators. However, the role played over the years by successive UK and EU regulators in bringing about much of the complexity and opacity of which the FCA now complains is significantly underemphasised.

Mind your Ts and Cs

The real difficultly lies in the fact that the FCA is looking to extend this initiative beyond general communications and promotional materials. It wants the initiative to cover the legal terms and conditions that underlie the products and services in question. This creates the potential for significant problems. For any legal terms and conditions to be effective, they must be incorporated into the contract and pass the test of certainty. Crucially, terms and conditions must be available in written form, in a durable medium, and be the same whether the consumer enters into a contract online or on paper.

It is difficult to envisage how pop-ups and cartoon characters, or other similar visual aids that may be used to stimulate interest, could be incorporated into a contract so as to have equal force in each format in which the contract is to have effect. There are also suggestions that terms and conditions could be layered, so as to give greater prominence to terms that are thought to be most relevant for consumers, with others given a lesser emphasis. This last idea is particularly alarming and could rightly be castigated by consumer groups in different circumstances or possibly fall foul of the Consumer Rights Act 2015. The industry is also asked to query the need for the sheer volume of terms and conditions in many cases, as well as to reassess their relevance.

"Can it not all be made very much simpler?" Is essentially the plea being made.

The basic conundrum is that many of the products and services that the industry offers to the retail market in the UK are not themselves simple. For example, the provider of a share dealing and custody service, or a discretionary management service, fulfils a wide variety of tasks, each of which has to be fairly described to the consumer and have its scope and limitations defined. Certainty in these matters is as important for the customer as it is for the supplier. As we all know, UK and EU regulation places myriad demands and disclosures on the industry that have to be reflected in the terms and conditions that firms offer. These burdens are likely to increase with the implementation of MiFID II and other developments.

Can we understand and not just agree?

Yet despite all these valid objections and the obstacles that face the FCA, there is a fundamental force in its argument. We all know that, when faced with many pages of closely typed terms and conditions and asked to certify that we have read them before entering into a contract, the temptation is to sign without reading. This is true whether the contract relates to financial services or any other service. It is also true whether we have the physical document in front of us or sign up online. All the required disclosures and risk warnings that may be set out in the document in practice do very little to protect or inform the consumer before they enter into the contract. The descriptions of limitations and exclusions are likely to remain unread. Very few investors study or understand these agreements before they sign up and yet everyone is, quite rightly, bound by the contracts they choose to execute.

What can be done if some of the more creative forms of communication lack legal certainty or are only available online? Undoubtedly, there is scope for the industry to review its practices, even without adopting any radically different means of communication. Sets of terms and conditions could in many cases profitably be reviewed for clarity, impact and relevance and be all the better for it.

In addition, there is an opportunity for the FCA itself to take a radical step. In recent years, we have become accustomed to regulatory requirements in respect of retail products such as UCITS that dictate the need for a summary document explaining the essential features of the product. For many consumers, reading this short-form document (the KIID) gives them all the information they need to know in a prescribed format. There seems to be no good reason why the FCA could not develop a parallel regime in the retail sector for services rather than products. The regulator would determine which services it wishes to cover and this would satisfy its objectives in large part, by using a tried and tested formula.

The important thing is who calls the tune

The crux of the issue is that, as with the KIIDs for UCITS, the FCA would need to take responsibility for deciding the format of the summary document and for determining the provisions that need to be summarised. It could then ensure that the summary document would be clear, short and relevant. Firms cannot be expected to take responsibility for such decisions themselves, as those decisions would always leave them vulnerable to challenge. The FCA, on the other hand, is perfectly placed to give certainty both to the industry and to consumers by defining, in relation to each service that it chooses, what consumers need to know before making investment decisions. Communication does not have to be high-tech to be smart.

Peter Richards-Carpenter
Consultant, Investment Management

TREADING A FINE LINE

SUBSIDIARY-LEVEL GOVERNANCE WITHIN GLOBAL FINANCIAL INSTITUTIONS

The PRA and FCA are pushing UK-authorised subsidiaries to become even more autonomous in their decision-making, but does this approach reflect the realities of how global groups operate? Nathan Willmott sets out some suggestions on how firms can tread the line between keeping regulators happy and pursuing the strategic initiatives of their wider group.

A firm stand: Regulator concern at global initiatives

One of the increasing pressure points between regulators and global financial institutions over recent years has been the question of how independently and autonomously the Boards of UK-authorised subsidiaries of global institutions are expected to operate.

The starting position of the PRA and the FCA is that, both in terms of its composition and its approach to decision-making on behalf of the relevant entity in the group, the Board should be fully autonomous and operate independently of the wider group.

For this reason, both regulators have been requiring wholly owned subsidiaries to appoint greater numbers of independent non-executive Directors. They have also insisted that key roles on the Board – such as Chairman, Chief Executive, Finance Director and Chairs of the main Board committees – should not be undertaken by individuals who are also executive members of the wider group or on the parent company Board.

In terms of decision-making, we have seen the PRA and FCA raise significant concerns when group-wide initiatives have been implemented by the Boards of UK subsidiaries, probing the extent to which the relevant decision was taken at UK Board or group-wide level. A huge amount of pressure is placed on the subsidiary to ensure that decisions are taken by the company itself, rather than by the wider group.

However, this approach from the regulators fails to take into account the realities, as well as the significant benefits, of being part of a global group.

Whose business is it anyway?

It is understandable that global institutions, whether banks, insurers, asset managers or intermediaries, are likely to want to implement consistent strategies in their operations throughout the world. Where strategic decisions are taken at group level, is it appropriate (or even realistic) for subsidiary Boards to be expected to take a different approach?

For example, where cost-cutting measures or other group-wide efficiency initiatives are announced, should the UK subsidiary Board simply ignore the announcement and adopt a more independent and autonomous approach?

Equally, when a management reshuffle is decided by the group and senior personnel are moved out of the UK and replaced by others from the group, should we expect Boards to veto the hire or departure of the new executives from elsewhere in the group?

The benefits to being part of a wider group include more flexible capital raising, access to resource and expertise, and significant cost reductions through shared service arrangements.

While the degree of central control varies significantly between different international groups, it is quite normal and acceptable for some key decisions to be taken at group level and cascaded down.

The PRA recently consulted (CP 18/15) on a proposed new supervisory statement covering its expectations of Boards. The unique position of wholly-owned subsidiaries is covered very briefly and without any guidance to Directors of UK subsidiaries on how they should approach their responsibilities. In particular, the draft statement provides no direction to Boards on the extremely difficult situation they face when presented with group-wide initiatives to be implemented in the subsidiary that they manage.

Fresh thinking for global initiatives

In my view, the PRA and FCA ought to be far more realistic and practical in their treatment of these situations. Where significant group-wide change is imposed on a UK-authorised subsidiary, it would be wrong for the Board to wave through the proposal without any consideration. Yet what degree of fresh analysis is required?

The Board ought properly to assess the proposals from a number of perspectives. Directors should consider whether the proposals are consistent with the subsidiary's own strategy and risk appetite – and whether they are consistent with commitments previously given to regulators and other stakeholders. In addition, the Board should assess whether implementation of the proposal would lead to customers being treated unfairly, or to any other breach of legal or regulatory duty.

Where senior executives are to be replaced, before the change is implemented there should be an assessment of whether the new individual proposed by the group is fit and proper to perform the role. This assessment ought to pay particular reference to whether he or she has the necessary skills and competence, coupled with sufficient understanding of the UK regulatory system to meet the role's requirements. Where headcount is to be reduced, the Board will need to assess whether the company will be left with sufficient personnel to manage effectively the risks that the entity assumes.

If the group-wide proposals raise concerns on any of these measures, they should be reconsidered with the wider group and either implemented in a way that is consistent with the UK subsidiary's legal and regulatory commitments, or a pause put on their implementation in the UK.

We have seen this approach adopted successfully in a number of institutions. A key element in practice is educating their parent companies on the reasons why these steps are necessary at a local level. This has led to a more harmonious approach to the implementation of global initiatives, both between parent company and subsidiary, and with the group's dealings with the PRA and FCA. It is to be hoped that the PRA and FCA can now issue some clear practical guidance to Boards of UK subsidiaries on these aspects to help them manage the significant challenges that they face when group-wide decisions are announced.

Nathan Willmott
Head of Financial Regulation

INDIVIDUAL *Accountability*

I PROMISE TO PAY THE BEARER

SMCR
TO CERTIFY OR NOT TO CERTIFY?

The new legal and regulatory risks that will be created by the Senior Managers Certification Regime have, for the most part, gone unnoticed. Polly James and Catherine Turner anticipate some of the key legal and regulatory risks that will be created by the new Certification regime, and offer three practical steps that firms can take to protect their positions.

What are the key duties upon firms under the new certification regime?
The core duties upon firms under the certification regime are:

- to take reasonable care to ensure that no employee performs a "significant-harm function" unless the employee has a valid certificate issued by the firm (FSMA Section 63E); and
- not to issue a certificate to any such employee unless the firm is satisfied that the person is fit and proper to perform the function to which the certificate relates (FSMA Section 63F).

Banks need to bear in mind that the decision to certify or not to certify an individual as fit and proper may be challenged by employees and their lawyers, or by the regulators. The annual certification process will therefore need to be robust and well documented, showing a clear and transparent decision-making process.

Where are new legal and regulatory risks likely to arise?
The certification regime creates several distinct areas of legal and regulatory risk for firms. To us, the clearest ones are as follows:

1. There is a risk that individuals who should be certified are not identified as certification staff and accordingly are allowed to perform a significant harm function without a certificate. Many firms are struggling to interpret the highly detailed guidance on the identification of significant harm functions in the final FCA rules and guidance. In addition, many firms do not realise how widely "employee" is defined for the purposes of the certification regime. Under the new FSMA 2000 Section 63E(9), the definition of "employee" will include a person who "personally provides, or is under an obligation personally to provide, services to [the firm] under an arrangement between [the firm] and the person providing the services or another person; and is subject to (or to the right of) supervision, direction or control by [the firm] as to the manner in which those services are provided". This definition would catch most contractors, as well as "employees" in the usual sense of the word.
2. There is the risk that a firm could be disciplined for issuing a certificate improperly, if an individual is later found not to have been fit and proper at the relevant time.
3. There is the risk that if a decision is taken not to certify an individual as fit and proper, given the consequences for the individual (such as potential dismissal and difficulties finding another regulated role), this decision is subsequently challenged by the employee in the Tribunal and/or Courts on employment law grounds.

What practical steps can firms take to protect their positions?

1. For firms struggling to interpret the rules and guidance on the scope of the certification regime, we strongly advise that when in doubt, you should document the rationale for deciding that a particular function is outside the regime, showing your workings. As with all regime changes, there will be an initial period of bedding-in during which both regulator and regulated will be finding their way through the new provisions. If you make the effort to document the rationale for any borderline decisions, you can be corrected by the regulators if you have got it wrong, but you should not be disciplined for it, provided the reasoning is not unjustifiable.
2. The key control in respect of the risk of issuing a certificate improperly is to be able to demonstrate that the decision to certify an individual as fit and proper was taken on a reasonable basis. If – as the FCA expects them to do – firms absorb the annual certification process into their existing annual performance review process, it will be necessary to review that existing process to check that the right questions are being asked and the right checks are being carried out.
   - Have you cross-checked the metrics used in your annual performance review process against the fitness and propriety criteria set out in the FCA Handbook, for example?
   - Have you given some thought to the order in which certification decisions will be taken, and considered ordering the process so that your senior certification staff are assessed first (to avoid the situation where a senior certification staff member carries out a number of appraisals and is then assessed as not fit and proper, with the result that the appraisals already conducted for the relevant year may need to be re-done)?
   - How will you ensure consistency of decisions between different managers and departments; will you, for example, appoint a Committee to deal with red flagged cases?
3. The legal risks for firms arising under employment law as a result of taking a decision not to certify an individual are significant, but can be mitigated to some extent by a careful review of the relevant employment contracts and HR policies and procedures. For example:
   - Have you made it a condition of employment that staff in significant harm roles continue to be deemed fit and proper throughout the duration of their employment, or have your policies been updated to expressly provide for suspension in circumstances when conduct issues come to light during the annual certification process? If not, you may run into difficulties if you need to suspend, re-deploy or dismiss them as a result of concerns over their fitness and propriety when the annual certification deadline comes around.
   - Have you reviewed and updated your employee handbook to reflect the fitness and propriety criteria? Time invested now in bringing your HR systems, policies and documents up to date will pay off in the longer term, by allowing you to be confident that you are able to comply with the regulatory duties of the firm (and its senior managers) without inadvertently creating employment law liabilities.

Polly James
Senior Associate,
Financial Regulation

Catherine Turner
Senior Associate,
Employment

WEEDING OUT THE ROLLING ROTTEN APPLES

TOUGHER OBLIGATIONS FOR REFERENCES

The FCA and PRA are on a mission to increase senior management accountability. From March 2016 employers must request references going back six years when they hire for senior roles. Eleanor Porter argues that a coordinated approach to gathering references and changing policies that cuts across multiple business units is the best way for firms to respond.

Part of the seismic shift towards greater individual accountability

Last October, the FCA and PRA published proposed new rules governing banks' and insurers' duties to provide and obtain regulatory references for candidates applying for certain roles. This is part of the wider regime change towards greater individual accountability coming into force in March 2016 in the form of the Senior Managers and Certification Regime ("SMCR") for banks and PRA-authorised investment firms and the Senior Insurance Managers Regime ("SIMR") for insurers.

Who will be caught by the proposals?

The new rules will affect banks, building societies, credit unions and PRA investment firms (collectively "Relevant Authorised Persons" or "RAPs") and Solvency II insurers and large non-directive firms ("insurers"). They will apply to candidates applying to the following roles:

- Senior Management and significant harm functions under SMCR;
- Senior Insurance Management Functions under SIMR;
- FCA insurance controlled functions;
- notified Non-Executive Director ("NED") roles;
- Credit Union NED roles; and
- key function holders within insurers.

The key changes affecting RAPs and insurers

- A new duty to request regulatory references going back six years from former employers (regardless of whether that employer was a regulated entity).
- Mandatory disclosures to be included in a new standard template, including:
  - any findings in the previous six years that the individual committed any prescribed regulatory conduct breaches or was otherwise found not fit and proper to perform a controlled function; and
  - details of any disciplinary action taken in relation to such findings.
- A continuing obligation to update references given in the previous six years as soon as reasonably practicable where matters come to light that would have caused the former employer to draft the reference differently if they were drafting it now.
- Complying with the new regulatory reference rules will become one of the prescribed responsibilities for Senior Managers in RAPs and insurers.

All authorised firms (i.e. not just RAPs and insurers) will be:

- clearly prohibited from entering into arrangements that conflict with their current regulatory reference obligations; and
- required to implement adequate policies and procedures to ensure compliance with regulatory reference requirements, including retaining records of former employees' conduct and fitness and propriety for a minimum of six years following their departure.

The final rules on regulatory references are expected to be introduced in time for the start of the new accountability regime on 7 March 2016.

Eleanor Porter
Senior Associate, Employment

What this means in practice

Firms must already, if requested, provide "all relevant information" to the FCA or a firm considering appointing an individual to undertake any controlled function. However, in our experience some financial institutions are either unaware of this slightly nebulous requirement or operate a blanket policy of only ever providing a standard form reference confirming job title and dates of employment.

The new rules will clarify and strengthen the current obligations. However, the current obligations will remain in place and may require a firm to make disclosures that go beyond the mandatory information to be provided in the prescribed new template. For example, firms may need to disclose certain regulatory breaches that are more than six years old if they are relevant to assessing an individual's fitness and propriety.

Shared responsibility: five steps HR, Legal and Compliance should take now

As the HR/regulatory cross-over continues to widen, firms increasingly need to have cross-disciplinary work groups to deal with issues that have both employment law and regulatory risk/compliance implications.

Firms should:

1. Review and update their record-keeping systems to ensure the necessary information is retained for at least six years.
2. Review and update their policies and procedures in relation to references.
3. Keep references under review for up to six years and update them where necessary.
4. Be aware they may need to obtain references for internal appointments to a prescribed role if the candidate has been employed elsewhere within the previous six years.
5. Avoid giving legal undertakings to withhold relevant information in order to secure a negotiated employee exit.

A regulatory framework for reputation management

The strengthening of the rules on regulatory references is intended to address the increased potential for individuals to escape their poor conduct records by moving from one firm to another – without information about their misdeeds following them.

Historically, responsibility for certifying an individual's fitness and propriety to perform controlled functions ultimately sat with the regulators. Although regulators will still access their own intelligence when assessing applications to Senior Manager functions, under the new certification regime, firms will assume responsibility for assessing the fitness and propriety of those undertaking significant harm functions. Given the potential impact the new rules will have on individuals' future employment prospects, we foresee increased impetus on individuals to clear their names in respect of any alleged regulatory wrongdoing before departing employment, including through litigation where necessary.

The Government intends to extend SMCR to all authorised firms in 2018. It is therefore inevitable that the new regulatory reference obligations initially intended to apply to RAPs and insurers will affect every authorised firm before long. In my opinion, HR, Risk and Compliance functions should bring together their cumulative knowledge to address the references challenge – sooner rather than later.

SIMR PRACTICAL STEPS FOR INSURERS

Hot on the tail of the new Solvency II requirements for insurers, the UK's new Senior Insurance Managers Regime comes fully into force in March 2016. Geraldine Quirk takes a look at the challenges arising from this extension of the FCA's individual accountability measures to insurers.

From 7 March 2016, the Senior Insurance Managers Regime (SIMR) will replace existing PRA controlled functions for insurance companies with more granular and role specific senior insurance management functions (SIMFs). These are designed to capture individuals who play a critical role in the business and are responsible for ensuring the ongoing safety and soundness of the firm and protection of policyholders. New rules also implement the Solvency II concept of key functions and key function holders (a group that includes but is wider than SIMF holders) all of whom will be subject to fit and proper requirements and conduct rules.

The rules implementing Solvency II governance requirements came into effect on 1 January 2016; those reflecting the SMR on 7 March 2016. There is a complex set of transitional requirements to address this two speed timetable.

Why is SIMR being introduced?

The principal impetus behind the changes is the need to implement the governance requirements of Solvency II. However, the new rules are a manifestation of PRA and FCA policy objective to ensure the accountability and responsibility of senior management. The UK regulators have seen fit to extend aspects of the new senior managers and certification regime for banks (SMCR) to the insurance industry. The SMCR seeks to remedy deficiencies in the Approved Persons regime identified by the Parliamentary Committee on Banking Standards, including the lack of personal responsibility of senior figures and their ability to shelter behind an accountability firewall.

Solvency II governance requirements

Governance requirements are set out in Articles 41 to 49 of Solvency II, and include a requirement for an effective system of governance subject to regular review and a transparent organisational structure, with clear allocation and appropriate segregation of reporting requirements. Persons who have key functions are subject to fit and proper requirements, and appointments of persons responsible for key functions must be notified to the supervisory authorities. Insurers are required to have risk management, actuarial, internal audit and compliance functions.

The Commission Delegated Regulation amplifies these requirements. It is directly effective in the UK and insurers therefore need to have regard to it and not just to UK legislation and rules implementing Solvency II. It contains provisions expanding on the responsibilities of the required functions and obliging firms to ensure that each function is free from influence that may compromise its ability to undertake its duties in an objective fair and independent manner.

EIOPA guidelines on systems of governance are addressed to member state supervisory authorities. EIOPA comments that persons nominated for a key function are not subject to prior approval and the guidelines do not therefore require this.

Who will the new regime affect?

The new regime will impact board members, senior management and more junior staff in teams performing key functions in all insurance firms subject to Solvency II. A modified regime will apply to insurers outside the scope of Solvency II.

The new SIMFs are more role-specific than the PRA controlled functions they replace. This means that not all board members will be subject to pre-approval by the PRA. However, the FCA is extending its director function to cover directors who are not PRA approved, and has created two new role specific NED controlled functions.

NEDs, and any other key function holders, who are not performing a SIMF or FCA controlled function must be notified to the PRA and all information necessary to assess their fitness and propriety provided. Certain prescribed responsibilities must be allocated to SIMF holders or, in some cases, a NED approved for a SIMF or FCA controlled function.

All key function holders (including SIMFs) and all individuals in teams performing key functions will be subject to conduct rules.

Key dates

PRA rules implementing the SIMR are contained in two instruments. The first implements the governance requirements of Solvency II and will be effective between 1 January 2016 and 6 March 2016. The second consolidates these requirements with the changes reflecting the SMR, and will be effective from 7 March 2016. The PRA has also issued a supervisory statement setting out its approach to, and its expectations of firms under, the new regime which provides some helpful clarification.

What should insurers be doing?

Insurers will need to:

- identify key functions and those responsible for them;
- prepare a governance map showing key functions and key function holders with a summary of their significant responsibilities, reporting lines and lines of responsibility;
- identify key function holders who will be performing a SIMF and those who will qualify for grandfathering;
- submit the following forms;
  - from 1 January 2016, application forms for SIMFs who do not qualify for grandfathering and notification forms for new key function holders not performing key functions at 1 January 2016;
  - by 8 February 2016, a grandfathering form covering grandfathering SIMFs and NEDs who will no longer be approved for a controlled function;
  - by 7 September 2016, a key function holder notification form (for non-SIMFs already performing a key function at 1 January 2016) and a scope of responsibilities;
- update internal compliance manuals and staff handbooks to reflect the new conduct rules;
- ensure contract terms for key function holders reflect the scope of the individual's responsibilities under the new regime; and
- update recruitment and review procedures to reflect the new fit and proper requirements and conduct rules.

Complex overlapping requirements

One of the tropes of any PRA pronouncement on Solvency II is that it cannot and will not gold plate the requirements. On this basis, the extension of aspects of the SMR to insurers seems difficult to justify, when EIOPA guidelines expressly state that key function holders are not subject to prior approval. The overlapping requirements make for a regime, and transitional provisions, of byzantine complexity.

The changes do not end here: further reforms being brought in by the Bank of England and Financial Services Bill which will extend the SMCR to the whole of the financial services industry, introducing a statutory duty upon senior managers to take reasonable steps to prevent regulatory breaches, and an annual certification regime relating to persons performing "significant harm functions". These changes are expected to come into operation in 2018.

It is unfortunate that the PRA chose to subject insurers to a version of the SMCR at an earlier stage, when they are already grappling with the final stages of Solvency II implementation. There do not appear to be any particular issues in the insurance industry which justify subjecting it to the regime ahead of the remainder of the financial services industry. Insurers would have benefitted from a breathing space to bed in Solvency II requirements, before being required to tackle yet another set of reforms.

Geraldine Quirk
Partner, Insurance

MIND THE GAP

WHAT YOU NEED TO KNOW ABOUT EQUAL PAY

Rebecca Harding-Hill
Partner,
Employment

David Cameron has pledged to 'end the gender pay gap in a generation'. Rebecca Harding-Hill examines the resulting regulation and explains why companies need to act now.

What is the gender pay gap?

The gender pay gap is the percentage difference between men's and women's earnings. Current pay gap statistics make for uncomfortable reading – the overall UK gender pay gap is now around 19%, and even higher in the financial services sector. An investigation by the Equality and Human Rights Commission, which examined 50 financial services firms, found evidence of gender pay gaps within the same job grade in 95% of cases.

In last year's 'Emerging Themes' report, we discussed the requirement to conduct equal pay audits in certain circumstances. As expected, the spotlight is shining brighter than ever on equal pay regulations requiring large companies to publish their gender pay gap.

What is set to change and when?

A Government consultation which closed in September 2015 sought views on what pay information employers should be required to publish. New measures will require employers with 250 or more employees to publish their 'pay gap' and cover more than 10 million workers across the UK. The aim is to create transparency and lead employers to take steps to address gender pay inequality.

A second consultation is due to take place on the detail of the proposals and legislation could be in place by October 2016. Implementation is likely to be delayed to give businesses time to prepare for the new regime. The consultation also suggests that companies with over 500 employees may be required to publish their data before smaller employers.

What information will employers have to publish?

Information that large employers have to publish could include:

- an overall gender pay gap figure;
- separate figures for full-time and part-time employees;
- figures broken down by grade or job type; and
- the gap between men and women in bonus awards.

Publishing one simple overall figure would certainly be easier for employers, but may be misleading and would inevitably ignore the complex reasons behind pay gaps. A more detailed requirement would allow for a fairer and more transparent comparison, but is likely to be a more onerous task for employers.

The Government's consultation also considered whether employers should be obliged or permitted to publish additional contextual information alongside the figures, allowing them to explain any gender pay gap and set out intended action to address the issue.

Opinions have also been sought on where employers should publish their data, for example on their website.

In terms of how often businesses will need to provide the data, this is still under consideration – it may be biennial or triennial reporting, in order to give employers time to address pay issues.

Equal pay: The impact on employers

The penalty for non-compliance is likely to be a £5,000 fine. However, employers may be more concerned by the risk of reputational damage.

Mandatory gender pay gap reporting may open up pay practices to employee and public scrutiny. Businesses will be compared to their competitors and poor pay gap statistics could affect recruitment, employee satisfaction and even customer loyalty.

Publishing clear figures showing pay differences could also encourage individual grievances as well as equal pay and discrimination claims.

The consultation document discussed the fact that mandatory pay gap reporting could be a burden on employers' resources. It asked what support employers may need in implementing and executing reporting.

What action should employers take now?

In short – review sooner rather than later.

Before the mandatory provisions come into force, employers should consider whether they have, and can address, any unjustifiable pay gaps in their organisation.

To understand fully what the figures are likely to be when the time comes to publish, employers will need to conduct a pay audit. This itself gives rise to its own challenges, as:

- a properly conducted audit requires substantial resources;
- findings and underlying analysis may be disclosable documents in any related litigation; and
- in the event that unjustifiable pay gaps are revealed, the employer will need to take steps to address them (or else face additional criticism).

However, the benefits of carrying out an audit are obvious:

- it will make the employer aware of any pay issues in its business, which is the first step to being able to address them;
- it can avoid being required by a tribunal to undertake an audit. (Tribunals will usually be required to order an organisation to conduct a pay audit if it faces and loses an equal pay claim); and
- employees are likely to welcome the fact that their employer has carried out an audit.

Before or instead of carrying out an open audit, employers may conduct an audit under legal privilege. Carrying out the process under legal privilege would avoid the audit being disclosable.

What causes a gender pay gap?

A gender pay gap does not necessarily mean that there is unlawful discrimination. There may be legitimate justifications for pay differentials. Objective justification will be important both for explaining a pay gap and providing a defence if the organisation is faced with equal pay or discrimination claims.

The causes of pay gaps are likely to be complex and varied, with the consultation document recognising a number of contributing factors. These include differences in career aspirations between men and women, a lack of female representation at a senior level and the disproportionate impact on a woman's career of having a family.

To close any gender pay gap, it is clear that organisations should work to promote cultural change and remove the remaining barriers that may prevent women progressing in the workplace. Part of this may be reviewing the organisation's family-friendly policies such as flexible working and shared parental leave. Many businesses have already done a lot of work following Lord Davies' report, 'Women on Boards', to increase the number of women in senior positions.

What's next for women on equal pay?

Over many years, varied efforts have been made to address the gender pay gap. Some success has been achieved, but many would argue that change has not happened fast enough. For employers, the time to start looking at their organisations and what their own pay structure is now.

There are many reasons for gender pay disparity, and not all of these are unlawful. However, employers will be better placed to deal with any gender pay gap in their organisation if they understand where their business stands on this issue and the reasons behind the figures.

THE IMPORTANCE OF PERFORMANCE MANAGEMENT

IN THE NEW REGULATORY WORLD

The FCA is starting to turn its gaze away from the 'tone at the top' and focus more on the 'tone at the middle'. Polly James and Adam Turner consider the increasing importance of good performance management in this context.

We are beginning to see a new regulatory focus on performance management from the FCA. Having addressed remuneration in the financial sector, the FCA is now moving on to scrutinise firms' performance management processes. As a result, you can expect your firm's approach to people management to be scrutinised soon. However, the good news for HR and Compliance professionals is that, in light of the new individual accountability regimes, your firm's senior management is sure to be onside.

The regulatory context: moving beyond an incentives-based view of conduct risk

The financial crisis, and the subsequent discovery of widespread misconduct in relation to LIBOR and foreign exchange, highlighted issues with incentivisation at the heart of the financial sector. In 2013, the Parliamentary Commission on Banking Standards (PCBS) said that "many bank staff have been paid too much for doing the wrong things." The "how much pay" issue has now largely been addressed: large cash bonuses for short-term success have been replaced by payment in shares, deferred payments and the possibility of clawbacks, all encouraging longer-term thinking. The natural next step is for the regulators to address how firms are defining and measuring what they are paying their people to do.

The FCA's Guidance Consultation, 'Risks to customers from performance management at firms', published in March 2015, signalled a step forward in the FCA's thinking about how, in practical terms, firms should be doing this. While the Guidance is directed specifically at retail financial services firms, the same ideas will inevitably find their way into the FCA's thinking about wholesale markets before long.

Key points from the FCA Guidance Consultation

The FCA has now recognised that performance management practices affect customers' experience of a firm more viscerally than 'tone from the top'; after all, how many of a firm's employees interact with its senior management on a regular basis? The Guidance Consultation clearly shows that the FCA has now developed its thinking to recognise a clear link between performance management, firm culture and customer outcomes.

> "The culture of a firm is important in ensuring customers are at the heart of how a business is run. A key driver of culture is how people are rewarded and the behaviours that are valued and recognised by the firm. The way in which staff are incentivised, and their performance is managed, plays a key role in this, which is why we are interested in it."

In this context, the FCA criticises performance management practices which focus too heavily on sales results (such as continuous reporting of sales figures, requiring staff to explain missed targets before peers, and linking career progression primarily to sales results). More interestingly, it emphasises the importance of performance-managing middle-managers, who are perhaps in a uniquely dangerous position in terms of conduct risk, being neither directly exposed to customers, nor in a position to set targets or policies themselves. We are starting to hear the phrase 'tone at the middle' used to describe the critically important issue of how you incentivise and manage the behaviours of your middle-management in a way that will protect the interests of the firm's customers.

Why firms' senior management will be interested in performance management

Individual regulatory accountability is to be reformed in March 2016 by the replacement of the Approved Persons Regime with a new Senior Managers and Certification Regime ("SMCR") for banks and PRA-authorised investment firms. The Bank of England and Financial Services Bill, introduced in the House of Lords in October 2015, is expected to extend SMCR to all authorised firms by 2018. A key feature of SMCR is the introduction of new 'prescribed responsibilities' which must be allocated to individual senior managers, including responsibility for "embedding the firm's culture and standards in relation to the carrying on of its business and the behaviours of its staff in the day-to-day management of the firm."

As a result, we expect to see a new level of personal engagement of firms' senior management with performance management issues.

Opportunities for transformation

Although the new accountability regime brings many challenges for firms and their senior individuals, we can see that these changes also offer positive opportunities for forward-thinking firms.

For example, some firms may consider creating a new, multi-disciplinary team of professionals to bridge the gap between HR and Compliance departments, focussed on nurturing and developing talent, as well as assessing past performance and measuring regulatory compliance. Such a team should be well equipped to steer the pipeline of talent towards best practice, and to minimise performance-related regulatory risk.

As performance management becomes a regulatory issue, the challenge for firms is to adapt their inter-departmental dynamics, instituting a system that is capable of realising the potential for positive change.

Adam Turner
Associate Director, Employment

Polly James
Senior Associate, Financial Regulation

IS YOUR TURNOVER GREATER THAN £36M? YOU NEED TO KNOW THIS ABOUT

THE MODERN SLAVERY ACT

The historic law to end modern slavery is the first of its kind in Europe and requires larger businesses with UK operations and a global turnover exceeding £36 million ($56 million) to publish an annual slavery and human trafficking statement. Katherine Pope considers how businesses should respond to this new reporting requirement.

The Modern Slavery Statement

The Modern Slavery Act 2015 places a new requirement on businesses to publish an annual 'slavery and human trafficking statement'. This statement must set out the steps an organisation has taken to ensure both its business and supply chains are free from modern slavery – i.e. slavery, servitude, forced labour and human trafficking.

With an estimated 13,000 victims of forced labour, sexual exploitation and domestic servitude in Britain, the new reporting requirement is part of the UK Government's strategy to fight modern slavery. An organisation's statement must set out the steps (if any) it has taken to ensure that modern slavery is not taking place globally in any of its supply chains or in any part of its own business. The statement will be publicly available, in that it must be published prominently on the organisation's website.

Businesses with a year-end of 31 March 2016 will be the first required to publish a statement for their 2015-16 financial year.

Who does the Modern Slavery Act 2015 impact?

The ambit of this new legislation is extremely broad. The requirement to publish a slavery and human trafficking statement each financial year applies to commercial organisations:

- with a total turnover of £36 million or more; and
- who carry on any part of their business in the UK.

There is no requirement for organisations to have a certain level of activity in the UK before the Act applies. Consequently, organisations with headquarters outside the UK but who carry on some business here are also impacted.

The statement must be approved by the Board and signed by a director (or a member/partner in other commercial organisations). However, day-to-day responsibility is likely to rest with either the legal or compliance functions.

Complying with The Modern Slavery Act 2015

Compliance will require a detailed analysis of the business's internal structures and those of organisations in its supply chain on a global basis. It is also likely that amendments to contracts, policies and staff training will be required. This makes compliance an onerous undertaking, especially for large institutions with a UK presence and global operations which touch higher risk jurisdictions, for example the Far East, the Indian sub-continent and parts of Africa.

The Home Office has published guidance on how businesses can comply with these requirements. This document contains useful practical advice on the development of a "credible and accurate" statement. It does not prescribe a particular form for the statement, however, recognising that individual organisations must determine what steps they consider reasonable in the context of their own business arrangements. Notably, the guidance provides that statements should be published as soon as possible after the year-end and, in practice, it is expected that this will take place within six months. It also recognises that this is a new obligation, so there is an expectation that organisations will continue to build on their statements year-on-year.

Eight steps organisations should take now

The key to dealing with this obligation is to start reviewing your existing business practices and addressing any issues you identify immediately.

Here are eight steps you should take to help ensure that your organisation does not face an adverse reputational, legal, financial or operational impact:

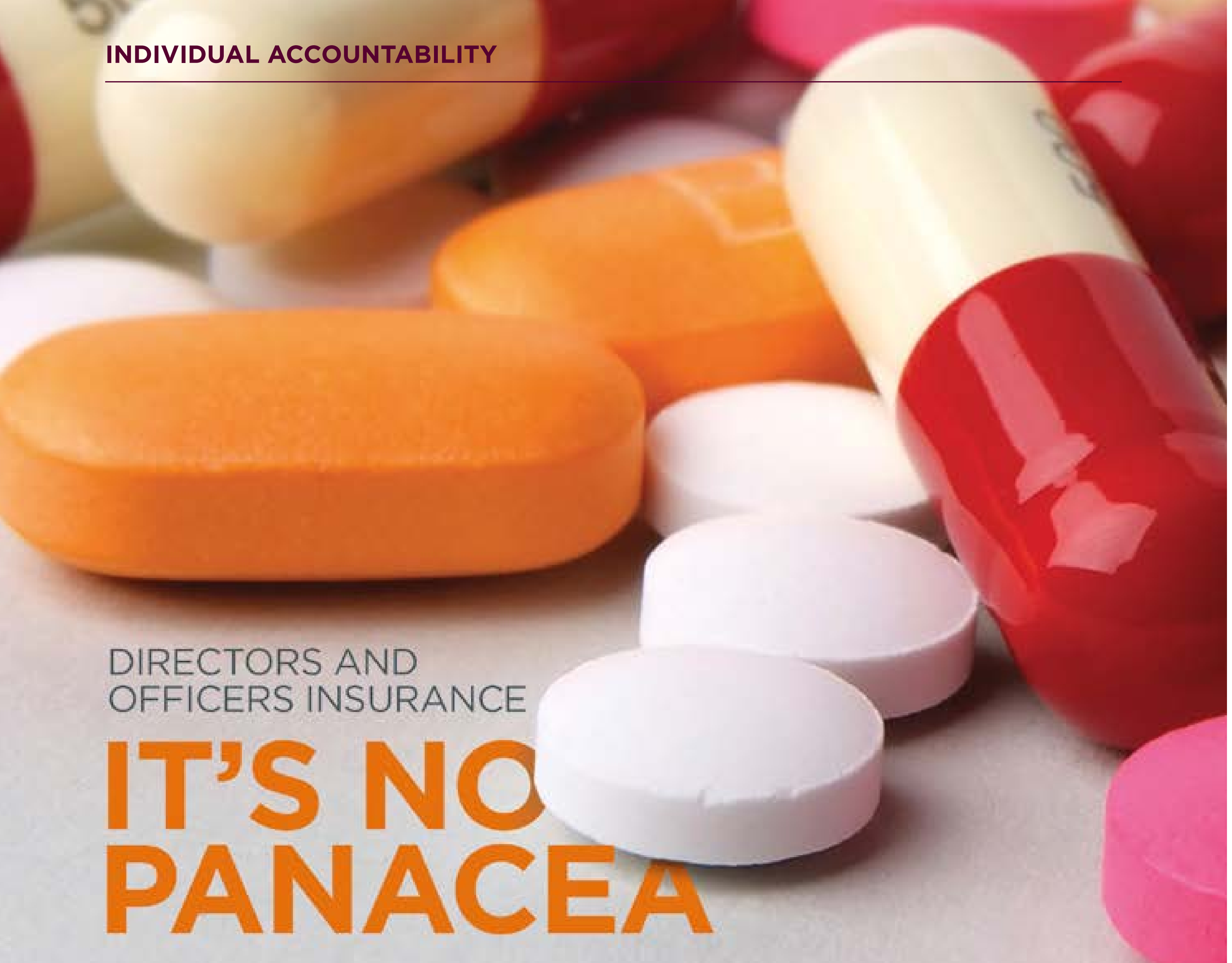
1. Assess which of your corporate entities are affected. Subsidiaries who meet the test above are required to publish their own statement, although they may simply repeat the contents of a parent's statement, if it is appropriate.
2. Consider in which parts of your business and supply chain might there be a risk of modern slavery? Do you operate in jurisdictions or sectors that are particularly high risk? There are online tools that can identify this. If so, how can that risk be managed?
3. Does your business ethics policy address issues around modern slavery? If not, consider what policies require amendment or whether new policies should be introduced.
4. Consider whether your induction and/or other training includes training on slavery and human trafficking. If not, this should be introduced, and be focused on informing employees about country-specific modern slavery risks.
5. Review your commercial contracts for provisions which deal with anti-slavery measures. Obligations on suppliers and contractors (particularly for services based overseas) should include a requirement to demonstrate compliance with all applicable laws and with your own policies. Country-specific provisions may also be appropriate where a particular risk has been identified.
6. Commercial contracts should also include reporting obligations to ensure any potential risks and breaches are brought to your attention.
7. Bear in mind that your supply chain extends not just to your own contractors and suppliers, but also subcontractors. Obligations in commercial contracts should extend not just to the supplier themselves, but also include a requirement to carry out due diligence on, and require compliance from, their suppliers and subcontractors.
8. Consider what due diligence you will carry out when entering into a relationship with a new supplier, or when considering an acquisition or investment.

Is modern slavery an issue for the financial services industry?

At first glance, this requirement appears to be simultaneously onerous and toothless. It is technically possible to comply simply by stating that no steps have been taken to address the issue. However, public relations concerns mean this is not anticipated to be a commercially acceptable option.

There is also no sanction for failing to comply, although the Government may, in theory, seek an injunction to compel compliance. However, while enforcement action seems unlikely, the Government's stated aim is to encourage businesses to do the right thing by harnessing consumer and wider stakeholder pressure. In the financial services sector, where public confidence is already low, the importance of reputation and brand may ultimately be the main incentive for compliance with both the letter and spirit of this new law.

Katherine Pope
Senior Associate,
Employment



DIRECTORS AND OFFICERS INSURANCE

IT'S NO PANACEA

Whilst D&O insurance is important, being an informed buyer is critical. Personal risks and regulatory scrutiny are increasing and D&O insurance is widely perceived to be the safety net. However, do today's corporate leaders really understand the extent that insurance protects them against individual liability? Andrew Rose examines one of the most talked about, but least understood, insurance options and concludes that it's no panacea.

Why do you need Directors and Officers (D&O) insurance?

The comfort blanket provided by D&O cover to senior executives in regulated entities cannot be underestimated. The shareholder and class-actions suits which have been a feature of the US market for many years are less common in the UK. However, exposure still ranges from the threat of claims by shareholders following unexpected share price falls or corporate mismanagement, to the tacit acceptance by a regulated entity that it is likely to be subject of some scrutiny or a formal investigation by one of the regulators.

Whilst the company may well have established legal advisors, there is always a real risk of conflict of interest between the company and individuals, which means that separate representation will be required. In other scenarios, individuals can be exposed where their company is insolvent and unable to meet legal costs, or where the individual director has since left and it's convenient for the company to "pass the buck" to previous management.

What is the cover?

Like any liability policy, cover will be provided in respect of claims against current and former directors, and the legal costs of defending those claims. While substantive claims have been made (and paid by insurers), many of the recent notifications to the market relate to the costs of investigations in the broadest sense. These can come from a number of different sources, such as the FCA, the SFO, the CMA, or internal investigations arising from information provided by whistleblowers. The full consequences of the Bribery Act 2010 are still being worked out, and the broad ramifications of the Senior Managers Regime for both banking and insurance means that regulatory and criminal enquiries are not going away.

The reality of making a claim

The first question is what triggers a notification and entitlement to claim, and the first concern of the director is usually paying legal costs. Whilst the FCA is not unreasonable, regulatory investigators won't wait until you're ready. Any D&O policy will cover the costs of an actual investigation by external bodies, but market demand and the availability of insurance capacity means that coverage now extends to circumstances beyond those situations. Cover for both anticipated enquiries and internal investigations is now commonly included, with payment of costs being subject to approval from insurers, approval not to be unreasonably withheld or delayed.

D&O policies are like any other insurance policy, and subject to requirements for disclosure of material information, which can be difficult to establish where the proposal is normally signed by one director and/or the company secretary. For any individual making a claim, the risk of the policy being affected by the conduct (or otherwise) of others is minimised by a non-vitiation clause. This ensures that the acts, omissions or the knowledge of one director are not to be imputed to any other directors for coverage purposes, unless the claiming director also had actual knowledge of the matter.

The Insurance Act 2015, which is due to come into force in August 2016, provides for a duty of fair presentation. In the context of a D&O policy this is likely to require more detailed enquiries to be made prior to the start date. Wordings also provide that the insurers are under an obligation to advance legal costs, rather than simply having a discretion to do so, which is often an immediate source of concern. Insurers will not cease to make costs advances available unless or until allegations of dishonesty (liability for which will be excluded) are either established or admitted. Nevertheless, insurers are still entitled to investigate whether the claim does fall within the policy. This can involve consideration of the conduct of other parties (including the company itself), who may be less willing to provide prompt co-operation to the insurers when the investigation is of a former director and the company has other pressing issues to address. Confirmation of coverage is a necessary precursor to any costs being advanced.

Delays and agonising waits

Any delays in a decision on coverage impact the usefulness of the coverage for an individual who either has to persuade his employer (or former employer) to meet the costs on an ongoing basis, pay out of his own funds, procure legal advisors to work on a conditional fee basis, or represent himself. The work involved in preparation for regulatory interviews, such as searching for documentation and document review, is time consuming and expensive. There is no easy answer to the question of delays, but ways forward may include insurers making a loan to the director, or capping the amount of available costs until coverage investigations have been completed. However, delays can cause real difficulty for a director who is faced with continued uncertainty, and feels that the umbrella has been taken away exactly when it is most needed.

Why disputes shouldn't be your first choice

A director looking to speed up a decision on the question of coverage doesn't have many options. The company, as the party purchasing the policy can, both itself and through its brokers, try to apply commercial pressure on the insurers. However, dispute resolution provisions in the policy will usually refer disputes to the High Court or to the London Court of International Arbitration. The provisions regarding determination by a QC on the reasonableness or otherwise of a proposed settlement do not generally apply to issues of this nature. The regulatory principle of 'Treating Customers Fairly' can also be invoked to an insurers' own complaints procedure.

An option which is no longer available is taking the matter to the Financial Ombudsman Service. In Bluefin Insurance Limited v. Financial Ombudsman Service (FOS), the Court decided that a director making a claim under a D&O policy was not acting as a consumer, and was therefore not entitled to the benefit of the FOS mechanism in relation to a complaint against an insurance broker; he was acting in a business capacity as a director, when making a claim. However, the same limitation would not apply to a claim by a spouse or executors, who in many cases are also covered by the D&O policy.

The executive checklist

In most cases, insurers recognise the need for a prompt decision on the provision of cover and will do their best to meet that expectation. However, like anything else, policy wording and factual scenarios are not always straightforward. My recommendation to today's executives would be:

- read the policy on taking your appointment, and don't leave it until you need to claim;
- if there are any doubts, ask the company or the brokers who arranged the policy for clarification; and
- don't expect insurers to make payment without asking questions, but do press them for a prompt decision.

Andrew Rose
Partner,
Insurance / Reinsurance

FINANCIAL CRIME And INVESTIGATIONS

FCA DISCRETION IN PENALTY SETTING

ART OR SCIENCE?

The FCA's penalty setting policy is under review. Ahead of the outcome, Paul Bennett discusses its effectiveness. Has it achieved its aim of bringing consistency and transparency to the penalty setting process?

Let's look at the process
DEPP 6 outlines the following five-step approach for the FCA to apply in determining an appropriate level of penalty:

1. **Disgorgement**
The profits made (or losses avoided) from the misconduct

2. **Seriousness of the breach**
This element of the penalty is normally based on a percentage of the firm's "relevant revenue", with the percentage adopted being a measure of the FCA's interpretation of the seriousness of the misconduct

3. **Aggravating or mitigating factors**
An adjustment upward or downward to reflect factors such as whether the firm voluntarily brought the misconduct to the FCA's attention, failure to disclose to the FCA or repeat offending

4. **Deterrent**
An increase in the amount of the penalty to achieve the required deterrent effect

5. **Early discount settlement**
A reduction in the penalty to reflect the firm's early settlement of the misconduct charge

It is immediately clear from this table that the framework provides the FCA with a significant degree of flexibility and discretion, particularly in respect of Steps 2, 3 and 4. As Steps 2 and 3 are progressive, with Step 4 being purely discretionary, some commentators have pointed to the need for more transparency from the FCA about its process, so that firms can see and learn from its thinking. It is worthwhile considering each step in turn.

Step 1 – Disgorgement
It is not always easy to quantify the profits made by a firm from misconduct simply by reviewing its financial statements. In many cases a detailed forensic investigation into the firm's accounting books and records is the only way to identify this element of the penalty at a sufficient level of robustness and certainty to satisfy the FCA. Under this step of the assessment of the level of the penalty that should be due, there is very little scope for the FCA to use its discretion.

Step 2 – Seriousness of the breach
This element of a penalty is calculated as a percentage of the "relevant revenue", a figure that can mean different things in different cases.

Establishing relevant revenue is not simply a matter of looking at the turnover achieved by the firm from the sale of the product lines in question, as this standard measure alone may not always accurately reflect the harm caused by the breach. The FCA has significant flexibility as to the appropriate yardstick it will adopt to measure relevant revenue. The following are all examples of measures of relevant revenue the FCA has used in assessing the penalty arising from regulatory breaches:

- client money balance;
- redress paid;
- market capitalisation;
- interest paid;
- number of transactions; and
- capital shortfall.

Once the figure for relevant revenue is established, the percentage that is then applied to arrive at the level of penalty is based on the FCA's view on the seriousness of the breach. DEPP 6 suggests this could range from 0% to 20%, depending on how serious the FCA considers the breach to be (on a scale of 1 to 5). The size of penalty derived from this step of the enforcement regime is therefore very much at the discretion of the FCA.

Step 3 – Aggravating or mitigating factors
The FCA can apply an additional percentage to the penalty figure arrived at under Step 2. This has ranged from an uplift of 10 – 100% for aggravating factors down to a 20% reduction due to mitigating issues, and is again a figure that is entirely within the FCA's discretion to determine.

An example of a mitigating factor is when the firm voluntarily pays redress beyond that which the FCA would have required, whilst the most frequent aggravating factor relates to instances where the breach has been committed despite prior disciplinary action, or regulatory warnings having previously been given by the FCA.

Step 4 – Deterrent
The FCA can increase the penalty figure arrived at on the basis of Steps 2 and 3 (by either a multiple, or a specific surcharge amount) in order to send a deterrent message to the industry. The FCA bases these increases on the penalties it has issued for similar misconduct and any specific messages that the FCA may wish to send to the market in respect of its current regulatory priorities, and of any type of misconduct that it considers to be particularly egregious.

As an example, in respect of the case against UBS AG for foreign exchange rate manipulation, Steps 1 to 3 suggested a penalty of approximately £44 million. The FCA then added a deterrent surcharge of £225 million. This surcharge was based on an increase of the previous highest penalty for benchmark fixing of £200 million, which the FCA felt could not have been at a sufficiently high level to act as a deterrent. The logical outcome of this approach would be for the size of penalties to continue to increase until they do provide the necessary deterrent factor that will change firms' behaviour and standards.

Step 5 – Early settlement
If the FCA and the firm are able to reach settlement at an early stage, then the penalty may be discounted to reflect the benefit of such agreements.

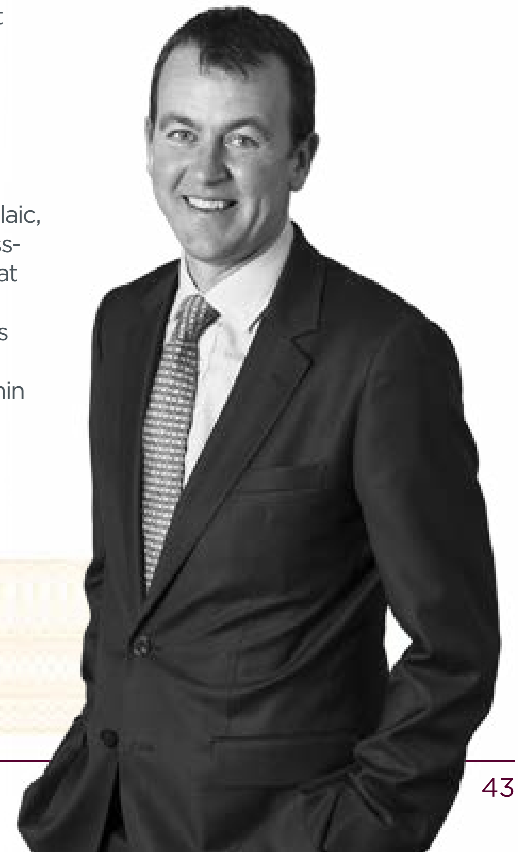
Negative perception of the status quo
A number of critics, including the Government, have suggested that the FCA's five-step process is not providing the consistency to the penalty-setting regime that was envisaged when the policy was updated in DEPP 6.

Whilst, on the face of it, DEPP 6 outlines a straightforward, formulaic, structured approach to the assessment of penalties, critics claim that this is not borne out in practice. They assert that the FCA appears comfortable using the subjective discretion that it is permitted within the regime to arrive at a penalty figure that is "right", often on the basis of its current regulatory priorities.

We have seen situations where the FCA appears to have reverse-engineered the DEPP 6 calculations to arrive at the total fine that it wishes to impose, on the basis of previous penalties, the desire to provide a deterrent to prevent repeat offending and the FCA's prioritisation of misconduct issues. This discretion-based approach from the FCA can make it extremely difficult for a firm and its advisers to assess with any degree of accuracy the level of penalty that it may be facing following a misconduct finding. This uncertainty is unsettling and makes early negotiation and settlement discussions more difficult. This delays the conclusion of enforcement actions and ties up FCA resources. It further leaves firms facing uncertainty in the outcome when remedial work may already have been carried out to render the firm fully compliant in the areas covered by the enforcement action.

Looking ahead
The Parliamentary Commission on Banking Standards found the FCA's penalty-setting regime to be unsatisfactory and recommended its review. That review started in 2015 and, at the time of writing, our understanding is that the FCA proposes to put out a consultation on review of the DEPP 6 process.

Paul Bennett
Head of Forensic Services



SETTING THE RECORD STRAIGHT

HOW TO SURVIVE A REGULATORY INTERVIEW

Daunting, pressurised and time-consuming are just some of the words that are used to describe regulatory interviews. After spending a year working on the front line of FCA and PRA investigations, Adam Jamieson shares some insider tips on how you can not only survive an interview, but perform to the best of your abilities.

In today's aggressive regulatory climate, with the focus squarely on individual accountability, being summoned to attend an interview with FCA enforcement is far more common than it once was and the stakes are higher than ever. It's not something anyone would look forward to, but as long as you're well prepared, there's no reason to dread an interview with the regulator. I spent a year on secondment with the FCA's Enforcement and Market Oversight Division, working as an investigator on FCA and PRA investigations into both firms and individuals and, having carried out regulatory interviews myself, I can share some insider tips on getting through the process with minimal stress.

What is the purpose of regulatory interviews?

The FCA and PRA use interviews as a crucial part of the evidence-gathering process for their civil enforcement regimes. Before commencing interviews the regulator will have outlined the scope of the investigation and will often have obtained large volumes of relevant documentation. They will then begin to work their way through a carefully selected list of interviewees.

Given the regulators' increasing focus on individual accountability, your performance could be decisive in whether enforcement proceedings are brought against you personally, your colleagues or your employer. It is an important opportunity to tell your side of the story. »

What powers do the regulators have?

Almost all interviews are carried out on a compelled basis using the regulators' extensive statutory investigation powers under FSMA. As a result, there are serious consequences for failing to co-operate with the regulators. You could be charged with contempt of court for failing to attend or failing to answer questions during the interview, which is punishable by imprisonment, a fine, or both. Providing deliberately false or misleading information is also a criminal offence. A failure to be open and co-operate could also result in civil proceedings against an individual (pursuant to APER 4) or the firm (pursuant to the FCA's Principle 11 and/or PRA Fundamental Rule 7).

Preparing for the interview: how to be at your best

Consider taking independent legal advice as soon as you receive notice of the interview. The cost of such advice may be covered by your employer or by Directors and Officers Liability (D&O) insurance (note that you may need to notify your insurer). As your legal advisor will tell you, careful preparation is the key to confident interview performance.

You can expect to receive advanced disclosure of the documents to be discussed during the interview a week or two before it is due to take place. Go over these thoroughly, reminding yourself of the circumstances of each document/communication, why particular decisions were made and what systems and controls were in place to mitigate against any risks. Try to anticipate what the regulators will ask and prepare accordingly, but avoid scripting your answers. For example, if the scope of the investigation is focussed on alleged weaknesses in systems and controls, be ready to explain your understanding of company policies and procedures.

Interviews can last anything from a few hours to a few days; it can feel like an endurance event. As a result, basic things can make a big difference to interview performance. In particular, a good night's sleep and eating well on the day are important in order to maintain concentration levels.

During the interview

Typically there are three interviewers who, in my experience, are courteous and professional: this is a fact-finding exercise, not an interrogation. They will be armed with a pre-prepared interview plan consisting of a scripted list of questions, including an order for taking you through the pre-disclosed documents. The interview will be recorded and any evidence you give could be used in future regulatory proceedings.

Listen to the questions carefully. Take your time to think before answering and don't be afraid to ask for clarification or say you don't know the answer. If you are unable to give a full answer on the spot then explain the reasons why. For example, if you need to review a document which you do not have with you. It is likely that the investigators will be asking about a single moment in the past, so try to focus on what you knew and thought at the time, rather than answering with the benefit of hindsight. Try to avoid speculating in your answers as it can easily be confused with actual knowledge of the facts. If invited to speculate, start your answer by saying that it is not based on actual knowledge. When you finish giving your answer, stop speaking. Don't feel the need to fill the silence at that point as you may provide irrelevant or, worse still, unhelpful evidence.

Perhaps the best advice I can give is to remain calm and polite. Maybe that sounds obvious, but it's surprising how many seasoned professionals get defensive or rattled under interview conditions. Building a professional rapport with the investigators based on openness and co-operation is likely to help you in the long run. Remember that flippant comments or throwaway remarks will be recorded and could be used against you in a Final Notice, so be careful.

Keep in mind that the regulator is not looking for perfection and understands that things can go wrong and that mistakes happen. It is likely that they will be focussing on whether reasonable steps were taken in specific circumstances. This is your side of the story, so explain any relevant factors such as difficult market conditions, any lack of resource and don't be afraid to highlight positive aspects of your performance, even when the end result may have been far from ideal.

Finally, it's surprising how tiring interviews can be, so make sure you stay sharp by taking advantage of the regular breaks and a full lunch hour.

Adam Jamieson
Senior Associate,
Financial Regulation

Legal advice during the interview

The regulator will allow you to have a legal advisor during the interview, whether this is your personal independent legal advisor or in-house resource. Often independent legal advice will be preferable, particularly as a conflict may arise between the position of the individual being interviewed and the firm. This is often the case when the individual is under personal investigation.

Your legal advisor is there to protect your interests and you should consult with them whenever you need to during the interview. The regulator will not hold this against you. If you are shown a document you have not seen previously (which is not uncommon), always ask for time to look at it with your legal advisor before giving a response.

After the interview

At the end of the interview you will be given a recording and sent a written transcript four to six weeks later. Typographical errors could change the meaning of the record, so identify and correct them. If you think information is missing or unclear in the transcript, or you forgot to make an important point, don't worry, this is easily done in the pressurised environment of the interview. Your legal advisor can help you write a statement to submit to the regulator in order to supplement the transcript.

MY TOP 5 DO'S & DON'TS

DO	DON'T
1 Take independent legal advice straight away (and notify D&O insurers if necessary)	1 Be defensive or aggressive
2 Prepare by going over documents carefully and try to recall past events in detail	2 Speculate, without stating that your view isn't based on actual knowledge
3 Anticipate questions and have confident answers	3 Make jokes or flippant comments
4 Stay calm and polite in the interview	4 Imagine the regulators expect perfection
5 Listen to the question and take your time before answering	5 Underestimate fatigue – ensure you take regular breaks

THE UPPER TRIBUNAL

AN EFFECTIVE BRAKE ON OVERZEALOUS ENFORCEMENT

In this era of record fines and with a broad range of non-monetary enforcement tools at the regulators' disposal, the Upper Tribunal is a crucial recourse for firms and individuals that are subject to regulatory enforcement decisions. Sidney Myers considers recent decisions that demonstrate the readiness of the Upper Tribunal to challenge the regulators head-on.

The Financial Services and Markets Act 2000 contains a number of vital checks and balances to guard against bad decisions by the FCA or PRA. One of the most important is the right of any person who is the subject of an adverse enforcement notice to refer the matter to an independent tribunal, the Upper Tribunal (Tax and Chancery Chamber).

The vital role of the Upper Tribunal

What is not always well understood is that the Upper Tribunal is neither an appellate court nor an administrative court tasked merely with reviewing decisions made by the FCA's Regulatory Decisions Committee ("RDC"). Crucially, the function of the Upper Tribunal is to decide matters completely afresh, rather than simply determine whether the regulator reached the wrong decision due to a procedural irregularity or some other ground of judicial review. It hears live evidence, with witnesses subjected to cross-examination, and considers detailed legal argument in a way that the RDC is simply not equipped to do. In short, the Upper Tribunal is a specialist court, hearing cases where the burden of proof is on the regulator.

The statutory right to refer matters to the Upper Tribunal is therefore a fundamental safeguard for those on the wrong end of a decision notice from the regulator, and applies to all decisions to impose a financial penalty, censure or a prohibition order. Even an individual who is not actually the subject of a notice has the right to refer the matter to the Tribunal if they are identified in a warning notice which, in the regulator's opinion, is prejudicial to them. »

Initial concerns

Given its role as a critical safeguard in enforcement cases, an obvious question arises: how independent is the Upper Tribunal? Can the firm or individual seeking to challenge a decision of the regulator expect to receive a fair hearing from a neutral panel of judges or is it, in reality, little more than a rubber-stamp? This question was hotly debated when the Financial Services and Markets Bill was going through its Committee Stage and several commentators expressed concern at the time as to whether the Financial Services and Markets Tribunal (as it was originally known) would be truly independent. However, a string of recent cases has hopefully laid to rest any notion that the Upper Tribunal is not wholly independent of the regulators.

The Upper Tribunal shows its teeth

The majority of references to the Upper Tribunal are made by individuals who have been found to have committed misconduct or been knowingly concerned in a breach by their firm. Enforcement action can be especially damaging for someone facing a prohibition order, which could prevent that individual from working in the financial services sector indefinitely. Given how high the stakes are, an individual who is facing the loss of his or her livelihood will wish to consider bringing a legal challenge. However, before doing so, they will rightly seek reassurance that the judges hearing the case are not likely to be predisposed in favour of the regulator. I have analysed each Decision by the Upper Tribunal over the last six years and highlight below those where the Applicant was at least partly successful. In my opinion, these clearly dispel any lingering doubts about the Upper Tribunal's independence.

A continuing trend?

As the graphic below shows, the Upper Tribunal has, in some cases, dramatically reduced the level of fines. Leaving aside the highest fine (which was itself reduced by £300,000), the combined effect of the Upper Tribunal's decisions was to reduce the total amount of fines imposed by the RDC by some 83 per cent. Furthermore, the Upper Tribunal has also overturned findings of lack of integrity, modified the scope of prohibition orders and, on one occasion, refused to impose a prohibition order even though it found that the Applicant had failed to act with integrity.

The Tribunal's recent Decision in the case of Angela Burns is, in many respects, the most remarkable. Not only did the Tribunal award Ms Burns £100,000 in costs due to the FCA's unreasonable conduct of the proceedings, but it also lambasted the FCA, saying "we...deplore the Authority's... failure to retain a sense of proportion in its approach to this case". It is almost unprecedented for the FCA to have an award of costs made against it, and judges rarely make such stinging criticisms of regulators. This extraordinary Decision is bound to make the FCA think long and hard before making serious allegations of dishonesty without very strong supporting evidence.

Ever since its decision in the landmark case of John Pottage in 2012, the Upper Tribunal has shown a willingness to reverse almost every type of decision by the regulator, sometimes criticising it in fairly trenchant terms. This is likely to embolden those who are minded to challenge enforcement decisions made against them. Whilst all cases are, of course, decided on their particular facts, the Upper Tribunal's readiness to keep the regulators in check is a trend we will continue tracking.

Sidney Myers
Consultant, Financial Regulation

Decisions, decisions

KEY:

Effect of Upper Tribunal Decision
Name of applicant
Initial RDC decision
Upper Tribunal decision

Shading indicates the degree to which the fine was reduced by the Upper Tribunal.

Fine and prohibition order overturned
Jason Geddis
£25,000 fine
+ prohibition order
Public censure

Fine overturned
John Pottage
£100,000 fine
No misconduct, no penalty

Fine reduced by 80%
Thomas Reeh
£170,000 fine (reduced to £50,000 for financial hardship)
+ prohibition order
Fine reduced to £10,000 with no prohibition

Fine overturned
Raymond Wagner
£100,000 fine
+ prohibition order
No fine, only a prohibition order

Fine and prohibition order overturned
David Hobbs
£175,000 fine
+ prohibition order
No action taken

Fine reduced by 10%
Alberto Micalizzi
£3 million fine
Fine reduced by £300,000

Fine reduced by 50%, prohibition order overturned
Andrew Wilkins
£100,000 fine
+ prohibition order
Fine reduced to £50,000 with no prohibition order

Late reference allowed
Christopher Ashton
N/A
Application to make reference out of time granted

Fine reduced by 28%
Christopher Ollerenshaw
£70,000 fine
+ prohibition order
Fine reduced to £50,000

Fine reduced by 87%, costs awarded
Angela Burns
£154,800 fine
+ full prohibition
Fine reduced to £20,000, prohibition limited to CF2 function and awarded £100,000 in costs.

Integrity finding overturned
Tariq Carrimjee
Found to lack integrity
No lack of integrity, but lack of due skill, care and diligence

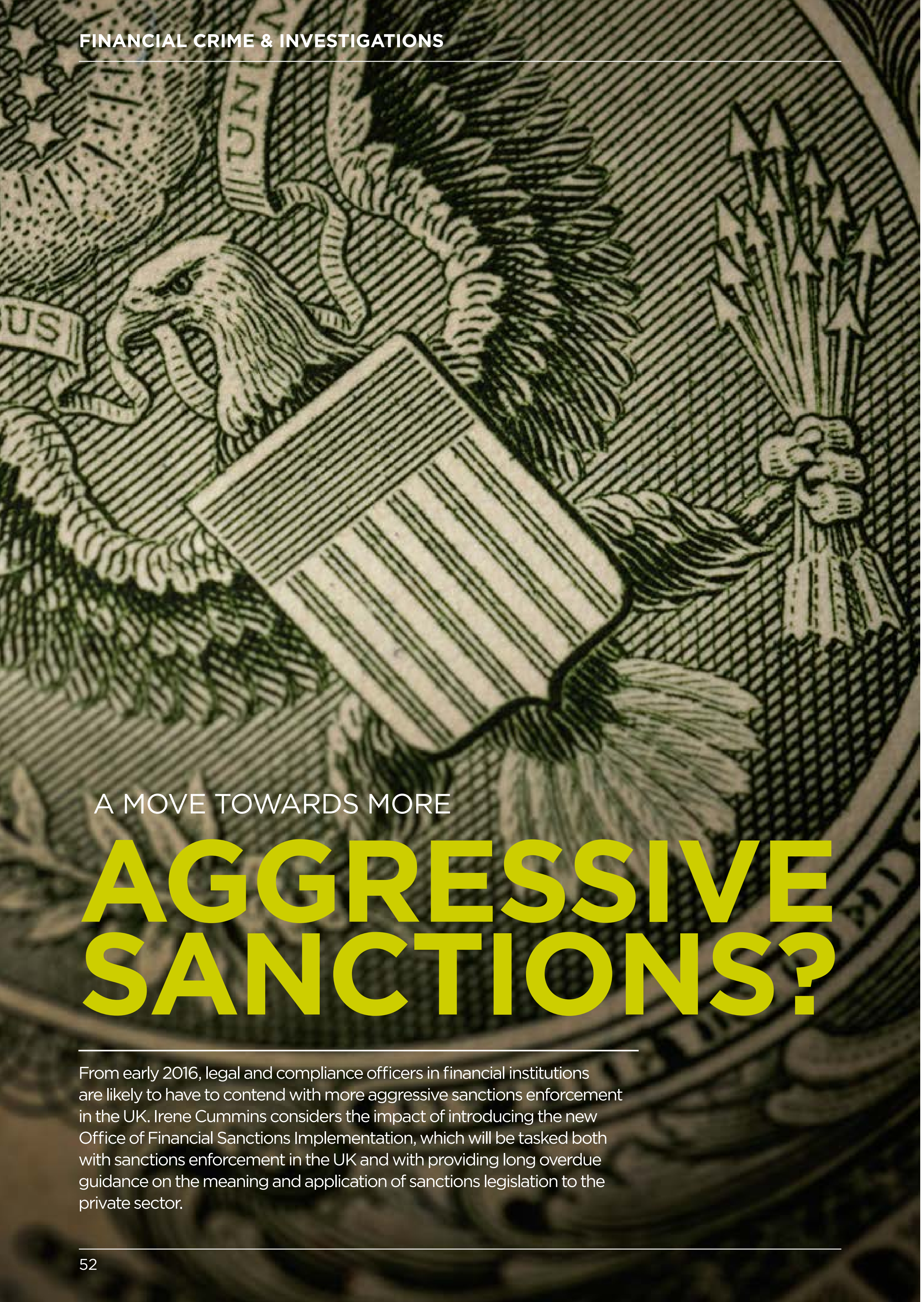
Third Party rights granted
Achilles Macris
N/A
Mr Macris had been identified in the FCA's Final Notice in respect of JP Morgan, so ought to have been allowed to make representations

Third Party rights granted
Christian Bittar
N/A
Mr Bittar had been identified in the FCA's Final Notice in respect of Deutsche Bank, so ought to have been allowed to make representations

> "We...deplore the Authority's ...failure to retain a sense of proportion in its approach to this case."
>
> **Upper Tribunal in the case of Angela Burns**

83%

The combined effect of the Upper Tribunal's decisions to reduce the total amount of fines imposed by the RDC in eight recent cases



A MOVE TOWARDS MORE

AGGRESSIVE SANCTIONS?

From early 2016, legal and compliance officers in financial institutions are likely to have to contend with more aggressive sanctions enforcement in the UK. Irene Cummins considers the impact of introducing the new Office of Financial Sanctions Implementation, which will be tasked both with sanctions enforcement in the UK and with providing long overdue guidance on the meaning and application of sanctions legislation to the private sector.

> "It seems that the Government may well have its sights set on the arsenal of enforcements weapons at OFAC's disposal, not least the abilities to levy civil penalties on companies who fall foul of sanctions legislation."

The road to Office of Financial Sanctions Implementation (OFSI)
The first indication that the Government had turned its attention to the issue of the effective implementation of financial sanctions in the UK came in the March 2015 Budget, with the announcement of plans to review HM Treasury's structures for the implementation of financial sanctions.

The UK Chancellor's Summer Budget announced the results of that review. The OFSI, which is to be established within HM Treasury by early April 2016 at the latest, will, according to the Budget announcement, "provide a high quality service to the private sector, working closely with law enforcement to help ensure that financial sanctions are properly understood, implemented and enforced". The Government also announced plans to legislate to increase the penalties for non-compliance with financial sanctions.

Lack of guidance
The financial sector will doubtless welcome the news that one of the dual roles of OFSI is to offer guidance to the financial sector on the meaning of financial sanctions. The wide-ranging and often imprecise nature of sanctions legislation, particularly that enacted in the aftermath of the Arab Spring and the Ukraine conflict, has led to confusion as to its application. Our clients have had particular difficulty in navigating the EU's sectoral sanctions against Russia (of direct effect in the UK). For months after the sectoral sanctions were introduced in July 2014, uncertainty reigned in the private sector due to the lack of any helpful guidance to assist in the interpretation of the capital markets and lending restrictions in place. While the creation of the OFSI will not be able to issue binding guidance on sanctions legislation (the question of the interpretation is ultimately a matter for the courts), we hope that the OFSI will have the resources and the capability to engage with complex questions from the private sector on the correct interpretation of sanctions legislation.

Enforcing sanctions in the UK
Both the spring and summer budget announcements point towards a significant change in attitude on the enforcement of financial sanctions in the UK. Indeed, the Spring Budget announcement stated that the review of HM Treasury's structures would "take into account lessons from structures in other countries, including the US Treasury Office of Foreign Assets Control" (OFAC). We understand from our clients and other industry insiders that HM Treasury has been discussing the form that the new structure will take, and the proposed legislation powers, with senior officials at OFAC. For those of us who are familiar with OFAC's sweeping powers and swingeing fines, this reference suggests that the sanctions enforcement landscape in the UK may change substantially.

Whilst the number of sanctions, entities and individuals has increased dramatically in the past few years, enforcement of sanctions breaches has been lacklustre in the UK. This is in large part due to the fact that HM Asset Freezing Unit only has the option of enforcing sanctions legislation by way of criminal proceedings. It does not have powers, as OFAC does, to impose civil fines or to enter into settlement agreements. In contrast to the lacklustre enforcement in the UK, OFAC has imposed eye-watering fines in recent years, often on UK banks, for breaches of US sanctions legislation. It seems that the Government may well have its sights set on the arsenal of enforcement weapons at OFAC's disposal, not least the ability to levy civil penalties on companies who fall foul of sanctions legislation.

Whatever the tools at its disposal, we expect that, once established, the OFSI will look to announce its arrival on the scene with some early enforcement wins.

Irene Cummins
Senior Associate,
Financial Regulation

WAIVING OR DROWNING?

PRIVILEGE IN FINANCIAL INSTITUTIONS' INTERNAL INVESTIGATIONS

Nick Pryor considers the two recent decisions in Property Alliance Group v RBS and their impact on firms making or challenging claims to privilege in the context of regulatory investigations.

In last year's Emerging Themes article "It's Been A Privilege", Sidney Myers and Andrew Tuson considered the FCA's attempts to challenge firms' rights to claim legal advice privilege when under investigation. This year we take a look at the risk that privileged documents produced in the course of a regulatory investigation might be disclosable in subsequent litigation.

Current practice in regulatory investigations

The pivotal Court of Appeal decision in Three Rivers No. 5 a decade ago has led to a relatively standard approach adopted by financial institutions when responding to a regulatory investigation. The firm will typically create an internal working group to take ownership of the issue, and to act as the client for the purposes of obtaining legal advice that can be covered by privilege. That working group will in turn instruct a law firm to carry out an internal investigation and report back. The client (on behalf of the firm) will then use the law firm's report as a basis for engagement with regulators confidentially, including on any potential settlement where the regulator has indicated that it proposes to take enforcement action. This approach increases the likelihood that legal privilege will cloak the investigative process and that without prejudice privilege will apply to the dialogue with the regulator.

The ability to rely on various strands of privilege gives the firm a degree of comfort that disclosures in a regulatory investigation will not count against them by being automatically disclosable in any third party civil actions.

So far, so good. The intended advantages to this approach are both practical and protective. Experienced legal advisers can bring to bear the resources and forensic rigour to demonstrate to regulators that the bank has done a thorough job of identifying and addressing past issues. However, the approach is not immune from challenge, as has been demonstrated again in 2015 by an interim decision in Property Alliance Group Limited v RBS.

The case

The case concerned four interest rate swaps entered into between the parties. The swaps referenced three month GBP LIBOR, which Property Alliance Group (PAG) alleged had been manipulated by RBS.

RBS was ordered to disclose internal documents (such as reports and summaries) that set out the results of its internal investigation into LIBOR misconduct. RBS objected to providing inspection of a number of documents, claiming either legal advice privilege or without prejudice privilege in each case.

Legal advice privilege: RBS Executive Steering Group documents

RBS asserted legal advice privilege over high level documents relating to the work of the Executive Steering Group (ESG) it had created to look into possible LIBOR misconduct. Normally, if a litigant claims that a category of documents is privileged, there is little credible ground for challenging that assessment. But here the judge perceived ambiguity over whether the ESG's role was purely to seek and receive advice from its lawyers on the regulatory investigations, or more broadly to "oversee the investigations and potential litigation"; "no doubt another purpose was to give legal advice but it is hard to credit that that could be the sole purpose".

Legal advice privilege covers communications between lawyer and client for the purpose of seeking and receiving legal advice. But if the ESG had a broader remit than simply seeking and receiving legal advice, doubt might arise over whether, as the judge said, "the totality of its meetings can have been for the purpose of imparting legal advice". For example, the judge wondered whether one purpose of the ESG might have been to inform the bank about factual findings, which would not attract privilege.

Mr Justice Birss was not persuaded that every part of every document prepared by the ESG could be covered by legal advice privilege. He resolved this uncertainty by ordering, as "a solution of last resort", that the documents be provided to the court to determine whether RBS had correctly made a claim to legal advice privilege. In a subsequent judgment, Mr Justice Snowden confirmed that, having undertaken the review, he agreed with RBS's claim to privilege. Upon review, it was clear that the documents in question had all been prepared by RBS's lawyers for the ESG, and communicated to the ESG, separately from any other work undertaken by the ESG. Each document was expressly marked "privileged and confidential". Furthermore, Mr Justice Snowden emphasised that legal advice privilege should not be defined too narrowly, and covers all information "communicated in confidence for the purposes of the client seeking, and the lawyer giving, legal advice". He also emphasised that the policy justifications for protecting legal advice privilege apply just as strongly to regulatory investigations as in other contexts.

The broad interpretation of legal advice privilege in this second judgment is extremely reassuring. However, the fact that the claim to privilege was challenged in the first place does carry significant implications for banks. It demonstrates the importance not only of managing the channels of communication during an internal investigation, but of considering the limits of what can be covered by privilege. Maintaining a clear separation between the provision of legal advice, and communications that cannot attract privilege, can be cumbersome and will often feel contrived. But it is crucial where litigation is considered a possibility.

Without prejudice privilege

PAG also sought disclosure of a third category of documents, namely communications between RBS and the regulator in the course of negotiations that ultimately led to an FCA Final Notice sanctioning the bank for manipulation of Japanese and Swiss Franc LIBOR. PAG argued that these negotiations did not attract without prejudice privilege in the same way as they would in a litigation context.

The court rejected the notion that without prejudice privilege was unavailable in relation to regulatory investigations. It acknowledged the invaluable public policy behind encouraging candid and cooperative negotiation between parties.

Nevertheless, the court found that RBS had waived privilege on the facts of this case. The bank had asserted in its defence that it had not been found guilty by regulators of any misconduct regarding GBP LIBOR, which, in the judge's opinion, put the negotiations into issue. Accordingly, the bank could not claim privilege over information it had provided to the regulator while at the same time arguably relying on the regulator's findings. The bank was treated as having waived privilege in its negotiations with the FCA, to the extent that those negotiations explained the lack of reference to GBP LIBOR in their Final Notice; was this due to a positive finding that there had been no misconduct, or was it a result of a negotiated outcome?

Legal advice privilege: limited waiver

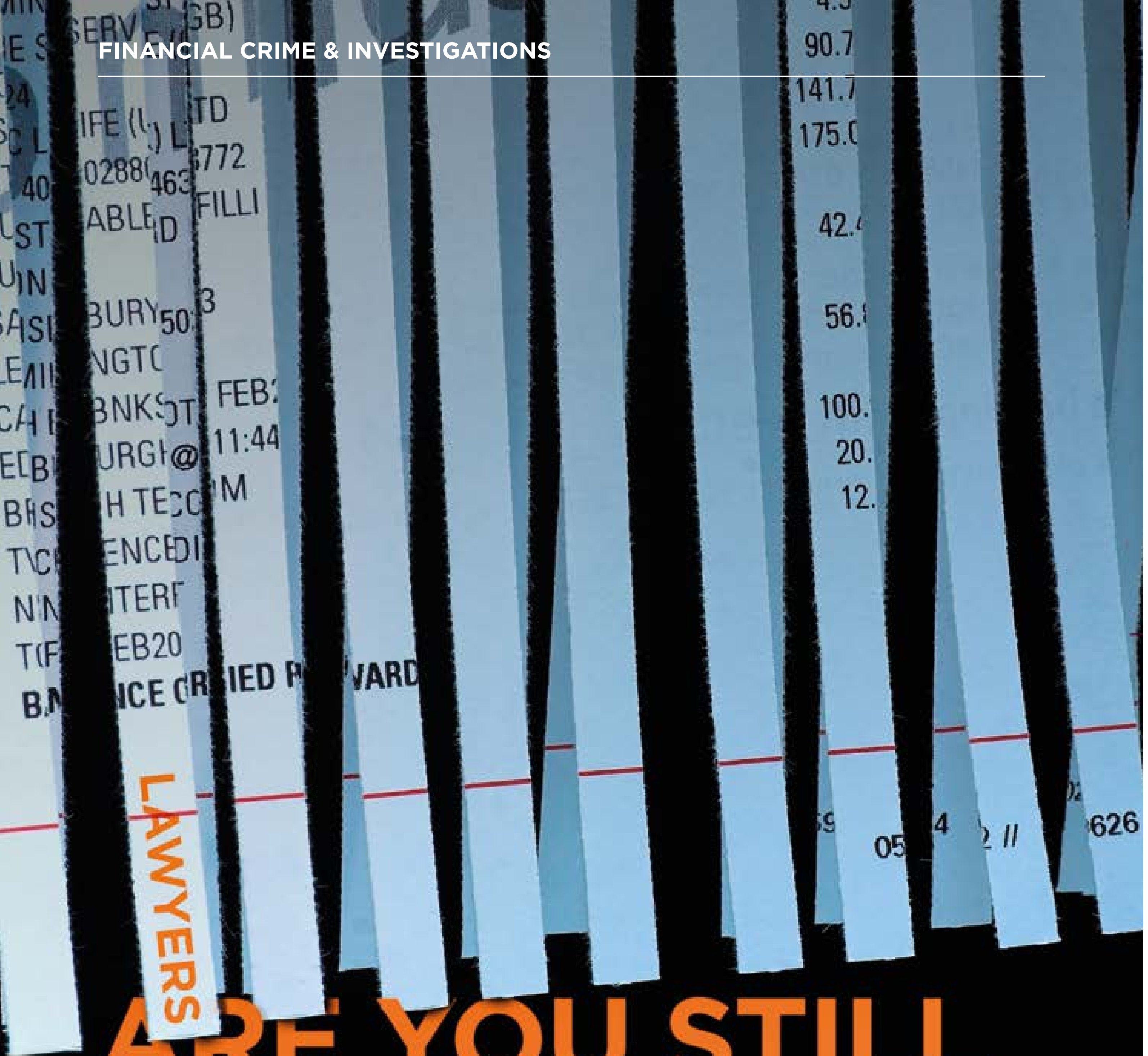
PAG sought disclosure of documents that had already been handed over or shown to US and Japanese regulators, but over which RBS asserted legal advice privilege and litigation privilege. The court found that disclosure to regulators is not in itself a waiver of privilege because the disclosures are made on a confidential and limited waiver basis and privilege would be preserved against third parties. The fact that the US and Japanese regulators are able to share the information with third parties or make it public does not mean the limited waiver principle cannot apply. The documents in question were privileged up to the point they were shared or published by the regulators.

In this case, however, RBS had relied on its defence on the findings of US and Japanese regulators, and as a result of this reliance it was found to have waived privilege.

A more cautious future for firms

Any perception that without prejudice privilege might be undermined is likely to impede negotiations and make it even more difficult to settle regulatory enforcement proceedings. In the past, firms would trade adverse findings for silent non-findings on other aspects. Now they may look for explicit exonerations that the FCA is unlikely to be willing to provide, and firms will perhaps be more cautious in future relying on a non-finding in defence of mis-selling claims. They will certainly be treading a much finer line than they thought they were before this decision.

Nick Pryor
Knowledge Development Lawyer, Commercial Disputes



ARE YOU STILL WELCOME AT SECTION 2 INTERVIEWS?

In the wake of the financial market conduct investigations in recent years, the Serious Fraud Office (SFO) has increasingly focused its attention on financial institutions. Oran Gelb singles out a High Court judgment in 2015 that may have gone a little under the radar, but could have significant ramifications for financial institutions and their employees involved in SFO investigations.

Section 2 interview powers

A key part of the SFO's investigation toolkit is its ability to interview individuals as witnesses under section 2 of the Criminal Justice Act 1987. The SFO regularly uses these section 2 powers to compel employees of financial institutions (both current and former) to attend interviews. Although there is no statutory right to legal representation at a section 2 interview, to date, the SFO has tended to allow section 2 interviewees to be accompanied by a legal representative pursuant to its operational policies. There can be a benefit to the SFO where that lawyer also acts for the employer, as they can prevent the interviewee from inadvertently disclosing the employer's privileged information, whilst still allowing the interviewee to answer questions openly.

A change in approach by the SFO?

A recent High Court decision may signal a change in attitude by the SFO. R (on the application of Lords and others) v Director of the Serious Fraud Office concerned the SFO's ongoing investigation of GlaxoSmithKline (GSK) into allegations of bribery. The applicants were senior employees at GSK who were compelled to attend witness interviews under section 2 of the Criminal Justice Act 1987. They wanted to be represented at the interviews by Arnold & Porter, the firm acting for GSK. The SFO refused to allow Arnold & Porter to attend the interview and the applicants sought leave to judicially review that decision.

The SFO relied upon the policy set out in its Operational Handbook which provides that legal advisers are permitted to attend section 2 interviews "provided that their attendance does not unduly delay or in any way prejudice the investigation". In this case, the SFO believed that the presence of Arnold & Porter (as opposed to an Independent Legal Advisor (ILA)) could prejudice the investigation because Arnold & Porter would be required to disclose the contents of the interview to its client GSK in circumstances where the interviewees might not want them to. This in turn, the SFO reasoned, might inhibit the interviewees in their response to questioning.

The Court refused permission to seek judicial review of the SFO's decision. In truth, that was not a surprising decision when viewed in the context of the high threshold for judicial review. The SFO merely had to show that (a) its policy was lawful and (b) the application of its policy to the facts of this case was not irrational. »

As regards lawfulness of the policy, there is no statutory right for a section 2 interviewee to have any lawyer present at an interview, let alone a specific lawyer of their choice. This contrasts with the express statutory right for a detainee or an individual being interviewed under caution to consult a solicitor under the Police and Criminal Evidence Act 1984.

As regards the application of the policy, there is certainly room for debate about the SFO's reasoning. If the interviewees themselves wanted Arnold & Porter to attend, it is difficult to see why they would speak more candidly without them. Moreover, although the SFO is not supposed to adopt a blanket application of the policy, their reasoning was hardly directed to the particular circumstances of the case; corporate counsel would always have an obligation to report back to the firm. Nevertheless, these points were never likely to be sufficient to render the SFO's decision irrational.

The impact on section 2 interviews

The real impact of the decision may be in how it emboldens the SFO to take a more assertive approach to legal representation at section 2 interviews. We have already seen in practice an increasing reluctance for the SFO to allow corporate counsel to attend interviews. Firms may now have to pay additional fees to enable their employees to instruct and brief an ILA at short notice even where the firm's counsel sees no conflict in acting for both employer and employee. It will be important in those circumstances for corporate counsel to give a full briefing to the ILA before the interview so that the ILA can adequately protect their client, including preventing them from inadvertently disclosing privileged communications.

It would not be a surprise to see the SFO go one step further and prohibit any legal representation in certain section 2 interviews. Indeed, that was the SFO's starting position in the Lords case before it backtracked and allowed lawyers other than Arnold & Porter to attend the interview.

Certainly, the current head of the SFO, David Green QC, has in the past expressed concerns about lawyers interfering with SFO investigations. We are also aware that the SFO is currently revising its Operational Handbook and we are waiting to see whether the updated version hints at a more restrictive approach to legal representation at interviews. In my view, this would be an unwelcome development. It is true that evidence gleaned in section 2 interviews cannot be used in criminal proceedings to incriminate the individual vis-a-vis the SFO's investigation to incriminate the interviewee, but there is no such bar against using the evidence in regulatory proceedings against that person. Moreover, a lawyer can provide a safeguard against the inadvertent disclosure of privileged information, and more generally reduce the anxiety of being interviewed by a criminal prosecutor even in a witness capacity.

We are also waiting to see whether this more assertive approach has any influence on the approach of the FCA, which in the past has been more willing to allow corporate counsel to attend an employee interview (whether on behalf of the employee or alongside an ILA).

Oran Gelb
Partner,
Financial Regulation

No right for SFO to impose confidentiality obligations

One other aspect of the Lord case is worth mentioning by way of postscript. The Court held *obiter* that it saw "no obvious bar to the applicants themselves telling GSK about the contents of the interviews after they have taken place". This runs counter to the strong confidentiality warnings which the SFO frequently plasters across its section 2 notices. Clearly, there could be severe legal consequences if someone discloses the contents of a section 2 notice or interview to a third party for nefarious reasons (including, for example, exposure to the common law criminal offence of perverting the course of justice). Moreover, if an investigation falls within the remit of the Proceeds of Crime Act 2002, one would need to avoid tipping off or prejudicing an investigation within the ambit of sections 333 and 342 respectively.

Nevertheless, the Court's comment underlines that the SFO has no absolute right to impose confidentiality obligations on its investigations. This is useful to know for firms or individuals who have legitimate reasons to share information received from the SFO, for example for internal reporting purposes or to notify employees or former employees as a matter of courtesy that they were named in a notice/interview and to arrange for them to be given independent legal advice.

SUSPICIOUS ACTIVITY

NCA SHOULD FOLLOW THE LAW

The suspicious activity regime needs a dose of pragmatism if it wants to progress. Daren Allen argues that smart firms will be the ones that manage these uncertain times, as, "uncertainty is the only certainty there is, and knowing how to live with uncertainty is the only security."[1]

For firms in the financial services sector the law and regulation relating to money laundering appears to have been in a constant state of flux for most of this century. This looks unlikely to change in the coming years. In the short to medium term, key changes are likely to emerge from:

- the results of the Department of Business Skills and Innovation review of the money laundering and terrorist finance regime and, in particular, the role of supervisors;
- the result of the Government's review of the Money Laundering Suspicious Activity Reporting regime contained in the Proceeds of Crime Act 2002 ("POCA"); and
- the new Money Laundering Regulations that will be introduced in 2017 to implement the Fourth EU Money Laundering Directive in the UK.

Unintended consequences

It has been well documented that the aggressive enforcement-led approach of the FCA in recent years in the financial crime space has led to unintended consequences. In particular, regulated firms have been busy de-risking their books to exit relationships that are likely to present a disproportionate compliance burden and lead to increased regulatory risk. In the last year the Government, mindful of the damage that may be caused if businesses are unable to establish banking arrangements, has sought to turn back the tide.

One of the reasons for de-risking relates to the cost of compliance. There is no question that the current money laundering regime places an enormous burden on firms who are required to put in place policies and procedures to comply with legal and regulatory requirements. Similarly, significant resources need to be deployed by law enforcement which receives a considerable amount of intelligence to consider.

An overworked NCA

There are signs that the National Crime Agency ("NCA") is struggling to cope with the burden placed upon it by the Suspicious Activity Reporting regime. Under the regime, if a person suspects that they might be dealing with the proceeds of crime that person is required (if they are within the regulated sector) to make a Suspicious Activity Report ("SAR") to the NCA seeking consent to continue with the transaction. The NCA has seven working days in which to consider the consent requested and can either grant or refuse consent. If consent is refused then the transaction cannot proceed and the NCA has 31 days in which to take steps to restrain the funds. If no response is provided within seven working days or no action is taken within 31 days then the person is deemed to have consent.

Recent press reports[2] have suggested that the NCA is over-burdened with consent SARs and that firms in the regulated sector are abusing the regime. The suggestion is that, rather than properly undertake due diligence, firms simply submit a consent SAR to the NCA in order to protect themselves if it later transpires that the transaction involved criminal property.

The NCA response

Anecdotal evidence suggests that one way in which the NCA has sought to deal with consent SARs, where it is unable to properly investigate a matter, is to advise the reporter, during the seven working day period, that it will neither consent nor refuse consent. This, however, is not an answer. Indeed, if such an approach was permissible then reporters would be left in limbo. If the reporter proceeded with the transaction it may be committing a criminal offence and would not have a defence to a charge of money laundering. If it froze the funds it may leave itself open to a claim in damages from its customer.

The approach the NCA has sought to adopt is, however, not permissible under POCA. Parliament has set out a prescribed mechanism in the Act to deal with the suspicion of money laundering and the NCA is obliged to deal with consent SARs.

It is understood that the NCA's resources are likely to be stretched by the current regime. The absence of resources, however, does not permit the NCA to disregard POCA. Firms who encounter this approach will need to remind the NCA that it either has to refuse or grant consent and if no response is received within seven working days then consent will be deemed to be granted. Clearly, if the NCA fails to comply with the mechanism contained in POCA, firms may have little option (if they wish to clarify the position) but to make an application for judicial review.

The solution?

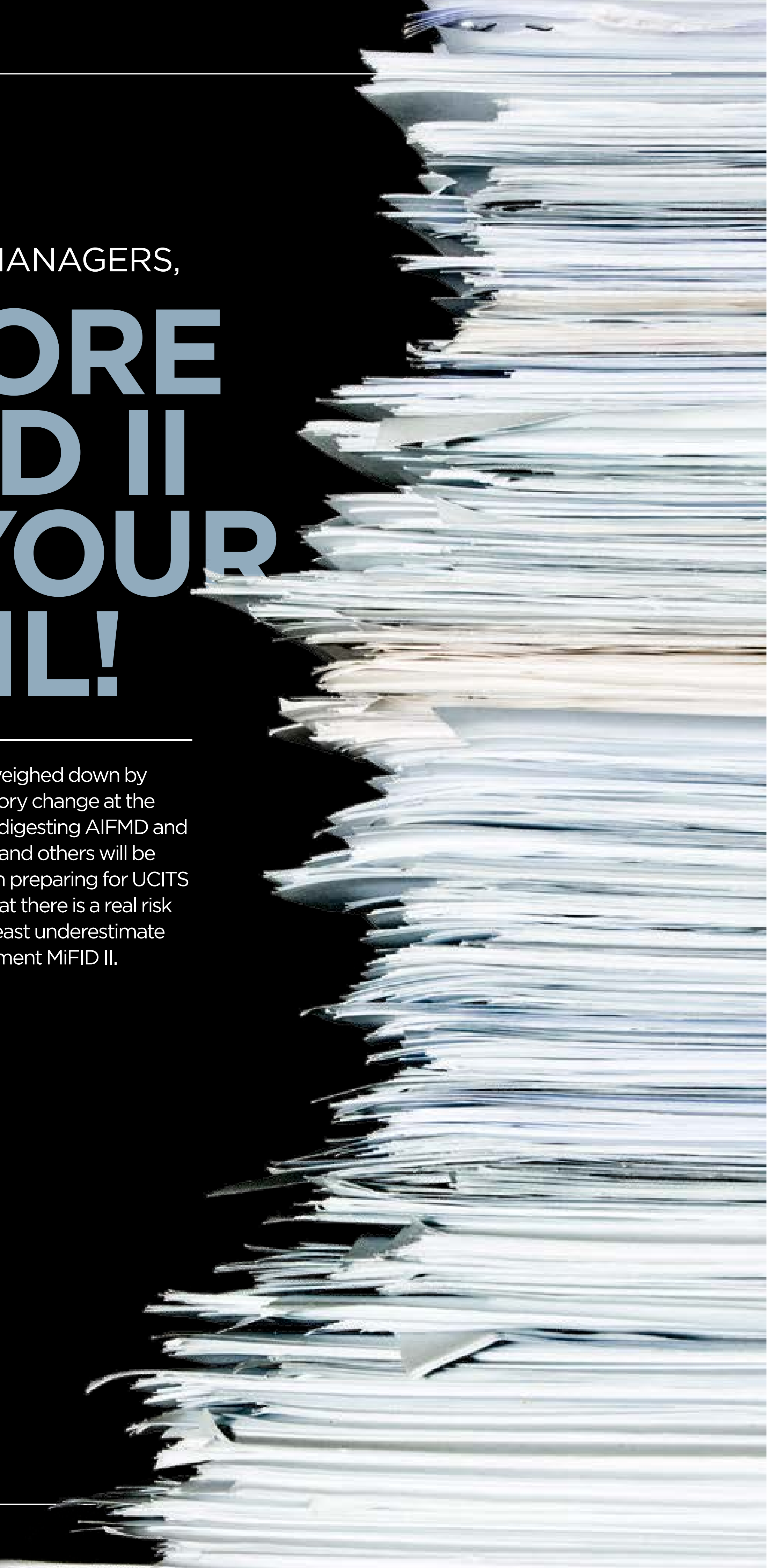
For years, firms in the regulated sector have complained about the SAR regime. It is highly questionable whether the massive cost of the regime provides a commensurate benefit in the fight against money laundering. In many ways the regime has only worked effectively because firms have adopted a pragmatic approach. In this regard, if all firms complied, in absolute terms, with the legislation, the NCA would be flooded with consent requests and would be unable to cope.

The pressure on the NCA should not be underestimated but rather than seeking to heap further pressure on firms and creating even more uncertainty, the authorities need to consider amending the legislation to reduce the compliance burden on all concerned. This, more importantly, will enable firms and law enforcement to devote resources to those areas that will genuinely make a difference in combatting money laundering.

1 – John Allen Paulos
2 – See the Financial Times article "NCA warns on Company abuse of money laundering checks", 12 October 2015

Daren Allen
Partner, Head of Corporate Crime and Investigations

MARKETS



INVESTMENT MANAGERS,

IGNORE MIFID II AT YOUR PERIL!

Investment managers are weighed down by the sheer volume of regulatory change at the moment – many will still be digesting AIFMD and changes to the CASS rules, and others will be focusing major resources on preparing for UCITS V. Matthew Baker argues that there is a real risk managers will ignore or at least underestimate the effort required to implement MiFID II.

MiFID II – state of play

MiFID II must be implemented by firms by January 2017 (although as discussed below, this may be subject to a 12-month delay). We had expected the European implementation process to be further along by the end of 2015. However, there have been a number of delays and the main implementation measures are still awaited at the time of writing this article. The knock-on effect of this is that the FCA has indicated that it, too, expects to be delayed in publishing its rule changes, and will not be publishing part of its necessary consultations until spring 2016.

At the time of writing, it is looking increasingly likely that there will be a 12-month delay to the implementation of MiFID II. Whilst this will be welcome news, there is much that still needs to be done and investment managers cannot simply sit back and wait to see what others are doing.

What should investment managers be doing now?

Probably more than for any other sector affected by MiFID II, the actual impact of these reforms on investment managers varies significantly depending on exactly what the firm does and how its business is conducted. For example, many of the more onerous rule changes will only be suffered by firms which either have internal dealing teams or which transact directly with retail customers. However, groups containing firms with AIFMD or UCITS permissions need to be giving some thought to how the various elements interact with each other.

Some of the biggest changes for every investment management firm will be driven by the way that MiFID impacts its clients and service providers. The distribution of funds and investment products will be impacted by the reclassification of many more products as "complex"; whilst insurers and retail distributors will need more information on the managers and their products to meet their own disclosure and reporting obligations. Managers will also need to look carefully at how they perform their dealing activities since more investment firms will be treated as markets and far fewer transactions will be able to take place "over the counter". Many managers will also be waiting to see how brokerage firms plan to address the likely ban on paid-for investment research.

Matthew Baker
Partner,
Investment
Management

Managers also need to consider how MiFID II will impact other areas of their organisation. For example, it will impose stricter standards of corporate governance. There will be restrictions on the number of board appointments held by senior management. Senior management will also have a direct responsibility for the design and approval of new products offered by the firm. These changes, as well as the need for enhanced compliance oversight and reporting, mean that managers need to take a fresh look at their governance and reporting procedures.

"Wait and see" is not an option

Once the detail of the rule changes appears in 2016, managers should be ready to undertake a more detailed analysis to assess where the gaps are between their existing processes and procedures and what will be expected of them from implementation. When the original MiFID was implemented in 2007, there was a flurry of activity from managers seeking to update their client terms and communications. Managers themselves also received a deluge of similar documentation from their brokers. Whilst much of that last-minute activity is likely to be unavoidable this time round, managers should not be complacent. For example, changes to rules around the content of agreements may well require that firms need to overhaul their discretionary IMAs and other agreements with professional clients. Where you have individually negotiated agreements, or are a business that has incorporated different sets of agreements through acquisitions, this could result in a significant workstream.

This significant change means that managers need to look carefully at how they design, sell and monitor their products, as well as how their group and group compliance functions are organised. Whilst the temptation is to wait and see how other managers, their clients, and their brokers adopt MiFID II, in my view, managers will delay thinking about MiFID II at their peril.

THE EU'S NEW SECURITISATION FRAMEWORK

BREATHING LIFE INTO A MORIBUND MARKET

The EU wants to rebrand securitisation. A new regulation will establish common rules and a framework for simple, transparent and standardised (STS) securitisation. Catherine Overton and Cathy Stringer summarise the key changes and comment on the proposed framework.

Simple, transparent and standardised

On 30 September 2015, the European Commission published its proposed regulations for a "high quality securitisation" framework. The regulations introduce criteria for STS securitisation, thereby identifying "sound instruments based on clear eligibility criteria", which will qualify for lower capital charges. The STS standard is not intended to mean that the securitisation is devoid of risk, but rather that the product respects a number of criteria which should enable a prudent investor to analyse the risk involved.

The regulations will also harmonise definitions and the rules on risk retention, disclosure and due diligence, which are currently set out in different EU regulations, are not consistent and don't yet apply to all sectors.

Originators, sponsors, original lenders and every type of EU institutional investor in securitisation transactions, including credit institutions, CRR investment firms, insurance and reinsurance undertakings, IORPs, AIFMs and UCITS management companies, will be affected.

The three key features of the proposed securitisation framework

1. **Risk Retention**
   As expected, there are proposed changes to remedy perceived weaknesses in the existing risk retention regime:
   - there will be a direct risk retention requirement and reporting obligation on the originator, sponsor or original lender (as opposed to the onus being solely on, or sanction resting solely with, the investor); and
   - the retention piece cannot be held by an originator entity which has been established or operates for the sole purpose of securitising exposures.
2. **Due Diligence and Disclosure**
   All institutional investors must carry out specified due diligence before investing, while originators, sponsors and securitisation special purpose entities (SSPEs) must make specified information available to investors and competent authorities at specific times.
3. **STS Criteria**
   A transaction may be designated by originators, sponsors and SSPEs as a STS securitisation if it meets all specified criteria. Notification is required if a transaction no longer meets the STS criteria.

   There will be two sets of STS requirements: one set of criteria for term securitisations and one set for ABCP. Synthetic securitisations do not qualify (i.e. only true sales will qualify).

How and when will the securitisation framework have an impact?

Originators, sponsors, original lenders and SSPEs that fail to comply with their obligations under the regulation relating to risk retention, disclosure and STS notification will be subject to sanctions. The potential sanctions may include criminal sanctions or administrative sanctions, such as bans and fines of up to EUR 500,000 or (for legal persons) up to 10% of the total annual turnover, which, in certain cases, could be an even higher percentage.

Crucially, transactions which do not meet the STS criteria will not benefit from the lower capital charges.

The framework will apply to securitisations closing after entry into force of the regulation. Due diligence requirements for institutional investors will also apply to securitisations issued on or after 1 January 2011 or to which new exposures have been added or substituted after 31 December 2014. Outstanding securitisations may be designated STS securitisations only if they meet the STS criteria.

Once adopted, the regulation will enter into force 20 days after publication in the EU's Official Journal. However, it must first be approved by the European Parliament and Council of the EU which can take many months.

How to prepare for the STS framework

Even though the new regulation is not expected to come into force until the second half of 2016 at the earliest, the proposed framework will need to be borne in mind when structuring current transactions. Structurers will want to ensure, when dealing with a relevant asset class such as RMBS, that their deals meet all of the criteria to qualify as a STS transaction. In particular, continued focus will need to be placed on structuring of the risk retention and identity of the holder of the risk retention piece.

There are certain asset classes which de facto will not meet the STS securitisation criteria, such as CMBS and managed CLOs. Although it seems unlikely that the regulations will change to accommodate such transactions, no doubt there will be further representations from the industry on this.

An important point to note is that a number of the provisions require further detail which will be set out in associated regulatory technical standards (RTS) to be published in due course. The RTS in force in respect of the current securitisation regime, such as the risk retention RTS and the disclosure RTS for structured finance instruments (under article 8b of CRA3) will be replaced. However, it is not known whether the new RTS will replicate these or whether there will be significant changes.

A broadly welcome measure

The securitisation market in Europe has been flooded by new regulations since the credit crisis. By drawing together the different regulatory strands under specific themes such as risk retention and disclosure, the new regulation has broadly been welcomed by market participants, providing as it does a more coherent and clear repository of, and source-book for, securitisation regulation.

In terms of specific technical changes that have appeared for the first time, the most significant is probably the risk retention requirement, being for the first time a direct legal obligation of the originator/sponsor/original lender, as opposed to the sanction for non-compliance resting solely with the investor. Regulators had expressed concern that the existing framework for risk retention was open to abuse and so they have sought to address this by extending the burden to those originating and structuring the deals.

In terms of direct economic impact, implementing the new concept of so-called "high quality securitisation" – a concept which itself has proved somewhat controversial as it implies the notion of 'good' and 'bad' asset based securities (ABS) – provides a means of alleviating the extremely onerous regulatory capital charges imposed by Basel III on ABS. The European market has already seen new demand from credit institutions and other institutional investors for new issuance of relevant asset classes, such as RMBS, largely stemming from the revised capital charges.

However, practitioners and issuers of CMBS and certain other asset classes are still waiting for relief as these asset classes have been (some would argue, arbitrarily) excluded from the "high quality securitisation" label. As the new regulation is still in draft form awaiting approval by the European Parliament and the Council, there is in theory still scope for further changes, although those hoping for further favourable revisions may yet be disappointed.

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FICC MARKETS

WHAT TO EXPECT IN 2016 AND BEYOND

As we enter 2016, the UK remains busy meeting G20 commitments to tackle the causes of the financial crisis and implementing EU single market measures. As if this were not burdensome enough, following the UK Fair and Effective Markets Review, this year will also see fundamental regulatory changes for FICC markets. Andrew Tuson evaluates the root causes and impact of reform – and outlines his key expectations for 2016.

The Fair and Effective Markets Review

Since the height of the 2008 crisis, governments, the European Commission and national regulators have sought to establish themselves in the eyes of the public as guardians of the markets, to restore public confidence that governments and regulators are not asleep at the wheel. In the UK, we saw the publication in June 2015 of the final recommendations of the Fair and Effective Markets Review, which was the culmination of a year's work by HM Treasury, the PRA and the FCA. The Review made a total of 21 recommendations designed to restore trust and confidence in FICC markets.

Whilst the Fair and Effective Markets Review may appear to have been at least in part a public relations exercise for the Government and regulators, we expect that the recommendations will remain of key importance to regulators and will guide their supervisory and enforcement focus over the coming year. As a result, all affected firms should keep the recommendations at the forefront of their approach to assessing conduct and risk.

Benchmark regulation

Whilst the Review's recommendations have been criticised as merely a set of high level principles which lack real impact, one area so far in which the Review has brought hard regulatory change is in relation to the manipulation of benchmarks within the UK.

Six key categories

The recommendations can be broadly grouped as follows:

1 Individuals
Measures need to be taken to set higher standards for trading practices; to make individuals more accountable for their behaviour; and to improve their professionalism.

2 Market practice
Market practice needs to be clearer, of better quality and better understood.

3 UK regulation
Measures need to be taken to strengthen UK regulation of FICC markets.

4 Global standards
These global markets need global solutions – international engagement is needed to improve FICC market standards.

5 Market structures
Measures need to be taken to make FICC markets both fairer and more effective.

6 Conduct risk
Conduct risk needs to be identified early and effectively mitigated.

Joining LIBOR, the first benchmark to be regulated in response to the 2008 financial crisis, an additional seven UK-based benchmarks have been brought within the regulatory regime as a result of the Review's recommendations. These include WM / Reuters London 4pm Closing Spot Rate and the ICE Brent Index.

Benchmark regulation is highlighted in the Review as being at the forefront of UK regulatory focus. In the FCA's thematic review into financial benchmarks (TR15/11) which was published after the Review's recommendations, the FCA made it clear that firms were not properly analysing which benchmarks were used in their businesses, or ensuring that the benchmarks they used were not at the risk of any manipulation. The FCA also made it clear that firms should not only be focusing on the eight regulated benchmarks in the UK, but also on all indices which are used to price financial instruments and products in their businesses.

Firms should be mindful of the FCA's continuing scrutiny in this area and ensure that they have proper governance processes and controls in place in order to identify and mitigate against the risk of benchmark manipulation.

Market abuse

One key area of regulatory change in 2016 will be regulation concerning market abuse. The EU Market Abuse Regulation takes effect in July 2016, bringing additional financial products traded on new trading venues within the scope of the UK market abuse regime. MiFID II, which, at the time of writing, is expected to come into effect in January 2017, will considerably reduce the volume of trading that can take place 'over the counter' (OTC). The MiFID II trading obligation will force more FICC products currently traded OTC to be traded on regulated venues, which in turn bring these products within the scope of the market abuse regime.

Whilst these hard regulatory changes are ahead, we should be mindful that the Review also recommends extending the maximum sentence for criminal market abuse from seven to ten years and also that the market abuse regime continues to be extended to bring all FICC products within scope. As a result, firms should be taking a broad approach as to which products fall within the scope of the market abuse regime, in line with the Review's recommendations.

One important finding of the Review was that because the UK market abuse regime has historically been focused on financial instruments traded on exchange, rather than OTC, many FICC products fell beyond the scope of firms' surveillance. The Review considered that this led to a culture of impunity in firms. One key way that firms can demonstrate that such a culture does not exist is by ensuring, and being able to evidence, that surveillance is extended beyond equity markets, so that it is conducted across all FICC markets. Suspected market abuse (in relation to both trades and orders, attempted or executed) in these markets should be reported through suspicious activity and transaction reports.

A renewed focus on recognising inside information

We can see, both from the Review itself and from the FCA's 2015 thematic review into asset management firms (TR15/1), that the FCA is concerned that market participants do not properly understand what constitutes inside information. Regulators are concerned that firms do not properly train their staff how to recognise what constitutes inside information or how such information should be properly safeguarded in order to avoid market abuse. Given the current regulatory focus on inside information in the FICC markets and the way it is handled by asset management firms in particular, we can expect that UK regulators will remain particularly sensitive to this issue. As thematic reviews are often a precursor to enforcement action, we can expect regulators to be quick to take action where they find a firm failing to implement the lessons of the Review.

Cultural and behavioural change: what's next?

During 2016, we can expect further output from the newly created FICC Market Standards Board in the form of guidelines and/or practical case studies.

The Senior Managers and Certification Regime will also come into effect in March 2016, increasing the accountability of individuals working in these markets.

Early in 2016, a review will be conducted in order to assess how well firms have reacted to the recommendations of the Review. The Chancellor of the Exchequer and the Governor of the Bank of England will be updated on the progress of the implementation of the Review's recommendations by June 2016. If firms have not learned the lessons and implemented the cultural change necessary to ensure that firms are properly mindful of ensuring market integrity and the reputation of the UK financial system, the Review has made it clear that further regulatory change will be introduced in order to ensure that the Review's recommendations are brought into effect.

In order to address the Review's recommendations and to mitigate the risk of breaching the new regulatory standards, firms should ensure they are prepared and able to evidence how they have factored the Review's recommendations into their businesses. Crucially, they must be able to demonstrate that they have the necessary up-to-date training programmes in place, so that all staff are aware of the current requirements and trends.

Andrew Tuson
Senior Associate,
Financial Regulation

> “The word “product”, “manufacturer” and “distributor” all take on a rather broader scope under MiFID II than normal usage of those words might dictate.”

MIFID II PRODUCT GOVERNANCE

A CAUTION AGAINST COMPLACENCY

MiFID II implementation will bring pan-EEA enhancements to investor protection, including new and more detailed requirements around product governance. Sara Evans explains why your framework is key to being ‘MiFID II ready’.

A quick look at the UK regime

The UK is not alone in its concern for investor protection. National Competent Authorities, ESMA and IOSCO have all produced guidance, and in fact the European Commission’s original product governance proposals for MiFID II were significantly toughened by the European Parliament during the trilogue negotiations prior to the directive’s adoption.

Poorly designed or inappropriately marketed investment products have the potential to result in mis-sales or mis-buying. It is inadequate, in investor protection terms, for firms simply to address issues at the point of sale, or wait for complaints. For this reason the FCA supervises the performance of firms over the full lifecycle of an investment product. Firms must have sufficiently robust systems and controls governing product design; financial promotions and other marketing communications; the sales process; post-sales customer support; and complaints handling.

Whilst the FCA Handbook does prescribe some specific rules for certain aspects of the product lifecycle (point-of-sale disclosures, for example), the overarching obligations on product governance are the “Client’s best interests” rule (COBS 2.1.1) and the FCA’s 11 Principles for Businesses. The Treating Customers Fairly (TCF) initiative, implemented in 2006 by former UK regulator the FSA, expands on Principle 6. The six consumer outcomes promoted by the TCF initiative have been embedded into the FCA’s conduct risk agenda and are key considerations firms should be taking into account in identifying and mitigating conduct risk.

Building on the FCA Principles, firms are also expected to be aware and follow the recommendations of the following supplementary guidance:

- the FCA’s regulatory guide, “Responsibilities of Product Providers and Distributors for the fair treatment of customers” (RPPD);
- finalised Guidance FG12/09: Retail Product Development and Governance – Structured Product Review; and
- most recently, TR15/02: “Thematic Review of Product Development and Governance”. »

MiFID II Level 1 – looks familiar?
MiFID II imposes the following obligations on product manufacturers:

- establish a product approval process;
- design the product according to the needs and characteristics of an identified target market of end-customers;
- assess whether the proposed distribution strategy is consistent with the target market and take reasonable steps to ensure the product is distributed to the target market;
- provide appropriate information on the approval process, the product and the identified target market to the proposed distributor(s); and
- undertake ongoing review of both the product and the distribution strategy to ensure they remain appropriate.

Distributors must meet the following obligations:

- obtain all relevant information in order to understand both the product and the target market; and
- assess the compatibility of the product with the needs of the clients to whom they propose to distribute the product.

Finally, MiFID II imposes a deceptively wide obligation on a firm's management body to "define, approve and oversee a policy as to services, activities, products and operations offered or provided in accordance with the characteristics and needs of the clients of the firm to whom they will be provided".

ESMA has provided technical advice to the European Commission in order that the European Commission can prepare Level 2 delegated acts. These will build on the familiar and, most would say, common sense provisions in Level 1. At the time of writing, the delegated acts have not been published, but ESMA's advice provides a steer on the final obligations firms will face.

Products, manufacturers and distributors – what's in a label?
The words "product", "manufacturer" and "distributor" all take on a rather broader scope under MiFID II than normal usage of those words might dictate.

"Product" covers all financial instruments under MiFID, which, from MiFID II implementation will additionally include emissions allowances (and related derivatives) and structured deposits. ESMA's advice makes clear that even straightforward instruments such as ordinary shares classify as "products" and as such are subject to the same governance obligations (such as approval process and target market identification) as more familiar investment products that might be targeted at the mass retail market. Put simply, this is not merely a "retail product" issue.

ESMA's advice provides useful clarity on who classifies as "manufacturer" and "distributor", sometimes with unexpected results, for example investment firms advising corporate issuers on the launch of new securities classify as "manufacturers". If carried through into the final implementing legislation, ESMA's advice will create a two-way "information loop" between manufacturer and distributor. Coupled with the obligations on the manufacturer to provide relevant information to the distributor, and on the distributor to obtain it from the manufacturer, ESMA also recommends that the distributor periodically (and proactively) inform the manufacturer about its experience with the product. This is so that the manufacturer can comply with its own ongoing product monitoring obligations post-launch. The requirement to collect and/or impart information passes down the distribution chain.

It is difficult to see, pending the final implementing measures, what the exact compliance challenges will be for firms, but additional costs for both manufacturers and intermediaries along the distribution chain seem likely.

Proportionality – FCA to the rescue
MiFID II will have the impact in the UK of codifying guidance and principles into hard rules. The FCA must clearly wait for the final form of the Level 2 measures before it can reasonably consult on Handbook changes. At the time of writing, the FCA expects to consult in spring 2016 on the investor protection measures including those on product governance. This timetable may change if, as is looking increasingly likely, MiFID II implementation is subject to a 12-month delay.

However, a couple of things arising from the FCA's MiFID II Wholesale Markets Conference in October 2015 were the FCA's expectation that firms would be able, to an extent, to take a sensible view on target market identification (ESMA having rather dodged the issue of how granular the identification exercise should be), and that firms should also be able to reach (written) agreement among themselves on which party will be meeting the various strands of the manufacturer/distributor obligations. This gives some scope to allow manufacturers and distributors to avoid duplication of effort. But what is clear in ESMA's Level 2 measures is the intent that there are no "governance gaps" – any firm classifying as a MiFID II investment firm should consider itself as under product governance obligations, wherever in the distribution chain it may sit. No firm can assume, in the absence of written agreement, that product governance obligations are being met by another firm in the chain.

What can firms be doing now? Going back to first principles
The familiarity of MiFID II's product governance provisions may have let it slip down a few levels of priority in firms' regulatory change management programmes. But these provisions have a wide ranging impact.

FCA guidance incorporates the recent work of ESMA and the recommendations of IOSCO. So, to be "MiFID II ready" firms should satisfy themselves that they are "FCA-compliant" in at least each of the following strands of their product governance framework where applicable:

Sara Evans
Knowledge Development Lawyer, Financial Regulation

1
Target market identification
To quote the FCA, "consideration of the target market should permeate all aspects of the product development and distribution". Where the target market is retail, the FCA's "Consumer Spotlight" microsite is periodically updated with useful consumer segmentation data.

2
Product approval process
As outlined by the FSA (in FG12/09), in some cases, policies and procedures that look robust on paper may not be followed effectively on the ground. In other cases, "product creep" can set in, where small changes to existing products are subjected to an abridged, or "light" approval procedure, but these incrementally changed products over time can amount to new products which have circumvented the full approval process.

3
Management information
Product governance will become a board issue under MiFID II. The adequacy and proper focus of Management Information will be vital.

4
Designing product features
FG12/09 provides a useful summary of factors that should be taken into account.

5
Product stress testing
The FCA's thematic review TR15/02 gives details of the failings it identified in its latest review, in 2015.

6
Due diligence on prospective distributors or product manufacturers
This may need to become more comprehensive and better documented by firms.

HM TREASURY DRIVES PRIVATE FUND VEHICLE REFORM INTO THE 21ST CENTURY

Despite the UK limited partnership structure's popularity, the law is now well over a century old and in need of an overhaul if it is to keep pace with the significant change experienced by the funds industry. Chris Ormond takes a look at HM Treasury's new proposals and considers the impact of the changes.

In July 2015, HM Treasury released its proposals to amend UK limited partnership law. The proposed changes are designed to maintain and enhance the UK as a competitive fund domicile. The proposals remove a number of the uncertainties and administrative burdens that arise from the current law, and touch on the life cycle of a limited partnership, from registration and capital contributions, through the day-to-day management of the partnership and on to its eventual dissolution.

HM Treasury's consultation makes no proposals on introducing separate legal personality for UK limited partnerships, but the consultation confirms that the Government remains committed to exploring the possibility of allowing funds in the UK (outside Scotland) to elect to have separate legal personality. This requires further work to examine the implications of such a change, and is likely to require primary legislation. The legal sector broadly welcomes the proposals, and BLP has submitted a joint response to HM Treasury's consultation with other law firms working in the investment management space.

A number of key proposals that are to apply to 'private fund limited partnerships' ("PFLPs") and UK limited partnerships ("UKLPs") are detailed opposite.

Private fund limited partnership

The proposed changes will create a new fund vehicle – a PFLP. UKLPs that meet the PFLP conditions and are so registered can take advantage of a more generous and flexible limited partnership regime.

Existing UKLPs can also elect into this regime on the same basis, although HM Treasury's proposals provide they can only do this in the first year of the changes coming into effect: we would prefer re-registration not to be limited in time at all. The existing rules will continue to apply for other UKLPs.

A white list of activities that a limited partner in a PFLP may undertake

A limited partner in a PFLP may undertake any activities on the so-called "white list" without being considered to be taking part in the management of the business and therefore without losing its limited liability. The list is comprehensive and includes, for instance, consulting and advising the general partner or manager on the partnership's affairs or accounts and taking part in investment decisions.

This is a welcome change and brings UK limited partnership law into line with other limited partnership laws (Jersey, Guernsey, Luxembourg, Cayman Islands and Delaware) that have safe harbour lists and so provide more certainty for investors as to what actions constitute "taking part in the management of the partnership business". We have asked for confirmation that the existence of this white list for PFLPs does not give rise to any inference that carrying on these activities in relation to a limited partnership that is not a PFLP would constitute taking part in management.

Capital contribution will no longer be required for limited partners in PFLPs

The proposals remove the requirement for limited partners in PFLPs to make a capital contribution, and a limited partner in a PFLP will not remain liable for any capital contributions that have been withdrawn. This is another welcome change that facilitates flexibility in how the partnership is funded.

Chris Ormond
Principal Knowledge Development Lawyer, Investment Management

Gazette advertisement no longer required

As well as simplifying the registration process, the proposals remove the requirement to advertise in the Gazette if a general partner becomes a limited partner in a PFLP or a limited partner assigns its interest in a PFLP to another person.

The advertising of notices in the Gazette is outdated and in our view, notice entered on the register of PFLPs maintained by Companies House should be sufficient.

Removal of some statutory partnership duties

Limited partners in PFLPs will not be subject to the duties to render accounts and information to other partners and to account for profits made in competing businesses.

This removes some of the statutory burdens from limited partners (whilst allowing partners to agree otherwise).

More flexibility in winding up a PFLP

The partners in a PFLP will be permitted to agree among themselves who should wind up the partnership, without having to obtain a court order.

This would make winding up by partners easier, as there would be no requirement for a court order if the winding up is by limited partners.

Being struck off the Companies House PFLP register

Currently, there is no procedure to remove a limited partnership from the register maintained by the Registrar of Companies. The proposals introduce a procedure to enable a PFLP to be struck off the Companies House PFLP register (either voluntarily on application, or by the registrar). The effect pending dissolution is that the PFLP would continue to exist but would become a general partnership.

This proposed change will ensure that the register is kept up to date, however the provisions as drafted would render the limited partners in a PFLP liable for all the debts of the partnership during the period between striking off and dissolution.

We would prefer that PFLPs that are removed from the register of PFLPs revert to ordinary limited partnerships, rather than general partnerships, so that limited partners do not thereby lose their limited liability.

HM Treasury's consultation closed on 5 October 2015 and has attracted a great deal of industry comment. We are following developments in this area and, as at the time of writing, the final proposals have not yet emerged. In the meantime, the law governing UKLPs remains unchanged.

IMPLEMENTATION OF THE MARKET ABUSE REGULATION

In mid-2016, the market abuse regime will undergo significant expansion in scope, when the Market Abuse Regulation becomes law. The directly applicable status of this EU legislation entails removal of large parts of the FCA Handbook, along with statutory changes. This will bring uncertainty to the status of the bank of current UK rules, guidance and established case law. Martin Sandler considers the challenges firms will face.

Background and timetable

The new Market Abuse Regulation ("MAR") and the Criminal Sanctions for Market Abuse Directive ("CSMAD") will replace the 2003 Market Abuse Directive ("MAD"). MAR and CSMAD have been developed in close tandem with other post-financial crisis measures to regulate markets and financial instruments, such as MiFID II/MiFIR, and alongside other national and internationally-coordinated initiatives to tackle misconduct and restore market confidence such as the Fair and Effective Markets Review. There is a degree of interdependence between MAR and MiFID II, with MAR being particularly reliant on definitions contained within MiFID II. Both sets of provisions extend the reach of the European regulatory regime to capture a wider range of markets and instruments and include specific provisions to address the proliferation of technology-driven trading practices.

MAR/CSMAD entered into force on 2 July 2014, and the majority of its provisions become law on 3 July 2016. The UK will not opt into CSMAD, but will instead implement UK criminal sanctions for market abuse. MAR, on the other hand, which contains most of the substantive market abuse provisions will, being a regulation, have direct effect in the UK and the other EEA states.

Since MAR/CSMAD entered into force, ESMA has developed and submitted technical advice and draft Level 2 regulatory and implementing technical standards to the Commission, and on 17 December 2015, the Commission adopted a draft delegated regulation supplementing MAR. Most of MAR will become law on 3 July 2016, except for provisions concerning organised trading facilities, small and medium sized enterprises, growth markets, emission allowances and auction products based on them, which will apply from the date MiFID II becomes law (currently expected to be 3 January 2017, although delays are possible). »

KEY PROVISIONS AND IMPACTS OF MAR

1

Beyond Regulated Markets

MAD applies to financial instruments admitted to trading on EEA regulated markets and related financial instruments, but MAR extends the range of instruments covered, to:

- financial instruments admitted to trading on the other types of trading platform set out in MiFID II – multilateral trading facilities ("MTFs") and organised trading facilities ("OTFs"); and
- financial instruments the price or value of which depends on or has an effect on the price or value of a financial instrument traded on a regulated market, MTF or OTF.

MAR will require ESMA to maintain a list of MAR-scope financial instruments. However, this list will be neither definitive nor exhaustive. The resultant uncertainty whether specific instruments are covered may lead compliance departments to take the cautious approach that any instruments are potentially covered and non-EU firms may inadvertently be caught if, unknown to them, a certain financial instrument or a linked instrument happens to be traded on an OTF.

2

Commodity Contracts and Benchmarks

MAR's market manipulation provisions extend the reach of the European market abuse regime further still, to include:

- any spot commodity contract having, likely to have, or intended to have an effect on the price or value of a financial instrument; and
- any type of financial instrument having or likely to have an effect on the price or value of a spot commodity contract whose price or value depends on the relevant financial instrument.

Through these provisions, MAR plugs a hole in the existing MAD regime: namely, the lack of oversight and visibility of the underlying commodity contracts to which the value of certain derivative financial instruments is referenced. This appears to create inconsistencies between the regulation of those commodity markets that may have an effect on the price or value of a financial instrument and those which do not. Nor may it be apparent, particularly to non-EEA persons trading commodities, if related derivative contracts are traded on OTFs, creating a risk that such persons may inadvertently be caught by MAR.

Not unsurprisingly in light of recent market scandals, the market manipulation provisions in MAR also extend to "behaviour in relation to benchmarks". Manipulation of benchmarks is already a criminal offence in the UK.

3

Algorithmic Trading and High Frequency Trading ("HFT")

MAR contains lists of indicators and examples of market manipulation, including some which specifically cover algorithmic trading and HFT. These include the creation of an abusive effect through the placing of orders to a trading venue where the orders:

- disrupt or delay the functioning of the trading venue's trading system, or are likely to disrupt or delay its functioning;
- make it more difficult for others to identify genuine orders on the trading system of the trading venue or are likely to make this more difficult (e.g. by overloading or destabilising the order book); or
- create, or are likely to create, a false or misleading signal about the supply of, demand for, or price of a financial instrument (e.g. by entering orders to initiate or exacerbate a trend).

As with insider dealing, MAR also specifically prohibits attempting to engage in market manipulation, whereas the market manipulation provisions of the MAD regime only extended to transactions or orders that had already been placed.

4

Market Soundings

MAR will allow inside information to be legitimately disclosed to a potential investor in the course of market soundings undertaken to gauge interest in a potential transaction or its potential size or pricing. However, certain prescribed and detailed steps will need to be taken prior to conducting a market sounding and detailed record-keeping requirements are imposed. These steps and requirements will be set out in regulatory technical standards.

5

Disclosure of Inside Information by Issuers

Issuers who have requested or approved admission to trading of their securities on an MTF or OTF (even where not on a regulated market) will now be brought within the scope of the public disclosure obligation.

Where an issuer wishes to delay public disclosure, it will need to inform its competent authority, who may require a written explanation.

Where a financial institution wishes to delay public disclosure, a new ground for such a delay is where disclosure would risk undermining the financial stability of the issuer and the financial system, delay is in the public interest, confidentiality can be maintained, and the competent authority consents.

6

Directors' Dealings

The reporting regime is similarly extended to include dealings by persons discharging managerial responsibilities ("PDMRs") and their connected persons in relation to issuers who have requested or approved admission to trading of their securities on an MTF or OTF (even where not on a regulated market).

The time period for a PDMR or connected person to notify the issuer of transactions has been shortened to three business days. Transactions will need to be reported once a threshold of €5,000 is exceeded in a calendar year. Member states may set a higher threshold of €20,000, although the FCA proposes to keep the threshold at €5,000.

7

Suspicious Transaction Reporting

Investment professionals will need to report suspicious orders as well as suspicious transactions.

8

Whistleblowing

Among other provisions aimed at encouraging whistleblowers to report market abuse, member states will be able to provide financial incentives for whistleblowers in some circumstances.

9

Investigations and Sanctions

MAR sets new EEA-wide minimum standards for regulators' investigatory and sanctioning powers. Regulators must have power to impose fines of up to at least €5 million for an individual and €15 million or 15 per cent of annual turnover for a firm.

UK Implementation

In CP15/35, published in November 2015, the FCA set out what the new rules are likely to look like. Large parts of the UK market abuse framework will be amended or repealed to make way for the new directly applicable MAR. In particular, much of FSMA 2000 Part VIII and the Code of Market Conduct will be removed and the Model Code on PDMR dealings will be replaced with guidance. MAR implementation also requires changes to the Disclosure and Transparency Rules, as outlined in CP 15/35 and a further FCA consultation, CP 15/38.

The FCA will provide handbook guidance on and "signposts" to MAR. However, the handbook will be treated as supplementary to the rules and "should not be regarded as the source of all provisions relating to market abuse".

This leaves some residual uncertainly as to the status of the various forms of "soft" guidance put out by the FCA, such as Market Watch bulletins and speeches. This may make compliance much more complicated and firms may make the wrong judgement calls due to reliance on disparate sources of rules and guidance, a problem exacerbated by the removal of helpful examples set out in the Code of Market Conduct.

Firms will need to make substantial changes to their compliance procedures, not only to implement the new rules, but also to reflect the changed references to the sources of existing similar rules. Furthermore, if final FCA rules are issued only a month or two before they are due to come into force, this leaves very little time for these changes to be made.

Martin Sandler
Partner,
Financial Regulation

CAPITAL EXTRACTION
BY RUN-OFF FIRMS

THE PRA ISSUES NEW GUIDANCE... AGAIN

Solvency II's new capital requirements have resulted in the PRA issuing new guidance on capital extraction for run-off firms for the second time in under two years. Adam Bogdanor considers the PRA's treatment of run-off firms and explains how insurers can tackle the main changes.

The background

Firms could be forgiven for thinking that the PRA's supervisory statement of April 2014 (SS4/14) set out the PRA's settled position on capital extraction for run-off firms in the general insurance sector. Instead, on 20 November 2015 the PRA issued a consultation paper including a revised draft supervisory statement. This update was perhaps inevitable to reflect Solvency II and the PRA claims that it does not represent a change in the PRA's policy, but the guidance has materially changed. This will be relevant to all run-off firms in the sector.

When does the new guidance become "live"?

The consultation on the draft statement closed on 20 January 2016. However, "firms should consider the proposals... if they consider applying for a capital extraction between 1 January 2016 and the publication of the final statement." In other words, the PRA intends to use the guidance set out in the draft statement from 1 January 2016, even though the statement is not yet final and even before the consultation period has ended! Nevertheless, firms with concerns should have raised them before 20 January 2016. Firms will remember that the PRA softened its stance on solvent schemes of arrangement following considerable industry protest (please see my article, PRA outlines tough solvent schemes approach, published on 1 May 2014 in Insurance Day).

What has changed?

The main changes compared to SS4/14 are as follows:

1. **Requests to be made by the CEO or CFO only**
   The original supervisory statement stated that a request to extract capital should be made to the PRA by an approved person – the new draft statement refers to the CEO or CFO (and no-one else) making the request. This is unlikely to create an issue in practice – one would normally expect the CFO to have approved any such requests – but it indicates that the PRA puts the onus firmly on these two individuals to make any such request personally.

2. **ORSA as a starting point**
   Solvency II firms will be expected to review their financial position by reference to their Solvency Capital Requirement (SCR) and, crucially, its "overall solvency needs as required for inclusion in a firm's ORSA". Interestingly, the April 2014 statement referred to their solvency position, so the terminology has become broader but also the PRA intends to treat the ORSA as the starting point for all such capital requests, not just a guideline. The statement provides that the PRA does not expect to see requests for capital extractions which would lead to lower capital than the firm's ORSA solvency needs, even if this figure is above the SCR.

3. **End of the 200% test**
   The main industry concern surrounding the original supervisory statement was that the PRA would likely request an independent review if the extraction resulted in projected coverage of less than 200% above the ICA. Many felt that this figure was arbitrary and will welcome its disappearance. It has been replaced by a reference to the proposed extraction resulting in the projected financial resources in a "stressed scenario being less than either its overall solvency needs or SCR". The PRA does not elaborate on this and "overall solvency needs" is of course a wide concept but Solvency II is a maximum harmonisation directive so this should not be an excuse for gold-plating. Or at least that is the theory. As for stress testing, this is now a fairly widely understood concept, used as part of the ICA in the Solvency I regime.

Concluding thoughts

Of course, for some firms the SCR or ORSA calculation may result in a higher capital requirement and for others, a lower or similar capital requirement but that is the consequence of Solvency II itself, not the new statement. It is welcome that the PRA has not again sought to impose a different capital test for run-off firms: no evidence of gold-plating there.

However, firms should bear in mind the PRA's continuing emphasis on the accuracy of data and the 3 – 5 year projections. In determining whether to approve a request to extract capital, the PRA will take into account "any other information that the PRA deems to be relevant". So firms (still) cannot be certain how the PRA will react to any particular request but the move away from a more formulaic test – and a reliance on Solvency II requirements as the benchmark – is a welcome change.

Adam Bogdanor
Partner,
Corporate Finance

ALL CLEAR?

CLIENT CLEARING OF OTC DERIVATIVES

The clearing obligation under EMIR has become mandatory for certain derivatives products. As a result, the requirement for client clearing has become critical for parties who are subject to the clearing obligation but do not have access to central counterparties. Tariq Rasheed looks at the benefits and pitfalls of the current market solution.

EMIR's mandatory clearing obligation

In December 2014, the Regulatory Technical Standards for the clearing of certain plain vanilla interest rate derivatives – basis, fixed-to-floating, forward rate agreement and overnight index swaps in EUR, GBP, JPY and USD – was published in the Official Journal of the European Union. This means that these derivatives are now subject to mandatory clearing over a stipulated time period, with the first Eligible Counterparties (as defined below) becoming subject to it in June 2016. The mandatory clearing of other derivatives, particularly index credit default swaps, is expected to be implemented in a similar fashion in the near future.

Mandatory clearing of OTC derivatives is a central plank of the Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (also referred to as the European Market Infrastructure Regulation (EMIR) (648/2012)). It applies to a wide array of market participants, such as financial institutions, funds falling under the AIFMD, pension funds and corporates exceeding stipulated thresholds ("Eligible Counterparties").

In addition, EMIR has extra-territorial reach. Overseas market participants which would be Eligible Counterparties if they were established in the EU are potentially caught, as are overseas market participants whose derivatives contracts have a "direct, substantial and foreseeable effect" within the EU, or which have been entered into to evade EMIR's provisions.

Access to CCPs

In order to continue transacting, derivatives are or become subject to mandatory clearing. Eligible Counterparties need to ensure they have access to authorised (EEA) or recognised (non-EEA) central counterparties (CCPs). Examples of EEA-authorised CCPs include LCH. Clearnet, CME Clearing Europe, ICE Clear Europe and LME Clear.

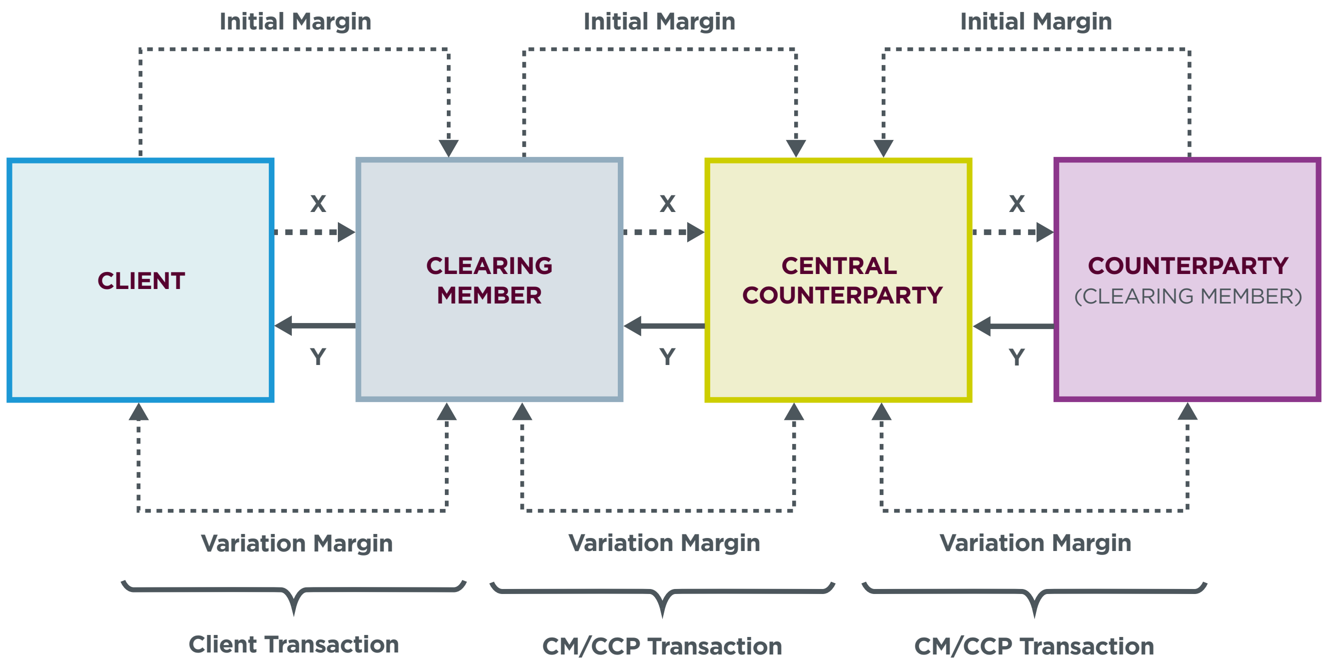
A CCP authorised or recognised under EMIR is subject to onerous requirements to ensure its safety and soundness. The CCP in turn imposes stringent membership costs and operational requirements on its direct members (Clearing Members). An Eligible Counterparty which only engages in limited derivatives trading will find it impractical or undesirable to become a Clearing Member, preferring instead to obtain access to the CCP by way of a clearing broker. That is, it will become a Client of an existing Clearing Member of the CCP. »

Client clearing arrangements in the EU

The diagram below shows the client clearing model prevalent in the European Union. Unlike the agency-based client clearing model prevalent in the United States, the European model operates on a principal-to-principal basis. This means the Client enters into an independent transaction (a Client Transaction) with its Clearing Member, who simultaneously enters into a back-to-back, independent transaction with the CCP (a corresponding CM/CCP Transaction).

In the EU model, therefore, the Client's relationship is solely with its Clearing Member; it will only have recourse to the CCP in exceptional circumstances. Whilst EMIR offers certain protections for the Client's benefit, the Client nevertheless takes credit risk in respect of its Clearing Member. Equally, the Clearing Member takes credit risk in respect of the Client. If the Clearing Member does not receive the relevant cash flows (whether of scheduled swap payments or collateral calls) from its Client under the Client Transaction, the Clearing Member still needs to pay the equivalent cash flows to the CCP. Otherwise, the Clearing Member will breach the terms of the CM/CCP Transaction.

EU client clearing model



"Client clearing negotiations will intensify due to the onset of mandatory clearing. The Addendum provides a helpful initial negotiating position."

Tariq Rasheed
Partner,
Derivatives and
Derivatives Clearing

The contractual provisions of the CM/CCP Transactions are stipulated in the relevant CCP's rule book (referred to as the "rule set"). On the other hand, the contractual provisions of the Client Transaction are negotiated independently between the Client and its Clearing Member.

Standardising Client/Clearing Member contracts

In 2013, the International Swaps and Derivatives Association (ISDA) and the FIA have jointly published the Client Cleared OTC Derivatives Addendum (the "Addendum") in order to help standardise the contractual provisions of Client Transactions. The Addendum is designed to form part of the existing ISDA Master Agreement between a Client and its Clearing Member, albeit with the Addendum (when taken together with the ISDA Master Agreement) only governing the Client Transactions and the ISDA Master Agreement (taken alone) continuing to govern non-cleared transactions between the parties.

Whilst the Addendum is rapidly becoming the market-standard document for the purposes of client clearing, the market sentiment is that it is an inordinately complex document and that it is tilted heavily in the Clearing Member's favour.

A key issue for firms: Complexity

Complexity is perhaps inevitable given the need for the Addendum to link the Client Transactions with the corresponding CM/CCP Transactions, especially for the purposes of determining the early termination amounts arising as a result of the early termination of the Client Transactions. It does mean, however, that negotiations are typically long-winded since the Addendum's provisions are still being understood and, depending on individual viewpoints, adapted by market participants.

A key issue for firms: Bias

The Addendum's inherent bias is an outcome of the insistence by clearing brokers that they be treated as financial intermediaries and that, as a consequence, their credit and market risks ought to be minimised. Part of the reason for this insistence is that the regulatory capital rules only permit a Clearing Member to have a zero trade exposure under a CM/CCP Transaction if there is a contractual agreement with the Client that the Clearing Member's performance under the Client Transaction is contingent on the CCP's performance under the corresponding CM/CCP Transaction following a CCP default.

The Addendum contains a number of provisions for the Clearing Member's benefit, including:

- if a CM/CCP Transaction's terms are altered (e.g. due to the CCP changing the rule book) and the Clearing Member cannot make equivalent changes to the corresponding Client Transaction, the Clearing Member is permitted to terminate the Client Transaction on a non-fault basis;
- all the ISDA-standard Events of Default and Termination Events as well as the Section 2(a)(iii) condition precedent are disapplied in respect of the Clearing Member. However, they continue to apply in respect of the Client;
- when determining the early termination amount in respect of a Client Transaction following a Client default, the Clearing Member is permitted to take into account the costs of terminating the corresponding CM/CCP Transaction (e.g. by transferring it to its proprietary account) and/or the costs of re-hedging its positions (e.g. by entering into close-out or risk hedging transactions);
- when determining the early termination amount in respect of a Client Transaction following a Clearing Member's default under the corresponding CM/CCP Transaction or following a CCP default, the value of the Client Transaction is deemed to be equal to the value of the corresponding terminated CM/CCP Transaction;
- the Client agrees to indemnify the Clearing Member for any losses the Clearing Member suffers due to, amongst other things, the Clearing Member following the Client's instructions or due to the occurrence of a CCP default; and
- the Client agrees that the Clearing Member's performance and payment obligations under a Client Transaction are limited by and contingent on the CCP's actual performance or payment under the corresponding CM/CCP Transaction.

Enhance your understanding to ease the pain of negotiation

Client clearing negotiations will intensify due to the onset of mandatory clearing. The Addendum provides a helpful initial negotiating position. However, the speed with which it is agreed between a Client and its Clearing Member depends not only upon their respective bargaining power but also their understanding of its complex provisions.

I have noticed a real hesitation amongst parties that they may end up conceding on key provisions/rights more than they should. This hesitation naturally slows down negotiations and can potentially delay the parties' ability to transact in derivatives that are or become subject to mandatory clearing, thereby negatively impacting their businesses. In many cases, this hesitation can only be reduced if the parties are confident they have advisers who not only understand the Addendum, but also the evolving market practice.

DIGITAL

Bank of England

STORING PERSONAL DATA

THE RISK THAT'S UNDER YOUR RADAR

This year sees the adoption of the new EU Data Protection Regulation, which is set to radically change the dynamic around storage of personal data. Firms that suffer a data breach could incur vastly increased fines based on their global turnover. Our data law specialists consider the upcoming Regulation alongside other key developments which could revolutionise your data storage practices.

Your firm has been amassing stockpiles of electronic information for many years. Structured, unstructured, emails and text messages – data is literally everywhere.

Typically, there are three reasons why organisations are collecting and storing personal data:

1. Collection and retention is mandated by regulatory regimes.
2. Personal data has intrinsic or commercial value for the firm.
3. Storage is the status quo – a default position mandated by firm-wide data storage policies and procedures.

However, the rationale for storing ever increasing amounts of data is beginning to be undermined by the risks of doing so. We have been following three key developments that are driving a fundamental reassessment of existing practices – reframing personal data storage as a business driver, as opposed to a default position:

- impending changes to EU rules on data protection;
- increasing risk of claims if data is lost or misused; and
- a data-savvy and empowered citizenry, determined to police what is being done with their data.

Individually each of these developments will, to a greater or lesser extent, impact firm-wide and/or departmental business strategy, internal policies and internal training for thousands of organisations. Collectively they have the potential to bring about irreversible change in favour of the individual. Let's look at each of them in turn.

The EU Data Protection Regulation

After the EU data agenda trundled along for several years, the wording of the new EU Data Protection Regulation was finally agreed in December 2015. The new law will come into force in early 2018. This is a game-changer in terms of enforcement, with regulatory fines set at up to 4% of annual worldwide turnover for serious breaches. Delving into more of the detail, the Regulation is pro-privacy with greater rights granted to individuals to demand that their data be deleted, returned or passed to a new service provider. Mapping and locating all of that data will be no easy task. The dynamic around data storage will also radically change, with the application of EU data protection laws to parties established outside the EU. In addition, direct obligations will now be placed on data processors, not just data controllers, meaning that the organisations to whom you outsource data storage will be caught by the new Regulation. Compliance will be required from day one so steps to ensure that this happens need to be considered now.

Paying Out: Compensation Claims for Data Misuse

Allied to the pro-privacy agenda of the draft Regulation are moves by the English Court to liberalise compensation claims for breaches of data protection law. In the last year, the case of Google-v-Vidal-Hall has continued to make its way through the courts. The Court of Appeal has now endorsed the view that individuals can seek compensation for distress arising out of the misuse of their personal data, regardless of any actual pecuniary loss. This is a radical departure from the prevailing view, enshrined in statute, that such claims should not be allowed. The point is to be tested by the UK Supreme Court, but if upheld it would make group litigation claims by affected individuals realistic for the first time. Each "distress" claim might only be worth a few thousand pounds, but multiply that by a few hundred or thousands of claims and it looks viable to claimants and the lawyers representing them. For example, we have already noticed law firms seeking to sign up claimants following recent data breach incidents in the UK.

The Rise of the Datavist

Finally, we have also seen individuals being more pro-active in policing their own data. To an extent this has been as a result of the so-called "right to be forgotten" ruling against Google from the Court of Justice of the European Union in 2014, but it was a trend even before then.

Perhaps the most notable "Datavist" is Max Schrems, an Austrian law student who took on Facebook and the European Commission and won, with the Court of Justice of the European Union declaring invalid the "safe harbour" agreement between the US and the EU, which for fifteen years had allowed companies to transfer data of European citizens to the US. This development alone is forcing thousands of companies to re-think transatlantic data transfers to avoid breaching data protection law. However, Max Schrems is only one of thousands of individuals who are increasingly asking questions about how their data is collected, whether it is securely stored and how it is used. If they do not get satisfactory answers, they are reporting this to Data Protection Authorities who will typically investigate.

Time for a Fundamental Rethink?

We are at a cross-roads. Simply throwing more capacity at the personal data problem is no longer an option for organisations. The default position of storing data is being seriously tested because of the costs and risks involved in doing so.

This represents a fundamental shift in thinking. Organisations must reconsider what it is necessary to store, the inherent and potential value of their data, whether it is secured and managed efficiently and the associated risk in continuing to hold it. This is not an easy conversation as it engages so many different parts of the organisation. Apart from the legal team, typically it involves information security, information technology, procurement, human resources and the business units. Each is likely to have their own agenda and aligning an approach is not straightforward. However, the three risk factors we have highlighted emphasise the increasing need to assess whether the organisation should continue to default to data storage – or defuse a ticking time-bomb.

Ian De Freitas
Partner, Intellectual Property and Data

Jamie Drucker
Associate, Intellectual Property and Data

Tamara Quinn
Consultant, Intellectual Property and Data

IT RISK IS ON YOUR BOARD'S AGENDA

HOW TO USE THE FCA'S PROCUREMENT GUIDE

The activity of outsourcing a firm's critical IT systems has finally become a Board issue. Marcus Pearl and Laura Jenkins consider how firms should use the FCA's IT procurement guidance to achieve 'effective, resilient and secure' IT procurement.

IT continues to play a critical role in the business operations of financial services organisations. Guidance in the form of "considerations" (the "Guidance") issued by the FCA in July 2014 on what regulated firms should be considering when procuring critical technology services has recently taken on greater relevance. Third-party IT systems must not only provide "business continuity" (recovering from an incident) – they must also be "resilient" (capable of withstanding critical failures). In its business plan for 2015/2016, the FCA highlighted that technological challenges, including technology investment and maintenance, may pose risks to its objectives and will be a key area of focus in 2016. The Bank of England has also recently made IT procurement a Board issue, stressing the importance of firms having effective systems to ensure resilience against cyber threats to their business. Given the continued growth in cloud computing, which led the FCA to start a consultation and issue proposed guidance on how to outsource safely and responsibly to the cloud, and the fallout from the decision by the ECJ to render invalid "Safe Harbour" arrangements for the transfer of personal data to the US (following the Maximilian Schrems v Data Protection Commissioner case), it is clear that IT procurement will continue to demand Board attention.

Who should take note of the Guidance?

The Guidance is aimed at any regulated firm that has or is seeking to engage with a third-party supplier for the delivery of technology services that are critical to its business operations. This applies equally to new entrants to the UK banking market and technology companies providing these solutions. »

What does the Guidance say?

The Guidance sets out a non-exhaustive list of questions that firms should consider, in order to validate that their commercial arrangements with third-party suppliers of technology services are effective, resilient and secure, and adaptable to the firm's present and future business needs. The Guidance should be viewed as supplementary to a firm's regulatory responsibilities specified in the Threshold Conditions and SYSC 8.

The list of questions covers 22 key areas of interest, including data protection, security, multi-tenancy and change management.

> "The key issue for the industry is concentration of risk. Firms should carry out extensive commercial and operational due diligence to verify that a potential supplier's solution is tailored to their needs, and to satisfy themselves that they are not simply following the market blindly."

They can be summarised as:

1

Decision to outsource critical technology services

Firms must ensure they have considered the business reasons for instructing a third-party supplier, having fully assessed the potential risks in such instruction.

2

Selection of outsourced service providers

Firms should consider their commercial relationship with the suppliers they select; assess the supplier's business model, verify its track record and relationship with other suppliers, diligence the solution itself and also ensure there is an adequate exit plan in place once the commercial arrangement ends.

3

Oversight and governance

A firm is fully responsible for ensuring it complies with its regulatory obligations. This cannot be delegated to a supplier. A firm therefore needs to ensure it has sufficient oversight of the supplier's activities and measures performance through tightly drafted SLAs and a robust risk management framework.

4

Operational

Firms should consider all of the operational aspects of the arrangement, including technological support, scalability, incident management and the quality of the service.

5

Service protection

Security provisions, resilience/disaster recovery and robust penetration testing procedures must be fully implemented.

6

Data

Personal data must be segregated, secured and processed in an acceptable jurisdiction.

Complying with the Guidance

The impact of the Guidance should not be understated. Firms are expected to comply with the spirit of the Guidance despite it not having the status of regulatory rules, particularly given the FCA's tendency to undertake thematic reviews into different areas of regulated activity. The prospect, therefore, of enforcement action for non-compliance and the attendant consequences that could follow, including potential penalties, is very real. The fines awarded against the RBS Group for the IT failures in 2012 are a testament to the potential bite behind the bark. No firm would wish to be a test-case for non-compliance with the spirit of the Guidance.

The key issue for the industry is concentration of risk. Firms should carry out extensive commercial and operational due diligence to verify that a potential supplier's solution is tailored to their needs, and to satisfy themselves that they are not simply following the market blindly. The FCA is particularly concerned about firms selecting the industry supplier of choice given the market consequences of any such supplier failure – despite any strong parental covenant that may be in place.

What should firms be doing now?

We recommend that in the procurement of third-party technology, firms validate their procurement targets and scoring matrices against the principles of the Guidance. For instance, firms should ask themselves if they are down selecting to a single provider too early in the process or whether they should ever formally stand down a reserve, assuming it is commercially viable to do so. The most effective way of managing this is to create a compliance matrix. This can then form part of an ongoing assessment of compliance risk throughout the life cycle of the procurement.

Choosing an effective, resilient and secure solution should be an inherent part of a firm's procurement process, and documenting such process is the key way of demonstrating compliance. But firms should also be checking their existing contracts to verify compliance. Do the contracts provide the firm with the appropriate exit flexibility? If the contracts relate to cloud technology, are they compliant with the proposed FCA guidance on outsourcing to the cloud? Do they pay more than lip service to the need to respect the integrity and segregation of personal data? How does the post-Schrems lack of 'Safe Harbour' regime impact firms' existing data arrangements? Should firms demand that their existing suppliers reroute data to friendlier jurisdictions or would the upheaval of the supplier's IT infrastructure be too onerous? Whilst it might be too late for existing arrangements, we would certainly recommend that firms demand the comfort – either contractually through supplier indemnification or only choosing, for example, suppliers whose servers are relocated to the EEA – that its personal data being processed by the supplier is being treated lawfully. Entering into data transfer agreements may not be the long-term answer. Perhaps extending cyber insurance to cover this risk is the only commercial option.

The FCA will expect firms to take all such measures necessary to ensure a smooth transition from their legacy system(s) (whether in-house or from a third-party supplier) to a replacement one. It is during transition, in particular, that the risk of failure is at its most accentuated. Ideally, a firm should rely on robust exit arrangements with an incumbent supplier (if relevant) and/or have the appropriate internal resources in place to assist with that cutover. Firms should also remember this for any eventual exit of the new contract. Firms should also agree comprehensive and transparent milestones with any new supplier to discincentivise and mitigate against any migration failure.

It is probably easier for new entrants to the market to achieve compliance provided they have the appetite and commercial leverage with suppliers to do so. Existing firms arguably have more entrenched legacy systems. Either way, demonstrating best efforts towards ongoing compliance is a step in the right direction.

Marcus Pearl
Partner,
Commercial

Laura Jenkins
Associate,
Commercial

REGULATORY CALENDAR

KEY DATES FOR 2016

QUARTER ONE

- FCA and PRA expected to publish policy statement on reforming the Credit Unions sourcebook (CREDS) following their joint consultation paper (PRA CP22/15; FCA CP15/21)
- FCA expected to publish policy statement on the disclosure rules applicable to non ring-fenced entities within groups that include a ring-fenced bank.
- Financial Advice Market Review (FAMR): FCA and HM Treasury expected to publish recommendations arising from the review and HM Treasury expected to report on the outcome of its consultation on public financial guidance
- FCA expected to conduct a further impact assessment in relation to the rules introduced in its 2014 policy statement, Credit broking and fees (PS14/18)
- UK Parliament to consider the Bank of England and Financial Services Bill
- ESMA expected to publish final report and final UCITS V remuneration guidelines
- ESMA expected to publish revised AIFMD guidelines on sound remuneration practices
- ESMA will continue work on the Technical Standards under Article 8 of the regulation on Packaged Retail and Insurance-based Investment Products (PRIIPs)
- FCA expected to publish feedback and a policy statement on UK implementation of UCITS V, including a UCITS Remuneration Code (new FCA Handbook Chapter SYSC 19E) ESMA: expected to publish its first half-yearly Report on Trends, Risks, and Vulnerabilities

Early 2016 – FCA expected to publish terms of reference to launch retirement outcomes review

Q1-Q2 2016 - FCA expected to publish findings from its thematic review of staff remuneration and incentives in consumer credit firms

Q1-Q2 2016 - FCA proposes to launch a market study on those aspects of the mortgage market that are not working to the benefit of consumers

Q1-Q2 2016 - FCA expected to publish report on mortgage market responsible lending review

Q1-Q2 2016 - PRA expected to publish a further consultation and issue final rules and guidance on ring-fencing requirements

Q1-Q2 2016 - Office of Financial Sanctions Implementation to be established within HM Treasury

Q1-Q2 2016 - HM Treasury expected to consult on implementation of the Fourth Money Laundering Directive and introduce measures for the revised Wire Transfer Regulation

Q1-Q2 2016 - Insurance Distribution Directive end Benchmark Regulation both expected to be published in the Official Journal of the EU

2016 - FCA expected to report on the findings from behavioural tests on possible policy options (including proposed rule changes) for presenting annuity comparison information

2016 - FCA expected to consult on preferred measures for measuring the value of general insurance products

2016 - FCA expected to publish a policy statement and final rules relating to fair, reasonable and non-discriminatory access to regulated benchmarks, following its consultation CP 15/18

2016 - FCA expected to consult on implementation of HM Treasury recommendations following the review of FCA and PRA enforcement decision making process

2016 - FCA and PRA expected to consult on extending whistleblowing rules to UK branches of overseas banks

2016 - FCA, HM Treasury and Bank of England expected to continue work on implementation of recommendations from the Fair and Effective Markets Review

JAN 2016

Early January - FCA and PRA expected to publish a policy statement following their joint consultation paper (FCA CP15/31; PRA CP36/15) on regulatory references under the SMR and SIMR

1 January - FCA and PRA, First set of rules to implement the SIMR and related reforms for Solvency II purposes comes into force

1 January - Firms can make SMR and SIMR applications

1 January - Solvency II insurers must have governance maps in place under the SIMR

1 January - Solvency II implementation date

1 January - New FCA and PRA clawback and deferral rules apply to variable remuneration awarded for performance periods beginning on or after 1 January 2016

1 January - The remaining provisions of the Solvency 2 Regulations (SI 2015/575) and PRA and FCA Solvency II requirements come into force

1 January - Provisions of the Single resolution mechanism (SRM) Regulation and the Bank Recovery and Resolution Directive (BRRD) will apply in full

4 January – Deadline for responses to FCA consultation CP15/30 on pension reform measures (excluding proposals on scope of the retirement outcomes review which had a deadline of 30 October 2015)

11 January - Deadline for responses to FCA/PRA joint occasional paper on minor and consequential amendments regarding introduction of SMR and SIMR (FCA CP 15/37; PRA CP 41/15)

12 January - Revised Payment Services

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11 January - Deadline for responses to FCA/PRA joint occasional paper on minor and consequential amendments regarding introduction of SMR and SIMR (FCA CP 15/37; PRA CP 41/15)

12 January - Revised Payment Services Directive comes into force, with a transposition date of 13 January 2018

22 January - Deadline for responses to ESAs' consultation papers on the fourth Money Laundering Directive

29 January - PRIIPs Regulation – deadline for responses to ESA's November CP on RTS for the PRIIPs key information document (KID)

FEB 2016

4 February - Deadline for responses to FCA consultation (CP 15/35) on Handbook changes for implementation of the Market Abuse Regulation

8 February - Deadline by which all-relevant firms (including foreign banks with UK branches) to notify the PRA and FCA of the approved persons who will be senior managers under the SMR and SIMR.

26 February - Deadline for responses to FCA CP 15/39 on amendments to the Payment Protection Insurance (PPI) complaints handling rules

MARCH 2016

March - FCA expected to publish consultation on Conduct aspects of MiFID II implementation

By 7 March - FCA expected to publish final rules on the inclusion of wholesale activities in the Certification Regime

7 March - Deadline for firms to assign responsibility to a "whistleblowers' champion"

7 March - SMR & SIMR enter into force for all relevant firms

7 March - Section 36 of the Financial Services (Banking Reform) Act 2013 enters into force, introducing a new criminal offence of reckless misconduct that causes a financial institution to fail

7 March - Streamlined SIMR for non-Solvency II insurers enters into force

8 March - Deadline for responses FCA's MiFID II Markets consultation (CP 15/43)

18 March - Deadline for Member States to transpose UCITS V Directive into national law

18 March - Deadline for responses to Commission green paper on retail financial services

21 March - The regulation of second charge mortgages transfers from the FCA's consumer credit regime to the FCA's mortgages regime

21 March - Deadline for Member States to transpose Mortgage Credit Directive (MCD) into national law

22 March - Deadline for responses to EBA CP on draft guidelines for remuneration policies and practices relating to sale and provision of retail banking products and services

31 March - Deadline for European Supervisory Authorities (ESAs) to provide draft RTS to the Commission under Article 8 of the PRIIPs Regulation

31 March - Deadline for firms with consumer credit interim permission to apply for authorisation under the full FCA consumer credit regime

QUARTER TWO

- FCA expected to publish findings from its thematic review of early arrears management in unsecured lending
- FCA expected to publish a policy statement and final rules relating to proposed Handbook changes outlined in CP15/30 on pension reforms.
- FCA expected to publish policy statement on Handbook changes for implementation of Market Abuse Regulation, following responses to CP 15/35
- ESMA: expected to publish Q&As on product governance and other MiFID II/MiFIR topics
- ESMA expected to publish 2015 Annual Report

Spring 2016 - FCA expected to publish final report following its investment and corporate banking market study and final report on credit card market study

APRIL 2016

April - CMA to publish its final report following its retail banking market investigation

1 April - FCA rules prohibiting opt-out selling come into force

1 April - FCA consumer credit regime comes fully into effect, replacing interim permission regime

6 April - Final rules prohibiting differential charging between workplace personal pensions scheme members based on contribution status come into force

MAY 2016

5 May - Deadline for CMA to complete its retail banking market investigation under the Enterprise and Regulatory Reform Act 2013

JUNE 2016

June - Fair and Effective Markets Review (FEMR): FEMR Chairs expected to provide an implementation report to the Chancellor and the Bank of England Governor

30 June - New FCA complaints handling rules in the Dispute Resolution: Complaints sourcebook (DISP) come into force

QUARTER THREE

- ESMA expected to publish second half-yearly Report on Trends, Risks, and Vulnerabilities
- ESMA expected to publish Level 3Guidelines on MiFID II/MiFIR
- ESMA expected to follow-up on peer reviews on information and marketing to clients and best execution
- European Commission expected to report on its review of the EU financial services regulatory framework and publish action plan on retail financial services
- EBA expected to publish a final version of its guidelines on remuneration policies and practices relating to sale and provision of retail banking products and services
- ESMA expected to finalise RTS under the European Long Term Investment Funds Regulation

JULY 2016

July - date from which FCA will accept applications for MiFID II authorisation

3 July - The majority of the provisions of MAR will apply (apart from those provisions which take effect on MiFID II transposition date)

Member states (apart from UK and Denmark) must transpose into national law the provisions of the Directive on Criminal Sanctions for Market Abuse (2014/57/EU) (CSMAD)

3 July - Member States must adopt and publish measures transposing MiFID II into national law

AUG 2016

1 August - Motor insurance: obligation to provide no-claim bonus (NCB) protection information to consumers will apply

SEPT 2016

7 September - Deadline for Solvency II insurers to:

- Prepare and submit to the PRA SoRs for grandfathered SIMFs
- Produce and make available to the FCA SoRs for grandfathered SIFs
- Submit notification forms for those transitional key function holders who are neither grandfathering to a controlled function, nor seeking approval from the PRA for a senior insurance management function (SIMF)

7 September - New PRA and FCA whistleblowing rules take effect (apart from the requirement relating to "whistleblowers' champion", which took effect in March 2016)

18 September - Payment Accounts Directive – Transposition date and deadline for EBA to submit to the Commission draft regulatory technical standards (RTS) and implementing technical standards (ITS)

By 30 September - Relevant firms are expected to have made necessary changes to their "sale journeys" to comply with new FCA rules on delivering appropriate and timely information for add-on sales

QUARTER FOUR

By Q4 2016 - European Commission to work with member states and ESMA to assess whether there is need for a co-ordinated approach to loan origination by funds, and consequently for an EU regulatory framework

- ESMA will draft the Regulatory and Implementing Technical Standards under the Securities Financing Transactions Regulation (SFTR)
- ESMA will contribute to the work of the Joint Committee on the Technical Advice to the European Commission on PRIIPs
- In the context of the Alternative Investment Fund Managers Directive (AIFMD), ESMA will deliver advice to the European Commission on the depositary frameworks of non-EU jurisdictions
- ESMA expected to provide Technical Advice on depositary frameworks of non-EU jurisdictions under Article 21(6) of AIFMD
- ESMA expected to provide advice on the application of the passport to third-country AIFMs and AIFs in accordance with the rules set out in Article 35 and Articles 37 to 41 of AIFMD
- ESMA expected to publish Regulatory Technical Standards on the clearing obligation and on CCP requirements
- ESMA expected to follow-up on and conduct additional thematic studies/exercises to further convergence related to the Prospectus and Transparency Directive
- ESMA expected to publish guidelines on asset segregation under AIFMD
- ESMA expected to publish three sets of guidelines under MAR

OCT 2016

October 2016 - ESMA expected to publish Technical Advices to the Commission and Technical Standards on the Money Market Funds Regulation

End October - Certification Regime (CR) – Firms must make first annual submissions notifying breaches of the conduct rules for staff who fall within the CR

DEC 2016

31 December - PRIIPs Regulation will apply in EU member states

2017

1 January 2017 - EBA final guidelines come into effect, relating to (a) sound remuneration policies (Article 74(3) and 75(2), CRDIV) and (b) disclosures (Article 450, CRR)

3 January 2017 - Date by which MiFID II Directive and MiFIR are to apply (subject to a small number of excepted articles)

3 January 2017 - Effective date for commencement of those provisions in MAR which come into effect on MiFID II/MiFIR effective date (provisions relating to organised trading facilities (OTFs), SME growth markets, emission allowances or auctioned products based thereon)

12 February 2017 - EMIR: Contracts entered into before the reporting start date and no longer outstanding on that date must be reported to trade repositories

1 March 2017 - EMIR: Variation margining requirements for non-centrally cleared trades will apply for all other institutions that are within scope

7 March 2017 - Deadline for firms to issue certificates for individuals falling within the Certification Regime (Banking Reform Act, Section 29)

7 March 2017 - Date from which the conduct rules apply to staff who are not within the SMR or CR

March 2017 - Consumer credit – FCA expects to conclude the process of assessing authorisation applications from firms with interim permission

April 2017 - HM Treasury/FCA – implementation of secondary market in annuities

By 26 June 2017 - Member states required to have transposed the Fourth Money Laundering Directive (MLD4) into national law

26 June 2017 - Date from which the revised Wire Transfer Regulation takes effect

22 July 2017 - The European Commission will start a review on the application and scope of the AIFMD

16 August 2017 - End of the transitional period relating to pension scheme arrangements

End October 2017 - Firms must make first annual submissions notifying breaches of the conduct rules for staff who are not within the SMR or CR

2018

2018 - SMR and CR expected to be extended to all financial services firms

Q1-Q2 2018 - Insurance Distribution Directive to take effect (two years following the date of its adoption)

13 January 2018 - Deadline for Member States to have transposed the revised Payment Services Directive into national law

1 June 2018 - Deadline for European Commission to review the implementation of the BRRD 22 October 2018 - ESMA is due to provide a further opinion on

- the functioning of the passport for EU AIFMs marketing non-EU AIFs in the EU and for non-EU AIFMs managing or marketing AIFs in the EU;
- the functioning of the marketing of non-EU AIFMs in Member States; and

the management and marketing of AIFs by non-EU AIFMs in Member States using national private placement regimes

2019

1 January 2019 - Deadline for key provisions of the Financial Services (Banking Reform Act) 2013, including ring-fencing and depositor preference, to come into force

By 26 April 2019 - Deadline for the FCA to have carried out a formal review of the impact of the mortgage market review (MMR) rules (required within five years of their implementation)

9 June 2019 - European Commission to start a review of the application of the ELTIF Regulation

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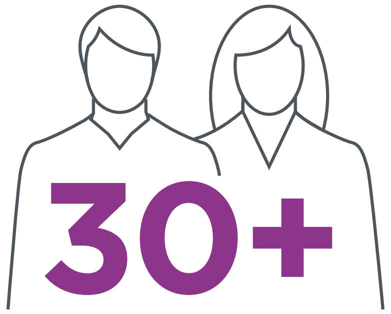

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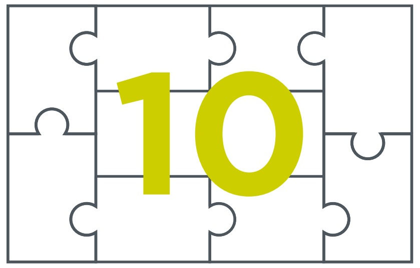

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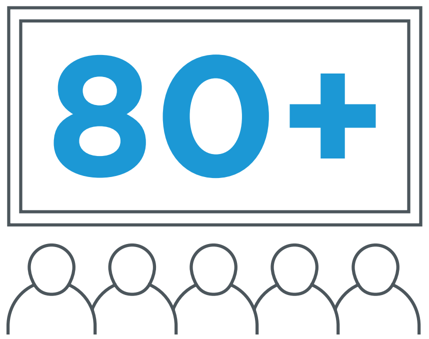

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