



GLOBAL ENFORCEMENT REVIEW

2015

Analysis and commentary on the impact
of regulatory enforcement on the evolving
global financial services landscape

As of 8 June 2015

 Kinetic
Partners

A Division of
DUFF & PHELPS



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To compile this report, we at Kinetic Partners, a Division of Duff & Phelps, studied published data released by the US Securities and Exchange Commission (SEC), the UK Financial Conduct Authority (FCA), the Securities and Futures Commission of Hong Kong (SFC), the US Commodity Futures Trading Commission (CFTC) and the Financial Industry Regulatory Authority (FINRA) in recent years.

Please note that as definitions and reporting standards vary across the authorities under review, certain data points may not be unilaterally comparable. We have nevertheless sought to examine figures from each regulatory body as indicative of wider trends in the financial services industry.

EXECUTIVE SUMMARY



Monique Melis
Managing Director
Global Head of Regulatory Consulting
e: monique.melis@kinetic-partners.com

The analysis contained in Kinetic Partners' 2015 Global Enforcement Review (GER) paints a picture of financial services regulators that are leaner, but more vigorous. Their smart, targeted approach to penalising poor practice and misconduct will require a similar response from the industry.

Spending increases among the regulators moderated or reversed this year, breaking the trend in our past GER report. Looking at the FCA in the UK,¹ the SEC, CFTC and FINRA in the US, and the SFC in Hong Kong, there's a mixed picture, but it points to a slowdown in spending growth from 2013 to 2014:

At the same time, there has been a spike in the size of financial penalties, with particularly big increases in the average size of fines from 2013 to 2014 at the FCA, FINRA, CFTC and SFC. **In the case of certain regulators, we saw this average increase by as much as 18 times over the course of only five years.**

Analysis shows that the number of enforcement actions grew only at the SEC (by about 10%); **the FCA, CFTC and FINRA all saw a decline in the number of cases filed.**

Combined with the rising level of fines, regulators seem to be concentrating on a small number of cases that are pursued aggressively to encourage the rest of the industry to comply. **The evidence also suggests that regulators are particularly focused on cases of market integrity and consumer protection**, although priorities vary by jurisdiction.

Whether spending growth accelerates again in coming years or not, however, this report also highlights two other trends are central to the regulators' approach:

- **Increasing reliance on technology:** with more and more trading being done electronically, regulatory attention continues to shift towards solutions that monitor vast numbers of transactions and data. This responsibility will be shared with the industry itself, as technological developments create both opportunities for firms, and greater expectations of them.

The averages are clearly impacted by a relatively small number of big penalties (namely Libor and FX rate manipulation), but they are still representative of the trend towards more serious punishments for wrongdoing.

New enforcement actions relating to such high-profile scandals will continue to be felt in future years. The industry must be wary, however, of the danger of firms "budgeting" for such massive fines and ultimately passing the costs onto shareholders and consumers. If this happens, the entire point of delivering severe sanctions will be lost.

Fewer, tougher enforcement actions

The increase in average fine values, however, has not in every case equated to an increasing numbers of cases in 2014.

Spending growth at the **SEC** WAS DOWN TO **8%**

The **FCA** CUT SPENDING BY **17%**

It more than halved at the **SFC** FROM **31%** IN 2013 TO **13%** IN 2014



- **Holding individuals accountable:** regulators see this as a powerful deterrent, though their success in this respect is mixed. Actions against individuals accounted for a substantial portion of SEC and CFTC cases, but at the FCA the figure was notably low.

Recommendations

It is dangerous to put too much weight on the findings from a single year, particularly given the difference between regulators and geographies. However, enough of a consistent regulatory approach can be discerned for some suggestions as to how the most successful firms will respond:

- **Invest in compliance and controls:** nine-figure and \$1 billion+ fines and settlements remain rare, but they are not the aberration of a single year. Despite the risk of costs being passed to shareholders and a desire to hold
- **Invest in technology:** investments in technology will continue to play a key role both for regulators and for firms. Increasing numbers of suspicious transaction reports suggest firms' capabilities are increasing, but so too are regulators' expectations of how firms are monitoring themselves. As technology develops and resources become more limited, regulators cannot expect to keep up with developments in the marketplace. The reliance on the industry to police the market is only likely to grow.
- **Invest in people:** as regulators increasingly focus on actions against individuals, they risk undermining the ability of firms to recruit appropriately skilled staff to fill key positions in the control framework. Compliance, internal audit and other control functions are valued highly, and firms need to continue to nurture internal talent in these areas. They must also ensure that responsibilities imposed by regulators reflect the organisational reality. In that sense, it is the duty of the Board to effect the institutional and cultural changes needed to support these functions in meeting compliance obligations.

SCALING BACK? REGULATORS' EXPENDITURE SLOWS

After years of growth, the annual increase in regulatory expenditure has slowed or even reversed since 2013. While it remains to be seen whether this year is an outlier or if this downturn in spending will continue, it nevertheless reflects changes in the regulators' approach to deploying resources.

The years following the financial crisis saw a significant increase in expenditures and headcounts at the regulators in certain major financial markets.² This expansionary phase may now be coming to an end, based on observations from the end of the 2014 fiscal year.³

As seen in **Figure A** (page 7), in the 2013/14 financial year, the rate of year-on-year expenditure growth at the SEC slowed from 11% the previous year to 8%, and more than halved at the SFC from 31% to 13%. Even more telling is the fact that spending at the FCA and the CFTC actually fell by 1% and 17%,⁴ respectively.

Staffing levels were less consistent, but again, while there were headcount increases at the SFC and CFTC (up 16% and 10%, respectively) there were employment drops at the FCA⁴ and SEC.

Changes in regulators' workforces in recent years have varied from region to region, with the need to enhance departments

or skills adding to costs. The SFC, for example, has been bolstering its corporate investigations staff.⁵

In the UK, however, the FCA has reduced its headcount following its departure from wide-scale cyclical reviews and relationship management of firms to its current approach of thematic reviews of the industry's activities backed by standards and attestation – requiring senior managers in firms to declare their compliance.

Changes in funding alone cannot fully explain this. The FCA, funded by the industry, did see a decrease in its budget from fiscal year 2013 to 2014.⁶ This decrease however is expected to be an anomaly, with the FCA already outlining their intention to increase their 2015/16 annual funding requirements (from £446.4m in 2014/15 to £481.6m).⁷ Similarly, the SEC saw a rise in its government support during that same period (after a

dip in 2013).⁸ The SFC, meanwhile, continues to harbour reserves that would allow it to continue operations for years if its income stopped tomorrow.⁹

Instead, the slowdown may reflect a growing restoration of balance following the financial crisis, as well as the consolidation of changes already in place.

Armed with hindsight and a greater understanding of what led to the 2008 collapse, regulators may well have devised an approach that enables them to achieve objectives and use resources more efficiently. More sophisticated approaches to monitoring using advanced technologies and the appointment of specialised staff (particularly those recruited from private equity and trading backgrounds) have enhanced and developed regulators' surveillance activities. These factors have likely contributed to a reduction in regulatory overhead, accounting for the recent spending deceleration.

“The slowdown of regulatory expenditure may reflect a growing restoration of balance following the financial crisis.”

In just one year, expenditure growth slowed from **31% to 13%** at the SFC and **11% to 8%** at the SEC

and decreased by

1% at the CFTC and **17%** at the FCA

2 Kinetic Partners, *Global Enforcement Review 2014*

From 2006 to 2013, the SEC, FCA and SFC increased staff numbers by 22%, 53% and 51%, respectively, and expenditure by 62%, 48% and 120%

3 Please note that each regulator maintains fiscal years as follows: SEC: 1 October – 30 September, FCA: 1 April – 31 March, SFC: 1 April – 31 March, CFTC: 1 October – 30 September, FINRA: 1 October – 30 September

4 Please note that this decline in spending and staffing was largely driven by changes in operating structure, organisational size and responsibilities following the split of the FSA into two separate bodies on 1 April 2013: the FCA and the PRA

5 Paul J. Davies, "Hong Kong's market watchdog streamlines push for more oversight," 10 March 2014, *Financial Times*

6 FCA Business Plan 2013/14 From £543.5m to £445.7 million in 2013/14

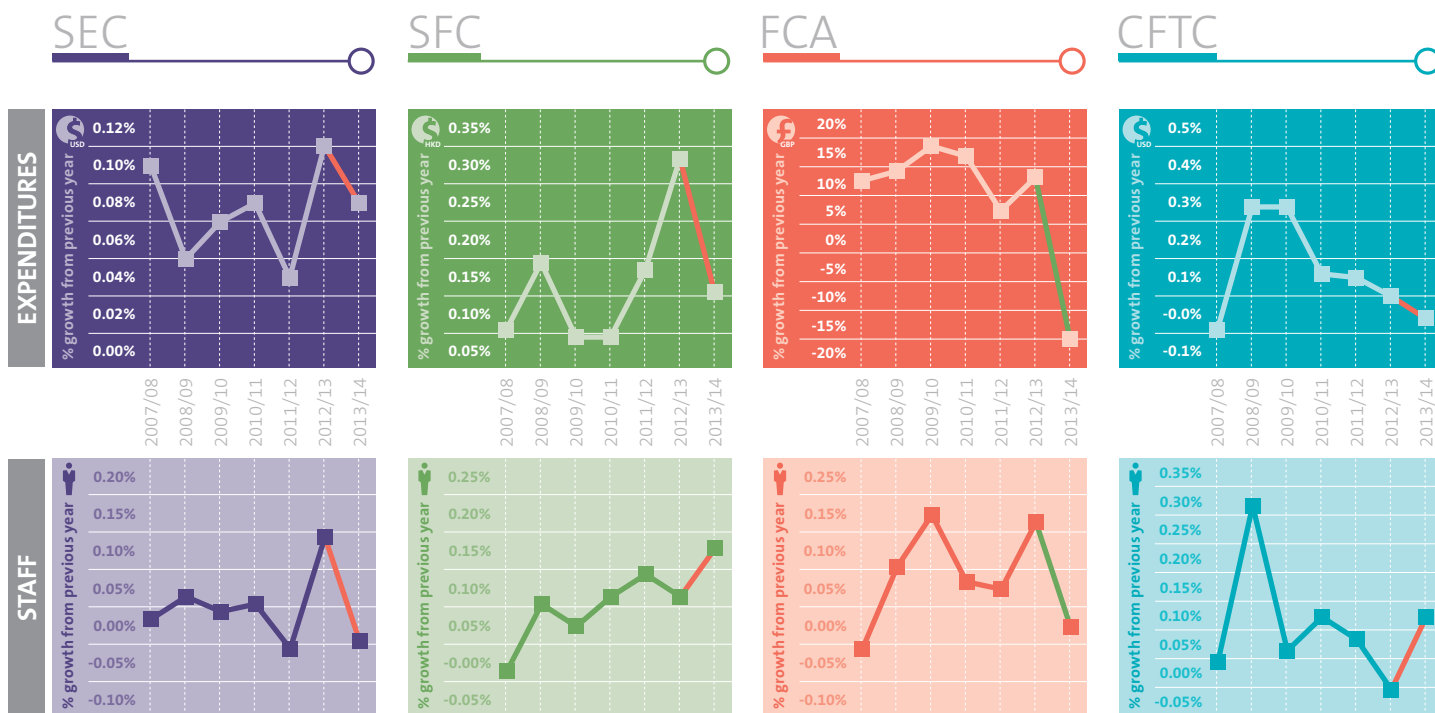
7 FCA Press Release, "FCA consults on 2015/16 fees for regulated firms," 16 March 2015

8 Melanie Waddell, "SEC Would Hire 431 Under Obama's 2016 Budget," 2 Feb 2015, *Think Advisor*

9 Enoch Yiu, "SFC suffers wider loss, but still a rich regulator," 25 Aug 2014, *South China Morning Post*



Figure A – Annual expenditure growth rates by regulator



Please note that FINRA data for 2013/14 was not available at the time this report was published.

Sources: SEC Agency Financial Reports, 2012-2014 / SEC Annual Report - Performance and Accountability Reports, 2008-2011 / SFC Annual Reports, 2007/08-2013/14 / FCA and FSA Annual Reports, 2007/08-2013/14 / CFTC Summary of Performance and Financial Information, Fiscal Years 2008-2014

The result has been greater coverage of current and future legislation as well as access to wider data at only a marginal extra cost.

As this year’s GER report shows, however, the apparent slowing of regulatory spending will not necessarily constrain enforcement activity.

Focusing to implementation

On the one hand, it is hard to argue that the pressure on either regulated firms or regulators has substantially eased: MiFID II, MiFIR, EMIR, MAR¹⁰ – the responsibilities on firms continue to grow. Likewise, regulators are still adding scope to their own surveillance obligations. The FCA, for instance, recently took on oversight of the UK’s consumer credit providers for the first time.

On the other hand, progress has clearly already been made. In the US, for instance, more than 60% of Dodd-Frank rules are now finalised.¹¹ As a result, while regulators might not have fully achieved their goals to transform the industry, there is now more room to focus on specific priority areas rather than stability generally.

As the FCA’s Director of Markets David Lawton told the UK’s House of Lords committee examining the EU’s financial regulatory framework: “From a regulatory point of view, we have had five years of measures trying to deliver stability and deal with the post-crisis agenda. We are now coming through that... The best thing for growth is to allow firms and regulators to get on with completing the job that was started in the last five years.”¹²

In this regard, implementation and precedent-setting is likely to be a significant focus for regulatory bodies in the years ahead. This will particularly be the case in jurisdictions such as Hong Kong, where local regulators have only recently undertaken initiatives relating to novel market areas such as electronic trading and OTC derivatives.

Perhaps more important for firms to acknowledge, however, is that much of the regulatory framework is now in place and regulators will be seeking to test the effectiveness of new rules via enforcement.

10 The revised Markets in Financial Instruments Directive (MiFID) and Regulations (MiFIR); the European Markets Infrastructure Regulations (EMIR); and the Market Abuse Regulations (MAR)

11 DavisPolk, “Dodd-Frank Progress Report,” 2015

12 Evidence before The Select Committee on the European Union Sub-Committee A (Economic and Financial Affairs). Inquiry on Review of the EU Financial Regulatory Framework, 28 Oct 2014

Enabled by technology

Technology continues to be a consistent driver for regulatory innovation throughout the world. Tools such as the SEC's Market Information Data Analytics System (MIDAS) and National Exam Analytics Tool (NEAT) are central to the Commission's market monitoring strategy. While requiring considerable upfront investment, regulators have ultimately cut costs in the long run and streamlined otherwise resource-intensive monitoring processes.

Using cloud computing, big data and quantitative analytics enables regulators to more efficiently detect and target cases, maximising the deterrent effect of enforcement actions. Moreover, the

availability of these technologies allows them to demand more self-policing from the industry – as regulators are and will be seeking to do in greater frequency. Both help them do more with less.

In the same way that the regulators are leveraging technological approaches, firms also need to demonstrate a strong understanding of how technology is affecting the market and be able to proactively identify potentially abusive activities on their own. The advent of efficiencies brought through technology means regulators globally may have greater capacity to identify more candidates for examinations in years to come.

However, there is a flipside: technological development continues to expand the opportunities for abuse, and regulators will always struggle to keep pace in this regard. Innovative trading strategies or tools open wide gaps for arbitrage, such as with high frequency trading or dark pools, and can create vulnerabilities in the market for manipulation.

This is particularly the case when regulators don't have clear oversight into how these new structures operate, such as with PowerLinux servers (see below INSIGHT: Technology - a double-edged sword).

For this reason, if nothing else, it may be that regulators will need to ramp up their spending again before too long.

“The best thing for growth is to allow firms and regulators to get on with completing the job that was started in the last five years.”

David Lawton, Director of Markets (Financial Conduct Authority)

INSIGHT: TECHNOLOGY - A DOUBLE-EDGED SWORD



Simon Appleton

Director

Regulatory Consulting

e: simon.appleton@kinetic-partners.com



Zach Johnson

Director

Regulatory Consulting

e: zachary.johnson@kinetic-partners.com

The regulators' investments in technology are simply a reflection of where the activity is. Electronic trading will probably soon account for a majority of trading in a whole range of markets, from swaps to US Treasuries and European credit.

In some, such as the FX market – the focus of so much recent attention – it is already dominant.

Given this and the rise of high frequency and algorithmic trading, it makes sense for the regulators to bring tools like MIDAS and NEAT to bear. In the future, regulators will also hopefully address some of the more obvious weaknesses and inconsistencies across jurisdictions. To take just one example, US and European stock

markets have “circuit breakers” to stop trading in the event of large drops in value (such as can happen with algorithmic trading). Hong Kong does not.

It will not be enough, however. Technology continues to expand the possibilities to profit from markets, both legitimately and otherwise.

PowerLinux servers, for example, which can efficiently handle huge quantities of data, are now being combined with trading applications scouring information from news feeds to Twitter to provide big data analytics in near real time. Combined with automated trading it has been dubbed “high intelligence trading.”

The technology has applications for both regulatory and trading purposes, but the incentives suggest the trading will come first. Regulators will always be playing catch up.

Their answer, though, is already apparent: to push more responsibilities onto firms themselves to play their role in policing the market through effective pre- and post-trade controls. This would include a greater expectation for firms to report suspicious transactions and increasingly suspicious orders as well. In fact, it already seems to be having an impact: FCA figures show the number of suspicious transaction reports (STRs) between 2013 and 2014 were up by almost a quarter (see page 16).



INSIGHT: FINDING A LIGHTER SIDE TO THE REGULATORY BURDEN



Alexandra Dobra
Senior Associate
Regulatory Consulting
e: alexandra.dobra@kinetic-partners.com

Any slowdown in regulatory spending is not too apparent for the firms they oversee. For them the regulatory burden remains substantial, with the costs to banks no longer a negligible percentage of annual pre-tax return on equity.

For example, some banks are paying up to \$4 billion per year to cover compliance costs relating to money laundering and stress tests data reporting.¹³

Such costs fall on businesses of all sizes, though smaller financial services firms do not enjoy the same economies of scale as their larger competitors. These smaller players are potentially more vulnerable to new business models such as peer-to-peer lending, for which the regulatory approach to date has proved much lighter. We should continue to call for both proportionality and consistent standards.

Larger firms also face challenges though, most obviously in the lack of regulatory harmonisation across jurisdictions.

It is not merely a case of differences in the scope, timings and reporting requirements that regulations impose; there is a fundamental mismatch between, for example, the principles-based regulation of the FCA and the prescriptive line of the SEC. A single approach from financial services firms cannot fully satisfy both, even where legislative requirements seem closely aligned. Work is inevitably duplicated and the potential for efficiencies reduced.

But this also presents opportunities. Most obviously, it leaves open the possibility of regulatory arbitrage. Over time, these will probably reduce, with pressure on lighter-touch jurisdictions to conform to increasingly international standards.

For now, if nothing else, it offers multinationals leverage in policy debates. HSBC's threats to move its headquarters from the UK are a case in point.

Regulatory differences can also be exploited in another respect, however. Financial regulation is one of the main catalysts in reshaping the balance of power among market players. The complexity and uncertainty of financial regulation means some firms will manage cross-border compliance better than others. Those able to see the regulatory environment holistically, identify overlaps and meet the varying requirements in different jurisdictions most efficiently (and subsequently be able to quickly restructure business models accordingly) will likely be in a position to secure international opportunities more expeditiously than competitors.

INSIGHT: THE POLITICAL ANGLE



Richard Crannis
Managing Director
Regulatory Consulting
e: richard.crannis@kinetic-partners.com

Political fascination with the finance industry remains undimmed, as reflected in the agendas of different political parties during election time. The results of the recent election in the UK, for example, gave victory to the Conservative Party, which is set to provide the industry with a more business-friendly environment.

However, such an environment could quickly become unsettled, given the issues with the European position and the forthcoming referendum.

In the US, President Obama used his State of the Union address this year to promise a veto of any future "unraveling [of] the new rules on Wall Street"¹⁴ – putting Dodd Frank up with health insurance and immigration as central to US families' security. His proposed "bank tax" on financial institutions with more than \$50 billion, as a fee charged on liabilities rather than assets, also neatly united governments' twin priorities – raising money and ensuring stability.

Continued focus and scrutiny on the banks is still seen as a vote winner.

However, other voices are also beginning to be heard – or at least a different tune. The key political priority now, particularly in the Eurozone, is growth. The modest rate of 0.4% in the first quarter of 2015 was the fastest for nearly two years.

In February of 2015, the EU Commission launched a consultation to review the securitisation market to ensure its regulation was not restricting growth. Jean-Claude Juncker, President-elect of the Commission, has also taken measures to fight against excessive bureaucracy through heavy vetoing of department proposals.

These sentiments are increasingly filtering through to the regulators.

Politics hasn't gone out of financial regulation, of course, and it is unlikely to do so any time soon. The priorities, however, are changing, and that might benefit the future prospects and prosperity of the industry.

¹³ Laura Noonan, "Banks face pushback over surging compliance and regulatory costs." *Financial Times*, 28 May 2015

¹⁴ President Barack Obama, "Remarks by the President in the State of the Union Address." 20 January 2015

A NEW NORMAL: HEAVIER PENALTIES FOR BREACHES

The level of financial penalties handed out has increased substantially from 2013 to 2014 as regulators get tough on both firms and individuals, and this trend is set to continue. Regulators' efforts to deter professional improprieties have set records around the world and made the message clear that egregious breaches will be penalised to the severest degree possible.

The fines being imposed for rule violations in just one year are up by half or more at many regulators, according to recent data published by key agencies in the US, Europe and Asia (see **Figure B**, page 11). The average value of each fine issued by the FCA in 2014 was £36.8 million, up more than two-and-a-half times on last year,¹⁵ while the CFTC also saw fines in 2014 more than double (up 135%) from 2013, reaching an average of US\$48.8 million per enforcement action; the SEC average in 2014 was up more modestly, by 10% to US\$5.5 million per penalty, although it brought a record number of enforcements during that year (755, a 10% increase from the previous).

Fines in 2014 were also substantially higher at the SFC and FINRA than in 2013, up 50%¹⁶ and 146%, respectively. The sums now dwarf the levels of financial penalties even five years ago, up nearly eight-fold (772%) at the CFTC and by more than 18 times (1,815%) at the FCA.¹⁷

“Severe punishments are likely to become a way of life for the industry.”

¹⁵ These figures refer to enforcement actions issued during calendar year 2014 and 2013, respectively (1 January through 31 December)

¹⁶ Freshfields Bruckhaus Deringer, “Enforcement trends in Hong Kong,” 2013 and 2014

¹⁷ These historical growth rates for financial penalties by the CFTC and FCA, respectively, tracks the average size of fines reported at the end of each fiscal year from FY 2008/09 to FY 2013/14

¹⁸ Sutherland Asbill & Brennan LLP, “2014: The FINRA Force Awakens – A Review of a Blockbuster Year and What it Means for BDs and Infinity and Beyond,” 22 April 2015

¹⁹ Ibid

²⁰ Standard & Poor's, “Report Says the Top Four UK Banks are Still Burdened by Conduct and Litigation Charges,” S&P Capital IQ, 27 Apr 2015

Skewing the figures

The averages tell only part of the story, of course, and have been pushed up by a relatively small number of massive fines. Those relating to FX manipulation accounted for several billion dollars of penalties across four international regulators, including £1.1 billion (approximately US\$1.7 billion) at the FCA and more than US\$1.4 billion at the CFTC in 2014.

The same is likely to be true at some of the other regulators. FINRA's average penalty was just US\$96,000 in 2013/14, for example, but in December of 2014 it agreed a settlement of US\$43.5 million with 10 investment banks over the Toys R Us IPO. The number of “supersized” fines, referring to those larger than US\$1million, more than doubled from 2013 to 2014 (12 to 25, respectively).¹⁸

Moreover, with the exception of the SEC, each regulator examined in this report actually saw a decline in the number of enforcement actions. The FCA saw 40 actions in 2014 against 48 in 2013 and 83 during the fiscal year 2010/11; the CFTC brought 85 actions, compared to more than 100 in 2011/12. FINRA too saw a 9% decline in the number of cases filed from 2013 to 2014.¹⁹ The inference here is that these regulators are honing in on the most

heinous offences and, in many cases, imposing the harshest possible penalties allowed by law.

There is an emerging trend among certain regulators to focus on complex, high-profile cases and leverage massive penalties. This indicates a shift in approach to enforcement, with prohibitively high fines becoming the norm. April's £1.7 billion fine against Deutsche Bank, for example, ensures future years' figures will receive similar boosts.

Moreover, the big four UK high-street banks alone face another £19bn of conduct and litigation charges in 2015 and 2016, according to ratings agency Standard & Poor's, which says such punishments are to become “a way of life” for the industry.

“...some form of charge seems probable every year for the larger banks and every other year for the smaller institutions,” it noted.²⁰

Investing in advanced centralised monitoring systems to closely track transactions will help firms understand where their market activity may open them up to enforcement risk so as to remediate accordingly. Having a strong culture of compliance in place will also help firms manage risk and stay ahead of regulatory expectations.



From 2009-2014, the average financial penalty grew by:

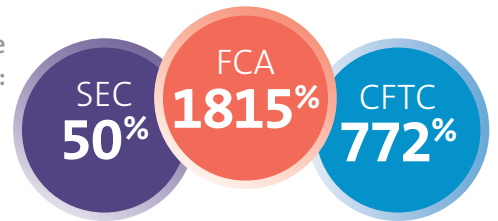
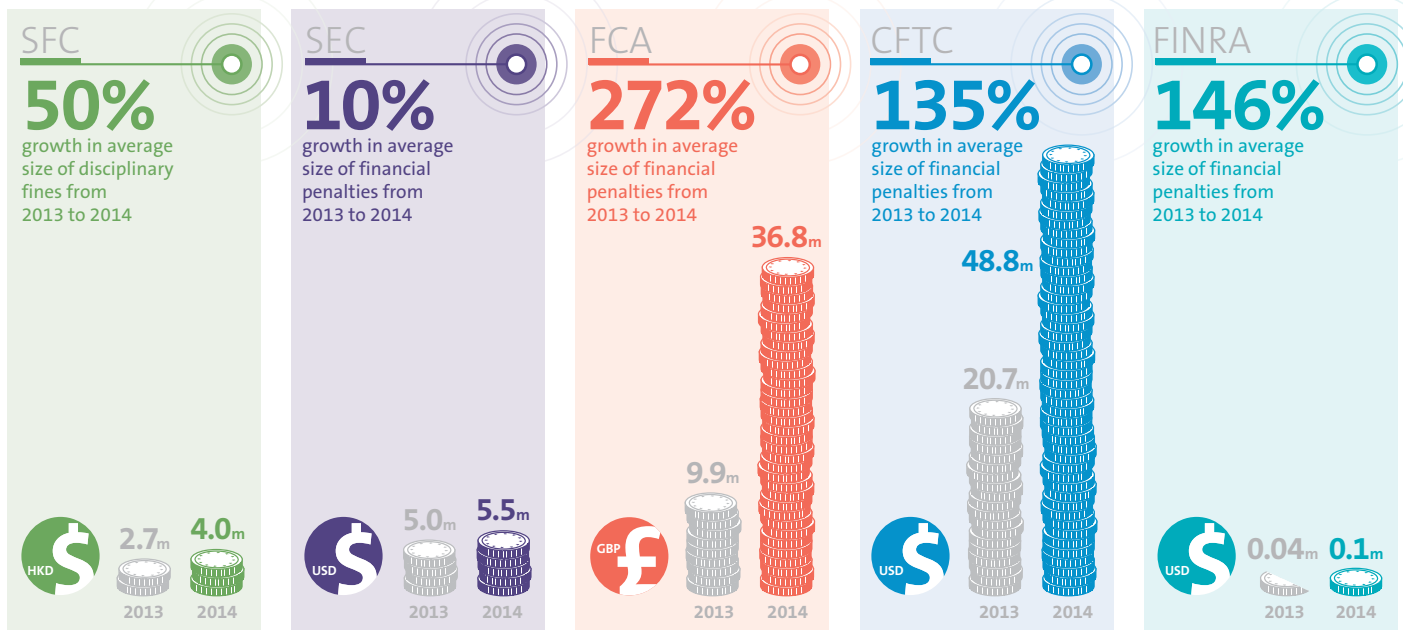


Figure B – Increase in average financial penalty size, 2013-2014



Sources: Freshfields Bruckhaus Deringer, "Enforcement trends in Hong Kong," 2013 and 2014

SEC Press Release, "SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases" 16 October 2014

Year-by-year Monetary Sanctions in SEC Enforcement Actions

FCA Fines Table, 2013 and 2014

FCA and FSA Annual Reports, 2008/09-2013/14

CFTC Summary of Performance and Financial Information, Fiscal Years 2009-2014

Sutherland Asbill & Brennan LLP, Press Release, "Annual Sutherland Analysis of FINRA Sanctions Reveals Blockbuster Year in Fines for FINRA, but Decrease in the Number of Cases." 19 February 2015

FINRA Year in Review and Annual Financial Reports, 2009-2013



INSIGHT: DISTRACTED BY THE BIG ISSUES?



Monique Melis
Managing Director
Global Head of Regulatory Consulting
e: monique.melis@kinetic-partners.com

Headline figures and regulatory enforcement efforts have both been dominated by the FX and Libor rate scandals over the past two years. The massive fines that resulted are the biggest financial settlements in UK history, setting a precedent and a tone with regards to how the regulator approaches these issues.

That is not surprising. The rigging of these markets directly undermined confidence in the UK as a trading hub, as well as impacting thousands of consumers and commercial customers. With such high stakes, the FCA could hardly be expected to walk away.

However, it does inevitably mean that other areas have received less attention. For all the talk of “zero tolerance” and “broken windows” policies at the likes of the FCA and SEC, regulators have finite resources, as our analysis in GER shows, and have had to prioritise. Some cases that may have resulted in enforcement action in previous years have undoubtedly been dealt with differently as a consequence of the preoccupation with these big cases.

The real question is how those being regulated choose to apply their resources. The temptation to focus where regulatory activity is greatest and enforcement most

severe is not entirely misguided; it is unlikely we’ve seen the last actions around FX and Libor rigging – nor those relating to mortgage-backed securities, which accounted for the biggest US settlements in history in 2013 and 2014.

Nevertheless, we should hope at least that these are historic failings. For firms, the challenge now is to ensure that learning the lessons of the past does not distract from identifying the problems and dangers they face in the future. That will also be central to the restoration of the industry’s reputation.



INSIGHT: SMALL FIRMS' COMPLIANCE CHALLENGE



Edwin Lowe
Director
Regulatory Consulting
e: edwin.lowe@kinetic-partners.com



Ronald Pong
Senior Associate
Compliance Consulting
e: ronald.pong@kinetic-partners.com

Regulatory enforcement action impacts firms' businesses far beyond the dollar value of the penalty itself. There have been cases where public reprimand, or even news of an impending regulatory investigation, was followed by a swift outflow of investor capital and catastrophic outcomes.

The impact of enforcement and reputational risk varies for different firms, with disproportionate impact to smaller firms. Bigger firms tend to better manage such risks as they have more resources and a "compliance mindset," viewing compliance as a necessary and integral part of doing business. Their established brand and market goodwill can also buffer the risk of capital withdrawals. Smaller firms, alternately, often lack robust and cost-effective compliance systems.

Asian financial institutions with investors from Europe or North America should note that such investors are relatively more sensitive to regulatory compliance, and enforcement and reputational risk is a key consideration in their investment decisions.

In Hong Kong, SFC CEO Ashley Alder has stated that helping smaller firms adapt to the complex environment is a priority of the regulator.²¹ In the SFC's view, the focus on senior management oversight has helped facilitate this. It is felt that pursuing cases involving failures of internal controls and responsible officers will help pave the way for the necessary cultural changes that reinforce compliance and governance frameworks.

The Hong Kong Monetary Authority's (HKMA) focus on anti-money laundering (AML) is similarly putting compliance risk at the forefront of decision making at financial

institutions. With the HKMA expecting to take more disciplinary and prosecution actions for AML violations as well as issue more fines, banks are carefully evaluating customers and in some cases turning down business for fear of violating AML laws.

Given the growing expectation for firms to have robust corporate governance and considering that the adverse consequences are greater than small firms can bear, such companies should be willing to devote adequate resources to compliance from the outset. In this regard, the smaller firms have a greater opportunity to demonstrate to investors their commitment to risk awareness, subsequently differentiating them from competitors.

Investing in robust compliance controls and infrastructure can be a key growth enabler and marketing tool, even at the early stage of building the business.



Walking softly and carrying a big stick

The seemingly conflicting trends of rising fines but a decreasing number of cases are not necessarily at odds with one another. In fact, the aforementioned swelling of pecuniary penalties arguably makes more sense in that context. Given the potential for stretched resources in the wake of a slowdown in regulatory spending (see **Figure A**, page 7), fewer but higher fines may seem to offer regulators the most efficient route to achieving a credible deterrence.

Speaking relatively, a smaller population of the industry is subject to action from the regulator, but those that are face significant consequences for breaches.

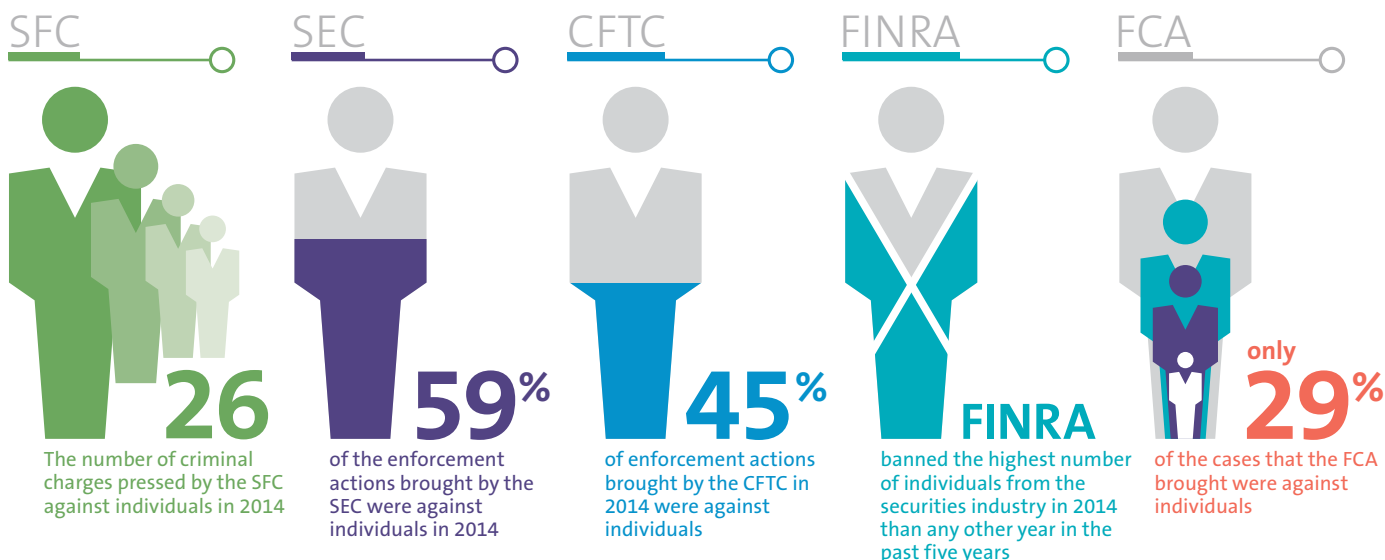
Actions against individual bad actors, as opposed to firms, are also likely to play an integral role, and have already formed a significant proportion of all enforcement actions in the last year. As illustrated in **Figure C** (below), this included 59% of SEC cases and 45% of the CFTC's. The SFC, meanwhile, pressed criminal charges against 26 individuals, and FINRA banned a higher number of individuals from the securities industry than in any year in the past five (481, up from 429 in 2013 and 294 in 2012).

The exception was the FCA: less than 30% of cases were against individuals. This partly reflects cultural differences and regulatory efforts in the UK to disperse responsibilities in firms' governance structures to avoid a concentration of power.

However, as with the move towards higher fines, the trend towards more individual accountability will ultimately be felt across jurisdictions. January of 2015 saw the first (but probably not the last) individuals fined by the FCA in relation to Libor rate-rigging, and March 2016 will see the new Senior Managers Regime come into force in the UK which will seek to create greater accountability at firms.

For the time being at least, the costs – both financially and otherwise – of failing to meet regulators' standards are only going to grow.

Figure C – Focus on individuals in 2014



Sources: SFC Annual Report, 2013/14 / Select SEC and Market Data, Fiscal 2014 / CFTC Enforcement Actions, 2014 / Madison Marriage, "Finra gets tough in 'high-risk broker' crackdown," Financial Times, 8 February 2015 / FCA Table of Fines, 2014



INSIGHT: GETTING PERSONAL



Claire Simm
Director
Regulatory Consulting
e: claire.simm@kinetic-partners.com



Nick Inman
Director
Regulatory Consulting
e: nicolas.inman@kinetic-partners.com

It is difficult to fault the logic behind the drive to penalise individuals. It is an undeniably powerful deterrent and, unlike penalties imposed on the firm, cannot be written off as a cost of doing business or simply passed onto shareholders or ultimately clients.

Well-intentioned committee structures with shared responsibility and mutual challenges can at times also have the adverse effect where individuals are no longer accountable. Clearly, balance is needed and this may come with clear role and responsibility mapping. Where there is the prospect for an individual being held responsible for failings, there is usually a strong voice calling for enough resources to ensure such an adverse result doesn't occur.

The FCA has recognised the public desire to hold individuals to account and has said it is serious about doing so²² as evidenced by the growing number of individuals in

the UK that have been fined over the past few years. Although in 2012/13 the FCA's predecessor the FSA took more actions against individuals than against firms compared with the FCA to date, with the growing use of attestations and the forthcoming Senior Manager's Regime, we can expect this to change. Nevertheless, the disparity with the response of the SEC in the US is striking.

Some of that is probably down to Byzantine business structures, in many cases made even more complicated by years of corporate restructuring and regeneration. A spider web of committees, matrix management and reporting lines across jurisdictions can make it impossible to hold any individual responsible. The US also enjoys the benefit of tools such as a well-established system of plea bargaining. Plans to establish similar arrangements in the UK have been mooted for years, but with limited success.

Much of this apparent disparity between the tools available to the regulators on opposite sides of the Atlantic is now being addressed. This is happening either through increased regulatory scope - for instance the additional benchmarks now under regulation or the inclusion of intent and orders in MAR; the introduction of the senior managers' regime; the programme of attestation; or even new protections for whistleblowers. In time, these should mean even further increases in the number of actions taken against individuals in the UK.

There is a risk, however, that senior individuals in the UK are being deterred from holding Controlled Functions, which is presenting a new challenge for firms. Only time will tell as to the real impact upon the shareholder, the industry and the regulatory landscape.

Fostering cultural change

According to Kinetic Partners' Global Regulatory Outlook 2015 report, 53% of executives polled from the financial services industry said culture of the company was the most important thing to get right to avoid significant regulatory problems (such as enforcement).²³ Here are a few suggestions that firms can seek to implement to help change firm culture and in turn support profitable growth.

01

Set a tone from the top

Ensure that compliance risks are understood and have a place in the Boardroom, that compliance objectives are forward-looking and that compliance values are embedded in top-level business strategy. These elements are all essential for conveying the gravitas of regulatory risk to the rest of the firm.

02

Reward examples of best practice

Ensure staff members are held accountable for non-compliance, but it is also important to incentivise those who are doing it right. Setting the right culture depends on highlighting good ethics and conduct risk across regulatory jurisdictions.

03

Recruit strong leadership

Ensure compliance personnel have an ability to lead and project a voice with front office staff. This should be a key criterion for building and recruiting senior management in compliance functions.

04

Train staff at all levels

Ensure that everyone at the firm, including senior front office staff, receives in-depth and regular training on compliance issues and procedures, any regulatory changes and what they mean in practice.

22 Tracey McDermott (speech), "Enforcement and Credible Deterrence in the FCA", 18 June 2013

23 Kinetic Partners, Global Regulatory Outlook 2015

PRIORITIES AND COOPERATION

Regulators having shared goals has given scope for significant cross-border cooperation that has seen some high-profile successes in the past year. Nevertheless, differences remain that limit the global harmonisation firms expect.

It is not just a trend towards higher penalties that unites the major financial regulators when it comes to enforcement actions: many of their targets are also the same.

Market abuse and customer protection are the most obvious examples of this, as these areas continue to be priorities for many agencies. In October 2014, for instance, the SEC brought its first enforcement action for market manipulation through high-frequency trading,²⁴ following the FCA the previous year.²⁵

At the SEC, the number of insider trading cases rose 18% in 2013/14 (with 52 enforcement actions) on the previous year, while market manipulation accounted

for another 63. In Hong Kong, market manipulation and insider dealing were the second and third most cited breaches.

The FCA, too, has focused on similar topics. Violations related to market integrity²⁶ cases together accounted for 84% of the fines the regulator issued during the year by value, a pattern which is likely to continue. According to research conducted by the FT, the number of STRs sent to the FCA to flag up possible market abuse soared by 24% from 2013 to 2014.²⁷

A similar story is found at the CFTC, where market manipulation cases (15) trailed only supervision and compliance cases (16) as the most common cause

of action. Meanwhile, the number of customer protection cases (8) was small, but included the second-highest financial penalty that year and accounted for 41% of the total value of fines in 2014.

Given recent high-profile cases, firms should expect to see the focus on these areas to continue and increase. Rigorous attention to maintaining and developing robust controls at the firm level will prove to be critical defensive measures that firms can take. Doing so includes fostering strong cultures of compliance, investing in technology and recruiting skilled, experienced employees.

24 SEC Press Release, "SEC Charges New York-Based High Frequency Trading Firm With Fraudulent Trading to Manipulate Closing Prices," 16 Oct 2014.

25 FCA Press Release, "FCA fines US based oil trader US\$903K for market manipulation," 22 July 2013. The FCA fined Michael Coscia for deliberate manipulation of commodities markets.

26 This category was defined by Kinetic Partners' own designations based on the nature of the offence and the mechanisms inherent to the breach. Other groupings included consumer protection, compliance failure and fraud/deliberate misconduct.

27 Caroline Binham, "FCA inundated with claims of possible market abuse." *Financial Times*, 22 March 2014.



INSIGHT: A NOTE FROM JERSEY



Malin Nilsson
Director
Regulatory Consulting
e: malin.nilsson@kinetic-partners.com

The Channel Islands' status as a centre for offshore structures means that regulations are inevitably more focused on anti-money laundering and governance than market abuse due to the nature of firms and activities conducted in the jurisdiction.

Nevertheless, the pressure for international conformity is evident. The IMF's 2008 assessment of Jersey's financial regulatory

standards highlighted that the Jersey Financial Services Commission (JFSC) had no ability to fine regulated firms for breaches of AML regulations. In 2015, new powers came into force enabling the JFSC to impose civil financial penalties for contraventions of the regulator's Codes of Practice and the AML Handbook. The civil penalties do not currently extend to fining individuals.

We have not seen the end of AML compliance sanctions for global enforcement yet. There is a clear need for all companies, including Jersey structures, to look into their systems and controls in order to ensure that they probe and investigate (and document such enquiries) when they identify something that they are not comfortable with. This may protect firms, not only during a Jersey-led investigation, but also from, for example, the long arm of the US probing into any structure from a sanctions and US perspective.

Firms would be advised to look at the wider remit of global AML requirements and move away from just local contractual obligations. The world is larger than we all thought.

Figure D – Market integrity and abuse as a focus globally



In the UK, the biggest enforcement actions were related to FX manipulation, resulting in the largest settlements in UK history



In Hong Kong, market manipulation and insider dealing were the second- and third-most cited breaches, respectively, for investigations by the SFC in FY 2014



Manipulation was the second most-cited offence in CFTC enforcement cases in 2014



In the US the SEC brought 18% more insider trading actions in 2014 than in the previous year



At the FCA, STRs sent to the watchdog soared by 24% in 2014 from the previous year



Sources: SFC Annual Report, 2013/14 / Year-by-year SEC Enforcement Statistics / CFTC Enforcement Actions, 2014

INSIGHT: SINGAPORE - EXCITING MARKET POTENTIAL, UNIQUE REGULATORY MODEL



AnnMarie Crowell
Managing Director
Compliance Consulting
e: annmarie.crowell@kinetic-partners.com



Sin Yee Koh
Director
Compliance Consulting
e: sinyee.koh@kinetic-partners.com

Singapore is increasingly becoming attractive to investors and financial intermediaries as the financial services hub of Southeast Asia and beyond.

Singapore's efficient business environment, infrastructure and open trade policy has led to particularly rapid growth in insurance, private banking, transaction banking and FICC and OTC derivatives markets. Rules and regulations have proportionately evolved to cater to Singapore's new financial services growth in a facilitative and sustainable manner.

Firms expanding in Singapore may be keen to understand some unique aspects of Singapore's regulatory model: first, unlike many jurisdictions such as the US, UK and Hong Kong, where separate agencies oversee the safety and soundness of different types of financial institutions, effective functioning of capital markets and consumer protection, Singapore has a single regulator with a uniquely wide mandate.

Under the same roof, the responsibilities of the Monetary Authority of Singapore (MAS) include central banking, financial surveillance and integrated supervision of all financial institutions. Additionally, MAS has a developmental focus on building Singapore as an international financial centre. MAS focuses on ensuring balanced regulation that is sound, robust and supporting the creation of a competitive and vibrant financial centre.

In rule-making, MAS tends to eschew one-size-fits-all, preferring to be consultative as it seeks to achieve clearly articulated outcomes with minimal compliance burden to firms.

In terms of regulatory tools, MAS relies heavily on frequent and in-depth ongoing supervision based on the circumstances of and risks presented by each institution, complemented by ongoing surveillance and stress testing. MAS has so far taken relatively few high-profile enforcement actions and has not levied large fines. However, in May 2015 MAS levied civil penalties totaling S\$11.8 million against two individuals in an insider trading case, the highest amount under the civil penalty regime to-date, and reiterated that it will spare no effort in investigating possible market misconduct transgressions.

As Singapore implements global best practices and regulatory standards, the financial services regulatory framework in Singapore is getting more complex. Firms which are able to develop robust controls and instil strong compliance cultures will now be positioned to anticipate and respond to MAS developments in the pipeline, such as AML, KYC and customer due diligence initiatives. The ability to navigate Singapore's regulations sensitively will be essential to attaining business success.

Common ground

In conjunction with enhanced scrutiny into market integrity and abuse in the major financial centres, the industry can also expect to see increased regulatory collaboration across jurisdictions to investigate and prosecute such activities. Greater coordination globally is driven by the regulators' shared priorities of preventing and deterring harmful market behaviour and has, in any case, already been a consistent feature of the post-crisis regulatory landscape.²⁸

With the growing globalisation of firms, the continued IT challenges facing the industry and regulators' commonality in goals, regulators will find more ways to cooperate with one another.

Prosecutorial and regulatory bodies from around the world have demonstrated a willingness and commitment to sharing information with one another throughout investigations. This collaborative approach proved to be an invaluable asset in pursuing recent complex multi-jurisdictional cases and has become one of the most powerful tools in the regulatory enforcement arsenal.

The 2013/14 financial year saw a number of actions, particularly around Libor rigging, relying on coordination between regulators in the US, UK, Europe and other regions.²⁹

This has continued since then, with historic fines relating to FX rigging coming down later in 2014.³⁰ Deutsche Bank, too, received a record fine in April 2015, with the FCA, CFTC, US Department of Justice and the New York Department of Financial Services announcing related fines on the same day.³¹ Hundreds of formal requests for assistance were also sent between the SEC, FCA and SFC in 2013/14.³¹



Collaboration is further driven by industry collectives such as the Cross-Border Regulation Forum (CBRF) and International Organisation of Securities Commissions (IOSCO). Tools such as deference and passporting have enabled IOSCO's Task Force on Cross-Border Regulation to foster agreements to share data held in nations' trade repositories.

That trend extends to other regions, too: witness, for instance, the recent Memorandum of Understanding between the SFC and European Securities and Markets Authority (ESMA) on central counterparties.

**Different strokes...
There are, however, limits.**

While common priorities between regulators can be identified, so too can differences. The concentration of SEC enforcement cases points to a regulator where administrative failings, such as filings or registration-related breaches, remain a key focus. Scrutiny on broker dealers was yet another target area for the SEC in 2014, with cases against them up by 37%.³³

Intermediary misconduct accounted for the bulk of the enforcement actions at the SFC in 2014, meanwhile, with that regulator also particularly focused on enhancing anti-money laundering controls.³⁴ Firms are therefore exposed to not just regulators' shared priorities, namely market conduct issues, but the particular bugbears of individual regulators in the geographies in which they operate.

Such differences are unsurprising. For start, legislation continues to be less harmonised globally than many would hope – there are important differences between Dodd Frank's Title VII and EMIR and MiFID 2, for example. Even within the European Union, the discretion given to countries in implementing European directives means consistency is difficult to achieve.

According to Kinetic Partners' recent survey of nearly 300 financial services professionals from around the world, 25% of senior respondents said that single global regulatory standards was the most important factor in maintaining an effective regulatory system for the industry.³⁵ Despite such calls for continuity, those firms with international operations should not be too hopeful for a consistent regulatory framework emerging any time soon.

In the meantime, firms should conduct regular risk assessments of their global operations in each jurisdiction, beyond simply ensuring compliance. Performing tests or due diligence on existing compliance infrastructure in the regions where business is done serves as a litmus test for where international regulatory risk is most prevalent.

But the differences also reflect that the markets and their needs remain very different, too – whether in terms of the local traded instruments, culture or maturity.

The approach of different regulators will continue to reflect this, even as cross-border cooperation increases. In this respect, firms should also recognise that too much uniformity between regulators is not only unrealistic, it would also be unwelcome.

“Cross-border collaboration has become one of the most powerful tools in the regulatory enforcement arsenal.”

Of senior respondents polled,
25%
said that single global regulatory standards was the most important factor in maintaining an effective regulatory system for the industry

Source: Kinetic Partners, Global Regulatory Outlook 2015

28 Reinforcing international cooperation was one of the five main themes of the 2008 G20 Washington Action Plan
29 See, for example, "ICAP Europe Limited fined £14 million for significant failings in relation to LIBOR," FCA, 25 Sep 2013, "The FCA fines Rabobank £105 million for serious LIBOR-related misconduct," FCA 29 Oct 2013
30 "Six banks fined £2.6bn by regulators over forex failings," 12 Nov 2014, BBC
31 The Financial Conduct Authority Press Release, "Deutsche Bank fined £227 million by Financial Conduct Authority for LIBOR and EURIBOR failings and for misleading the regulator," 23 Apr 2015
32 Raj Parker, Michelle Bramley and Chris Morris, Freshfields Bruckhaus Deringer, "Going global: the resolution of cross-border investigations," 4 Aug 2014
These included 1,022 received from overseas regulators by the FCA, 508 requests received by and 717 sent by the SEC, and 107 sent to, and 113 made by, the SFC
33 Year by Year SEC Enforcement Statistics
34 SFC Annual Report, 2013/14
35 Kinetic Partners, Global Regulatory Outlook 2015

INSIGHT: OVERSIGHT LIABILITY IN VALUATION FUNCTIONS



David Larsen
Managing Director
Portfolio Valuation Services
e: david.larsen@duffandphelps.com

Under Dodd-Frank legislation, the SEC continues to increase the rigour of its inspections and related enforcement actions, particularly with respect to funds using alternative investment strategies.

Similar to 2014, the 2015 examination priorities of the SEC's Office of Compliance Inspections and Examinations include a "...particular focus on: (i) leverage, liquidity, and valuation policies and practices..."³⁶

SEC inspections can and do, as appropriate, result in enforcement actions. In many cases these enforcement actions have been directed at individuals responsible for supervising and approving valuation conclusions as well as at individuals responsible for estimating value.

Examples include:

- **Negligence of directors in delivering effective oversight on delegated valuation responsibilities**
- **Intentional misleading of investors by overstating the value of investments**
- **Failure to institute robust internal controls over the Fair Value estimation process**

With the growth of the alternative asset investment industry and the expanded regulatory mandate of the SEC, fund managers must adopt best practice valuation policies and improve the rigour applied in determining fair value conclusions.

While a fund manager cannot abdicate or outsource their valuation responsibilities, many managers are improving the rigour of their valuation process and reviewing their valuation policies through the use of a qualified, experienced, independent valuation adviser. This approach has enhanced many investment advisers' abilities to demonstrate and support compliance to regulators and investors alike.

The message is indeed clear: valuation issues strike at the heart of how the SEC seeks to protect investors. The liability rests on the shoulders of those responsible parties charged with maintaining the integrity of valuation standards, and the Commission has shown it will not hesitate to take action against those people.

INSIGHT: GATEKEEPERS AND FRAUD



Ann Gittleman
Managing Director
Disputes and Investigations
e: ann.gittleman@duffandphelps.com

The financial services industry has made a strong recovery since the 2008 crisis, but regulators are taking extra precautions to protect markets and consumers from misconduct that could lead to future crashes.

Particularly in the US, the SEC has become increasingly more focused on holding gatekeepers accountable and has emphasised imposing stronger penalties on those who fail to satisfy their professional obligations.

Accountants and accounting firms play a crucial role in this regard. With the creation of the Financial Reporting and Audit (FRAud) task force, the SEC has demonstrated a commitment to uncovering faulty financial reporting controls and weak implementation of accounting standards in areas that are traditionally sources of fraudulent activity. The task force is staffed with experts to investigate cases of egregious malpractice.

Historically, pursuing legal action against accounting firms in instances of alleged fraud, such as through an

investor lawsuit, has been difficult to secure successful outcomes, largely due to the litany of defensive case law these firms have protecting them. However, the SEC is now relying on administrative proceedings to investigate and prosecute cases outside of the formal court system as an alternate method for bringing regulatory action against gatekeepers and fraudsters.

There are a number of advantages and disadvantages to this approach, but the Commission has made its objective apparent: fraudulent activity will be a priority on its agenda, and securities firms must have robust policies and procedures in place.

In the event of a breach or possible litigation, being able to defend one's innocence requires in-depth forensic accounting and analysis, often at great cost to the firm. Ensuring compliance and adherence to best practice of both staff as well as third-party auditors is a necessity. Otherwise, it will be the individual stakeholders who will suffer, not just the company.

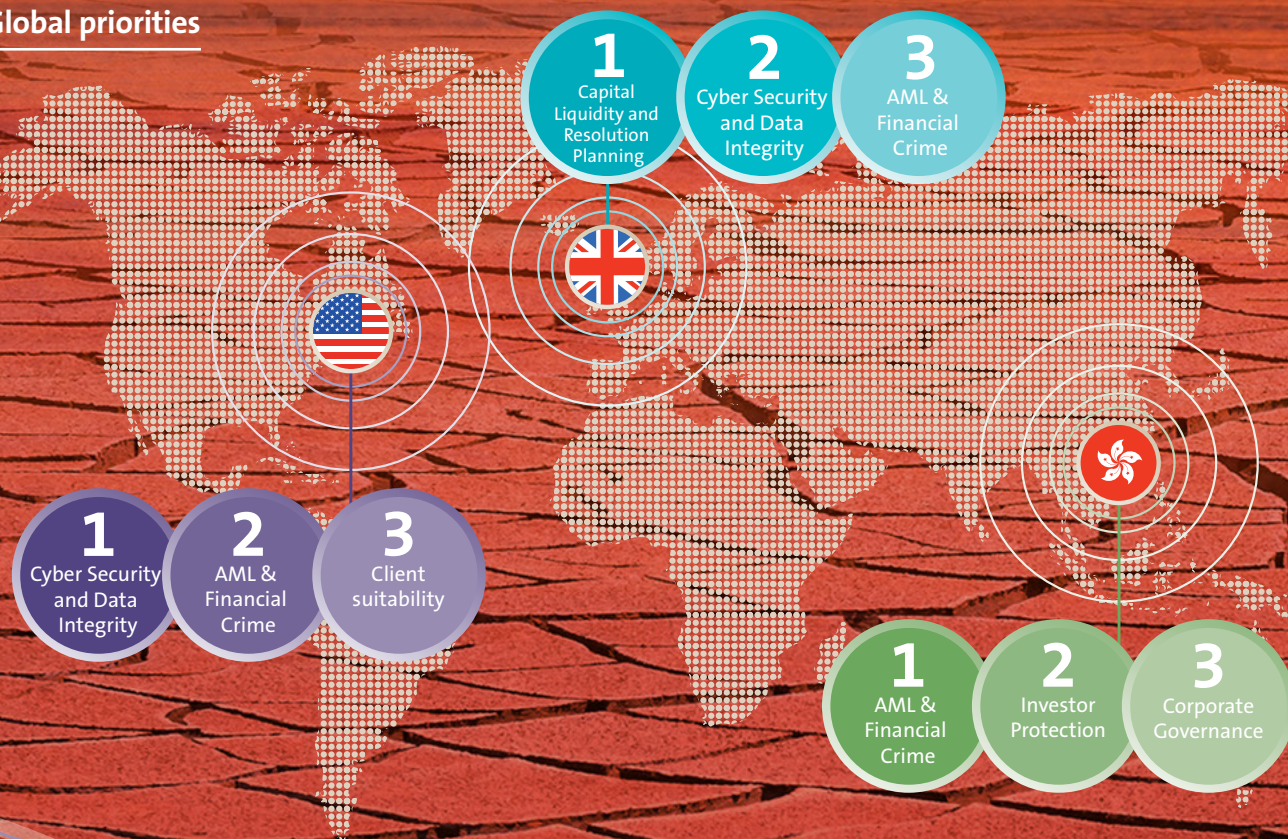
³⁶ The US Securities and Exchange Commission Press Release, "Examination Priorities for 2015," 13 January 2015



Looking ahead: *regulatory focus in 2016*

Firms must understand where they are most exposed to enforcement risk in order to proactively manage it. Looking ahead to 2016 and beyond, Kinetic Partners believes that the following areas will be priorities for regulators across the globe.

Global priorities



A CALL TO ACTION

The picture may be mixed, but the direction of travel is clear. The reliance on technology, international collaboration and high penalties is a logical move for regulators facing constraints on resources, but it is not an approach without risks for the industry.

It was inevitable that the big increases in regulators' expenditures and staffing seen in previous years could not continue indefinitely. However, along with a slowdown in spending this year, there are also signs that regulators have found an approach they believe is sustainable.

It is one largely based on two pillars: technology and heavy penalties. The first – together with international cooperation to share information – enables regulators to more efficiently detect market abuse and other misconduct, on which they increasingly focus. The latter, to which we can also add the increased targeting of individuals, enables them to maintain a credible deterrence while the absolute numbers of enforcement actions remains relatively small.

This makes sense not just in terms of efficiency, but also in light of the risks regulators must manage now and in the future. Investments in technology are essential for the regulators' efforts in such areas. Similarly, high fines and the prospect of individual action do seem effective ways of discouraging bad behaviour and focusing minds.

Regulators' spending may yet increase faster in coming years. However, firms can expect both the trend to higher fines and regulators' reliance on technology to last. That means looking to their own investments in technology to both meet

regulators' expectations in terms of monitoring and demands for data, and to avoid the potential consequences of failing to meet these.

Preparing for the future

The regulators' approach also presents a number of other challenges and dangers.

For the regulator, technology such as cloud computing, big data and analytics can efficiently target and streamline cases. However, regulators will still need to source the expertise to apply this effectively. In doing so, they will be in competition with firms seeking to exploit the new opportunities technology opens up.

The difficulties for regulators in keeping up with such developments may only heighten the trend towards high penalties and the threat of individual sanctions. However, these, too, may prove to have limits – or at least firms should hope that is the case.

When targeting firms, the regulator faces a difficult balance: on the one hand fines can simply become a cost of business passed onto shareholders – a risk that regulators have acknowledged. But regulators also must seek to avoid ramping them up so much that they endanger the stability of large organisations, thereby undermining the regulator's role. However, with smaller firms, there may be this risk from the trend towards high fines.

Targeting individuals avoids this. But there are questions as to its fairness in this respect, given that governance structures have been designed to avoid concentrations of power, and also questions about its effectiveness. Kinetic Partners' previous research shows limited support in the industry for holding executives criminally liable for the actions of employees, for example.³⁷

More practically, there is also a real risk that the targeting of individuals reduces the attractiveness of financial services as a career. Either way, the trend means that firms' ability to attract and retain talent in responsible roles will be central to their success going forward.

It is vital that firms recognise their degree of vulnerability as it relates to enforcement risk and take steps to proactively manage their regulatory burdens beyond mere compliance. Enforcement is no longer something that can be considered a "cost of doing business." Authorities throughout the globe have demonstrated their commitment to penalising securities law violations, and firms must conscientiously adapt to changes as the market and industry evolve.

³⁷ Kinetic Partners, *Global Regulatory Outlook 2015*

41% of executives say it would have a long-term negative impact on the industry, compared to 29% supporting it



41%

of executives say holding executives criminally responsible for employees' actions would harm the industry

Source: Kinetic Partners
Global Regulatory Outlook 2015



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