DUFF & PHELPS

REGULATORY **FOCUS**

A synopsis of the Financial Conduct Authority's (FCA) latest news and publications issued in Q4 2017.

ISSUE 111

The last few months of 2017 were busy for firms that were working hard on MiFID II, therefore this edition is a round-up of regulatory news issued by the FCA and ESMA for the last quarter of 2017.

We hope that 2018 and the transition to the new MiFID II world has been a smooth one for our readers.

Now MiFID II is here, we can look forward to the next European Directive coming our way and the next big project for firms to grapple with. In the two decades since the UK Data Protection Act 1998 was implemented, technology has developed and systematic personal data processing has increased significantly. In addition, because the Act was a Directive, interpretation by Member states was open to discretion and led to inconsistencies. The General Data Protection Regulation (GDPR) will apply from 25 May 2018, in under four months' time, and will supersede the Data Protection Act. It is a directly binding Regulation and is therefore not open to discretion by Member States. The key implications of GDPR are as follows:

- Harmonisation of EU rules
- Enhances the territorial scope of data protection
- Introduces new supporting principles for processing personal data by a controller or processor
- Makes consent harder to obtain
- Strengthens the rights of data subjects
- Increases the direct compliance obligations for data processors
- Introduces accountability rules
- GDPR breaches need to be reported within 72 hours
- Introduces stronger sanctioning powers to supervisory authorities, including larger fines
- A requirement to appoint Data Protection Officers for firms processing personal data on a large scale

Firms will therefore need to make sure that they are compliant with GDPR by 25 May to avoid the possibility of significant fines and reputational damage. If you are seeking advice or support with GDPR, please let us know. Duff & Phelps' GDPR team provides a broad range of GDPR solutions, ranging from a comprehensive and cost-effective GDPR Toolkit for firms to undertake their own impact analysis and implementation of GDPR arrangements, to ad-hoc advice, independent assessments and full implementation support. Aside from GDPR, firms will need to also consider the Senior Management and Certification Regime (SMCR). The FCA published additional consultation papers in December 2017 on SMCR and these provided insight on how the regime will be implemented as well as estimated timeframes. Duff & Phelps published an update on this which can be found here.

Additionally, ESMA and FCA released statements on the temporary relief provided to investment firms regarding Legal Entity Identifiers (LEIs). More details on this can be found in Duff & Phelps' update.

OUR RECENT AWARDS

BEST COMPLIANCE CONSULTING TEAM
Women in Compliance Awards 2017

BEST GLOBAL REGULATORY ADVISORY FIRM
Hedgeweek Global Awards 2017

EUROPEAN SERVICES - BEST CONSULTANCY FIRM 2016
CTA Intelligence

BEST EUROPEAN OVERALL ADVISORY FIRM 2016
HFMWeek

BEST OVERALL ADVISORY FIRM IN THE U.S. 2014*
HFMWeek

BEST ASIAN ADVISORY FIRM FOR REGULATION AND COMPLIANCE 2014*
HFMWeek

BEST EUROPEAN ADVISORY FIRM FOR REGULATION AND COMPLIANCE 2014*
HFMWeek

BEST ADVISORY FIRM REGULATION AND COMPLIANCE 2014
*HFMWeek**

BEST SEC REGISTRATION TEAM - HONG KONG 2014*
Acquisition International

*Awarded to Kinetic Partners, which was acquired by Duff & Phelps in January 2015

Supervision Matters

FCA statement on EU withdrawal

20 December 2017

On 15 December 2017 the European Council agreed that enough progress had been made in Brexit talks to move on to the second phase of negotiations. The negotiations will cover the transition period and the framework for the future relationship between the UK and European Union.

The FCA published a statement on 20 December 2017 on the UK's withdrawal from the EU, welcoming the progress and maintaining its support of open markets, free trade and robust financial regulation.

Passporting

The FCA stated that whilst an implementation period has not yet been agreed on or finalised, firms are likely to continue to be able to passport into EEA states, both during the implementation period and after the point of exit.

The FCA will keep firms updated on these discussions accordingly.

Permissions

The FCA also noted HM Treasury's announcement that the government may legislate for a temporary permissions regime which will permit firms and funds to do the following:

- Conduct new business within the scope of their permissions
- Carry out their contractual rights and obligations
- Manage existing business
- Mitigate risks which could arise from permissions ceasing abruptly

Firms and funds solely regulated by the FCA and wishing to benefit from the temporary regime would need to notify the FCA of this before the UK's withdrawal, however would not be required to apply for authorisation. The FCA advised UK-based firms servicing clients in the EEA to continue preparing for an array of outcomes and discussing the impact of a transition period with the applicable EU regulator.

The FCA confirmed that it would provide more details on its approach to the temporary regime in 2018, maintain its cooperation with home state regulators of EEA firms, review expectations as negotiations progress and keep firms updated accordingly.

Credit Rating Agencies and Trade Repositories

The FCA also noted HM Treasury's announcement that it will provide the FCA with powers and functions in respect of UK and non-UK credit rating agencies and trade repositories.

Finally, the FCA reminded firms that the UK remains a part of the European Union. All firms continue to be subject to and must abide by EU law, whilst continuing to plan for legislation that is yet to come into force.

Full article can be found here.

FCA's approach to authorisation and competition

11 December 2017

The FCA issued a series of documents providing an in-depth explanation of its approach to authorisation and competition. The FCA committed to providing further explanations on its approach to regulation within its 'Mission' document, which sets out the FCA's reasoning, framework for strategic decisions and tools used within its approach.

These publications follow on from the press release and paper on the FCA's approach to consumers (issued in November 2017) and focus on (a) the authorisation process itself, and (b) the FCA's approach to competition.

The purpose of these documents is to create greater transparency around how the FCA regulates and makes decisions. Both provide a reasonably detailed summary of the FCA's approach (for example, at different stages of the authorisation process) and are 28 and 23 pages respectively. The documents are kept refreshingly simple, and provide concrete examples (i.e. applications for authorisation or variation of permission examples) to emphasise points. The document on competition includes (in Annex 2) a list of market studies or reviews conducted by the FCA, flagging the Asset Management Market Study and the Investment and Corporate Banking Market Study.

Both approach documents are open for consultation until 12 March 2018 whilst the FCA collects views on a number of questions about each approach to evaluate its clarity and what else it can be doing. The final approach documents will be published later in the year. This is an opportunity to provide feedback to the FCA on clarity on the 'threshold conditions' and how they deal with applications (all applications, not just authorisations) as well as communication around the FCA's competition powers.

To read the press release, the approach documents or to provide feedback, please click here.

Assessing the value of financial advice

2 December 2017

On 14 November 2017, Megan Butler delivered a speech to The Personal Investment Management and Financial Advice Association (PIMFA), covering the importance of the suitability of advice that financial advisors provide to customers. Megan Butler is a Director of the FCA, with responsibility for the Investment, Wholesale and Specialists Supervision Division.

Ms. Butler spoke about the FCA's 'Assessing Suitability Review', published in May 2017, which found that suitable advice was dispensed in 93.1% of cases in 2015. She referred to this as a *"significant endorsement of the standard of UK financial advice".* However, Ms. Butler noted that this leaves the FCA with the challenge of dealing with the pockets of underperforming advisors that remain within the industry.

Ms. Butler explained that this would be accomplished through a combination of FCA-led work and industry-led initiatives. In addition to its continuing use of market studies, the FCA intends to focus its supervisory work on more risky areas such as high-risk investments and transfers from defined benefit to defined contribution pension schemes. Ms. Butler also cited the importance of whistleblowing and passing on market intelligence to the FCA, for example in relation to pension scams, and discussed industry-led initiatives in relation to the sharing of standardised costs and charges between market participants under MiFID II.

Ms. Butler concluded by summarising the findings and next steps arising from the FCA's Asset Management Market Study, and emphasising the need for the FCA and industry to continue working together to improve outcomes for consumers.

To read the speech in full, please click here.

Julia Hoggett delivers speech on effective compliance with the Market Abuse Regulation - a state of mind

14 November 2017

Julia Hoggett, Director of Market Oversight at the FCA, recently delivered a speech focusing on effective compliance with the Market Abuse Regulations ("MAR") and the market abuse regime more widely.

The overarching themes throughout the speech were of compliance with MAR being "a state of mind" (requiring "critical thinking" from relevant participants) and how the FCA continues to adapt and develop in response to MAR and the market abuse regime. To demonstrate the issues at hand, Ms. Hoggett used the definition of inside information. Describing it as "fluid and situational", she explained that its real-life application requires an air of judgement. As a result, combatting insider dealing does not just involve following a "set of rules", but rather the "vigilance" to identify inside information, the "skill" to make an assessment and the "awareness" of the next steps to take.

As part of the FCA's approach to effective oversight of the markets, focus was given to structural changes within the FCA in respect of the various newly developed departments working on MAR: Listing Transactions, Primary Market Oversight and Secondary Market Oversight. Ms. Hoggett confirmed that the FCA does indeed have a greater focus on the quality of disclosures of listed issuers, whilst acknowledging that the obligations and expectations on them have increased. In an effort to understand within which areas compliance is "most complex", she welcomed open communication from the issuer community. Ms. Hoggett further remarked on the low number of Suspicious Transactions and Order Reports ("STORs") from fixed income and commodity activity, illustrating that equity insider dealing accounts for over 70% of STOR submissions. She reinforced the notion that preventing market abuse is a "multi-asset exercise" and the perception that market abuse only takes place in equities must be "thoroughly broken".

Ms. Hoggett also cast light on the importance of recognising that "financial crime" does not just relate to money laundering and terrorist financing. It has a broad definition which includes market abuse – the two are "inextricably linked". She made clear that, if a firm has a reasonable suspicion that insider dealing has taken place and has raised numerous STORs in relation to a client, then that firm will almost always have established reasonable suspicion that the criminal offence of insider dealing may also have taken place. In such circumstances, a firm must consider its obligations to counter the risk of financial crime through, inter alia, further risk-assessment of its client, enhanced monitoring and perhaps consideration of the termination of that client relationship.

Ms. Hoggett emphasised that preventing market abuse involves adapting and addressing "the culture and understanding of market participants" in relation to what constitutes market abuse and how critical it is to keep our markets clean. The regulator and market participants "share a common interest" and protection from market abuse and manipulation can only be achieved if all parties work together to achieve these collective aims.

In her concluding statements, Ms. Hoggett strongly reminded market participants of the FCA's enforcement powers and stated that abusive conduct "committed in ignorance" will be investigated and treated just as seriously as "deliberate, dishonest conduct". She closed her speech by advocating that trust remains "essential in any society" because it is critical to the reliable functioning and efficacy of markets. Ultimately, it is this "state of mind" which the market abuse regime seeks to uphold.

Full speech can be accessed via this link.

Robo Advice: an FCA perspective

2nd November 2017

On 11 October 2017, Bob Ferguson - Head of Strategy and Competition at the FCA, delivered a speech setting out the FCA's approach to supervising robo advice. This has taken on a heightened focus in recent years due to the FCA's mandate to promote competition and innovation in the financial sector, which led the FCA to establish its 'Advice Unit' to assist robo advisors to comply with FCA rules.

The Advice Unit had assisted 20 firms at the time of the speech, and has provided assistance to firms in clarifying ambiguities in the rules as they apply to the robo advice model. They have also published a document signposting the various rules which are likely to be relevant to firms providing robo advice.

The themes raised in the speech can be summarised as follows:

- The FCA views automated advice as an important element of the financial advice market, helping to bridge the gap for those consumers who are underserved by current advice models, as well as promoting competition
- The FCA encourages firms developing automated advice models to make use of its Advice Unit, which continues to provide regulatory feedback and tools to such firms
- While the FCA notes that new risks can be created by using automated advice models, they also state that well-designed models have the potential to benefit investors and to reduce some of the risks associated with traditional advice models
- The FCA will actively supervise this market, and intends to undertake assessments of some of the distributors who are active in the investment sector. From an authorisation perspective they will also rigorously assess new entrants into the market and will critically assess the client journey and robo advisory models being developed by firms

The FCA is focusing its attention on the outcomes that the automated models and their algorithms generate. The FCA will evaluate the suitability of advice given to consumers and take action where they see risk of harm. Click here to read the speech in full.

Enforcement Matters

Andrew Bailey speech on Free Trade in Financial Services matters

29 September 2017

On 29 September 2017, the Chief Executive of the FCA (Andrew Bailey), delivered a speech at the Official Monetary and Financial Institutions Forum covering free trade in financial services.

The speech reflected on historic and current financial events to understand the impact these play on free trade and open markets and whether the two can exist on an even foundation, particularly in a post-Brexit environment. The speech highlighted lessons which could be learnt from examples such as repeal of the corn laws, the Bretton Woods conference and GATT, with a focus on free trade and the role played by trading blocs and the concept of the 'most favoured nation principle'. Mr. Bailey then moved onto regulatory co-operation and regulation (including Basel) when considering the concept of trade in financial services and open markets.

Mr. Bailey referred to the global financial crisis as a learning point for the potential risk for disruption to financial services following withdrawal from the EU, noting that 'cliff-edge' risks have the potential to create instability in the immediate term. In the longer term, we need to consider our relationship with the EU and how that might look.

Mr. Bailey considered that if we are to continue to promote open and innovative financial markets then firms should be able to do so under the new relationship, regardless of where they are based. This should be a seamless process which avoids any interruption in the supply of services, but to achieve that, common regulatory standards are necessary and active cooperation between authorities is essential.

To read a full transcript of the speech please click here.

Defendants sentenced in FCA prosecution of £1.4 million investment scheme

20 December 2017

Four individuals implicated in the operation of a fraudulent investment scheme were sentenced on the 20 December 2017 at Southwark Crown Court.

Between 2009 and 2014, the four individuals played significant roles in purposefully misleading investors to believe that they were buying shares in a valuable investee company. They engaged vulnerable investors and used unfair and biased material to inflate both the value of the company and the potential profits to be gained. In reality, the shares in the company were worthless.

The prison sentences averaged 15 months for the individuals. Two of the defendants are already serving sentences in connection with a separate investment scheme and their total sentences will be over 7 and 8 years respectively. Initially, one of the individuals set out to reimburse the losses of the investors and thus his sentence was put on hold. However, he will now be sentenced in late January 2018, since this offer was subsequently withdrawn. The FCA plans to return the losses to the investors by way of confiscating any benefit the defendants enjoyed as a result of their criminal actions. Three of the individuals have been banned from being directors for a significant number of years.

The director of Enforcement and Market Oversight at the FCA said: "The perpetrators of this scheme repeatedly misled investors for their own gain. The FCA is committed to ensuring that the operators of unauthorised investment schemes are brought to justice and are accountable for their misconduct."

Full article can be found here.

FCA stops unlawful foreign exchange investment scheme

19 December 2017

A number of persons implicated in an unauthorised foreign exchange scheme have been prosecuted by the High Court.

Between December 2014 and November 2015, the unauthorised company took at least £1.2 million from 65 investors under the pretense of operating a managed foreign exchange trading facility, but none of this money was ever used in foreign exchange trading or in any other investment.

The unauthorised company and others implicated in the contravention are now required to pay £1,230,298.41 to investors who have suffered losses as a result of this scheme. However, it remains unclear as to whether the company has enough assets to offer full compensation and the Court has issued a freezing injunction to aid the process of recovering any possible funds.

Full article can be found here.

AIM Investment Company fined for failing to disclose inside information as soon as possible

14 December 2017

An AIM listed investment company whose shares were traded on AIM between March 2006 and December 2017, has been fined £70,000 for failing to inform the market of inside information as soon as possible. This conduct was found to have breached Article 17(1) of the Market Abuse Regulation (MAR).

The breach relates to the investment company's holding of shares in a company, and the acquisition of these shares by a third party. On 12 July 2016, the investment company was made aware of the compulsory acquisition of the shares. The shares in question were acquired for no initial consideration under a Share Purchase Agreement (SPA), with any potential deferred consideration being of a significantly lower value than the value of the shares at the time.

The news received by the investment company regarding the acquisition constituted inside information. Under MAR, inside information must be disclosed to the market as soon as possible. The investment company's failure to disclose led to market speculation about the amount paid for the shares. This in turn lead to the investment company's share price increasing 38% over 22 and 23 August 2016. The London Stock Exchange queried the sudden rise, at which time the investment company stated that it held no inside information and had not sold its shares, apparently based on a misunderstanding of the legal effect of the SPA.

Having obtained clarification from its legal advisors, the investment company subsequently made an announcement on 24 August 2016 which confirmed that it had indeed sold the relevant shares for no initial consideration and that it was unable to assess the value of any potential future consideration. The investment company breached Article 17(1) of MAR because it did not release an announcement disclosing the inside information as soon as possible after receiving it on 12 July 2016.

The investment company notified the FCA of its breach and co-operated fully with the investigation. The investment company agreed to settle at an early stage and qualified for a 30% discount as a result. The fine would have been £100,000 without this discount.

Full article can be found here.

FCA issues public censure in relation to fund operator

10 November 2017

The FCA announced that a fund operator had been publicly censured and will pay up to £66 million to investors who suffered loss because of investing in a Guaranteed Low Risk Income Fund, ("The Fund"), which is now in liquidation. The payment will be supported by the Firm's ultimate parent company and will be made via the FCA.

The Fund started in March 2009 and was an unregulated collective investment scheme. It provided short term bridging finance to commercial operations in the UK property market. The Firm was the operator of the fund until 25 September 2009, until it resigned. The Fund went into liquidation on 3 December 2012.

Serious issues arose during the Firm's time as operator and the FCA found that it had breached 2 and 7 of the FCA's Principles for Businesses, because it did not:

- Conduct adequate due diligence on the Fund prior to taking it on
- Fully rectify this failure when it became aware that its processes had been inadequate
- Adequately monitor the Fund throughout most of its time as operator
- Fully inform the replacement operator about the issues which had arisen
- Communicate with the Fund's investors in a way that was fair, clear and not-misleading

It was noted that such failures would normally result in a penalty. However, the FCA realised that the Firm would not have been able to pay up to £66 million to reimburse investors, as well as pay a financial penalty. With this in mind, the FCA instead decided to issue a public censure in relation to the Firm.

The FCA is no longer investigating the Firm but will continue to investigate the operation of the Fund.

Full press release can be found here.

Global mining group fined £27m for breaching Disclosure and Transparency Rules

17 October 2017

The FCA imposed its largest fine to date (£27m) on a UK listed global mining group, for a breach of the disclosure and transparency rules for failings in its financial reporting process relating to the $3.7bn purchase of coal mining assets.

In a press release issued by the FCA on 17 October 2017, the FCA stated that this inaccurate and misleading conduct demonstrated a 'serious lack of judgement'. The issue related to the failure to carry out an impairment test (which would have resulted in recognition of an impairment loss on the value of the assets), when the Firm decided there was a lack of clarity around development of the mines in question. Had the Firm carried out an impairment test then that would have resulted in a material impairment being reported in its 2012 interim financials. However, the impairment was not announced until January 2013 when the Firm wrote off approximately 80% of the value of the investment.

The UK listing regime requires listed companies to adhere to high standards of disclosure and transparency and this unprecedented fine reflects how seriously the FCA takes its overarching strategic objective of ensuring that the markets function fairly and effectively.

To read the press release in full, please click here.

FCA fines and bans husband and wife financial advisors for lack of integrity

12 October 2017

The FCA issued a press release confirming that it has fined and banned from the industry a husband and wife who previously founded an IFA, with a "serious lack of integrity" being cited as the principal driver behind the decision.

The couple were owners of a firm that offered independent financial planning services, which included recommending instruments such as GTEP plans (geared traded endowment policies) to their clients. In May 2011, the persistent mis-selling of these plans resulted in the FCA taking action against the Firm. This involved a financial penalty of £100,000 for breaching Principle 7 (Communications with clients) and Principle 9 (Customers: relationships of trust) of the FCA Principles of Business.

The Financial Ombudsman Service received a number of claims with reference to the mis-selling of GTEPs and the Firm was ultimately placed into bankruptcy. However, as a partnership formed with unlimited liability, the couple remained liable and a Trustee was appointed in late 2011 to assess the value of their assets and liabilities and to determine how much could be paid to creditors.

However, the couple continued to worsen the breaches of integrity as they did not reveal the full scope of their finances to the Trustee in charge of the process. One of the examples, later brought to light, showed that the couple owned an off-shore trust into which payments exceeding £1 million per year were made from an unregulated company.

A total of £2.6 million was paid out to the couple between April 2012 and December 2014 in the form of loans from the company, which in the FCA's view were never intended to be repaid. Furthermore, living expenses, such as an expensive property rented in London and a luxurious lifestyle, were covered by the company for the benefit of the couple. During this period, the couple only paid £200 per month to their creditors.

Despite the above, it was the Financial Services Compensation Scheme that dealt with those customers who were negatively impacted by the couple's investment advice and planning, paying out compensation of over £3.8 million. The FCA has taken a view that the couple's action was intentional and their conduct throughout the process showed a "serious lack of integrity", for which they now face a ban and a further fine.

Full article can be found here.

Other publications

European Commission proposes new prudential regime for MiFiD investment firms

20 December 2017

The European Commission (the "Commission") has proposed a two-track overhaul to simplify prudential requirements for smaller MiFID investment firms ("investment firms"), while keeping larger systemic bank-like investment firms within the same regime as European Banks. This is in response to the EBA's recommendation for a more appropriate prudential regime for investment firms and is in line with its Capital Markets Union ("CMU") initiative. The CMU is the action plan by the Commission to establish the foundation for an integrated capital market in the EU by 2019. However, it seems unlikely that the new regime will be in force much before 2020.

Under the Commission's proposal the majority of EU investment firms would no longer be subject to the Capital Requirements Directive ("CRD") IV's provisions, which were designed predominantly with banks in mind. It is intended that the proposed changes will bring in a more suitable regime which will be better tailored to the nature and risks of investment firms. This will reduce the administrative burden, boost competition and increase investment flow, all of which are priorities of the CMU, whilst not compromising financial stability.

It is proposed that investment firms would be split into three categories, or classes, which would determine which rules would apply. Class 1 firms are the systemic and bank-like investment firms to which CRD IV would continue to apply. The Commission has stated that Class 1 firms are able to underwrite on a firm commitment basis, deal on own account, and have balance sheet assets that exceed €30 billion. These firms will, it proposes, be subject to direct supervision by the European Central Bank ("ECB") under the Single Supervisory Mechanism. This is an interesting point, as it is presumably based on the ECB also being the central banking supervisor of those firms within EU Member States which are not part of the EU's Monitory Union.

The new regime then splits non-bank-like investment firms into two further groups, Class 2 and Class 3. The capital and liquidity requirements for these investment firms will be set in a simpler and more appropriate way. The new regulations are intended to be comprehensive enough to capture the risks faced by these investment firms but will still be flexible enough to cater to various business models.

The concept of Pillar 1 and Pillar 2 (i.e. ICAAP) will remain in most cases, but it is likely that the capital required under Pillar 1 will increase, leaving less to be met through the need for additional capital and liquid assets. Furthermore, some firms will face additional requirements on corporate governance and all will be subject to some form of revised Remuneration Code. The smallest firms, Class 3 firms, will only be subject to MiFID II's Remuneration Code. Class 2 firms, which will account for most firms, will be subject to something like the current CRD IV Remuneration Code, but the bonus cap is not expected to apply to these firms.

Duff and Phelps will shortly announce two events at which these proposed provisions will be explored in greater detail, one at the end of February and a more detailed event in late March. At the March event, we hope to have the main architects of these proposals speaking to us. If you wish to attend these, please either accept the invitation we will be sending or speak direct to us and we will make sure that you are included.

Further information can be found by reading the European Commission's press release here and fact sheet here.

Keynote Address : ESMA viewpoint - Priorities for 2018

16 November 2017

ESMA's Chair, Steven Maijoor, at EFAMA's Investment Management Forum, delivered a speech on 16 November 2017 addressing some of their key regulatory concerns for 2018. The speech was divided into three major topics which we have summarised below.

Cost and charges

In 2017, ESMA published its first findings on the cost and performance transparency of the main vehicles for retail investment such as UCITS, retail AIFs and structured products. The aim of this report was to highlight the importance of transparency, which in turn would establish a more trusted and protected environment for investors. The report measured a three-year period and found that "on average, nearly 30% of the gross fund return was eaten up by ongoing fees, one off charges and inflation".

In light of this, one of ESMA's priorities for 2018 is to deepen the analysis into UCITS funds and ultimately extend the scope of the report to EU AIFs, structures notes and structured deposits. Ultimately, ESMA's aim is to analyse products into which retail investors are likely to place their money.

The Chair also touched on the topic of research and inducements and that the unbundling of dealing commissions should pave the way for increased transparency in terms of costs borne by the investor in comparison to the value-add of the actual research. Additionally, the SEC adopted no-action letters in relation to US broker dealers and sub-advisors that deal with EU portfolio managers and the impact of MiFID II on this area.

The next issue that was covered was the "closet indexing" phenomenon happening in the EU equity fund sector. This is when a fund might stick to an index in terms weighting, industry sector or geography. However, there are two concerns: higher fees and not delivering the service detailed in the offering document. ESMA had published a statement on this issue back in February 2017 and since then National Competent Authorities (NCAs) have carried out work on a domestic scale to address this phenomenon. The Chair highlighted that ESMA is in current conversations with NCAs to understand the outcome of their follow-up work in their respective countries.

He then moved on to the issue of active versus passive funds; primarily highlighting that cost structures differ for these two types of funds with an ultimate impact on investors. Moreover, ESMA still sees fee structures as lacking in transparency and hopes that MiFID II will address this.

Finally, he brought to light the varying performances fee models that exists in the EU. The issue here lies in the fact that some Member States allow a performance fee model that is not permitted in another Member State; thereby creating inconsistent treatment experienced by investors living in different countries. Furthermore, the fee model structures themselves will be reviewed and tested by ESMA in order to ascertain whether they match with the reasonable expectations of a retail investor. ESMA will continue this work into 2018.

Stress Testing

The Chair introduced the concept of "stress testing" as an effective way of measuring the resilience of a fund in light of severe but plausible shocks as well as in the wider supervisory context. ESMA is working on paving a way for "Regulatory stress simulations" in which potential industry risks would be replicated as well as macro-economic shocks.

Money Market Funds Regulation (MMFR) requires MMFs to have the appropriate stress testing processes that would help identify potential risks and changes in the economic environment that would subsequently have a negative impact on the fund. Whilst some guidance already exists in the regulation, ESMA will soon be publishing some technical advice and guidance which should help firms to implement the Regulation. In the future, ESMA will also be working on stress testing practices covering both UCITS and AIFs.

Supervisory convergence work on Brexit

In light of the Brexit vote, the Chair spoke of the relevant considerations for firms as they contemplate moving their place of business from the UK to an EU27 Member State to secure their passporting rights. He highlighted that, whilst Member States may wish to attract those firms, there must be no "regulatory arbitrage" between Member States and the provisions of conducting business in one Member State in comparison to another must not differ. In other words, the EU Member States should apply the same rules in the same way. With this in mind, ESMA has published Level 3 Guidance to aid firms in complying with relevant EU legislation. The fear is, of course, in the rush to attract Financial Service undertakings to their jurisdiction certain 'incentives', such as short-cuts, might be on offer which might compromise Member State obligations in EU law.

Additionally, it was clarified that ESMA recognised the key role that delegation plays in the fund industry. He also goes on to explain that ESMA does not have an issue with this concept; instead, it would like to re-iterate the importance of substantive presence in a Home Member State, the need for sufficient processes in place for effective oversight and the role of the non-EU branches.

Finally, the Chair described the ESMA Supervisory Coordination Network which will be a forum for experts from NCAs who table live cases involving UK entities looking to move to EU 27 in an anonymised manner.

Update to MiFiD II notifications obligation for firms

6 November 2017

The FCA published an update on the notifications obligation for firms under MiFID II, providing additional guidance to its user guide issued earlier in the year. In summary:

- Firms or individuals who trade in commodity derivatives, emission allowances and derivatives on emission allowances could potentially rely on the 'ancillary activity exemption' from authorisation under article 2(1)(j) of MiFID
- The Firms that rely on this exemption from authorisation must notify the FCA annually as the notification lasts for twelve months from the date it was first made
- Firms are not required to notify the FCA if they want to act as a General Clearing Member
- Systematic Internalisers (SI) must monitor their trading levels for the instruments they trade and inform the FCA when they commence, or cease, to be an SI in a particular instrument
- Authorised firms, and certain firms exempt from MiFID II, must notify the FCA when they commence activity as a Direct Electronic Access provider (DEA) and/or undertakes algorithmic trading and, thereafter, when they cease any of these activities
- Firms can make this notification via the 'Electronic Trading Notification' form on Connect

The update also expands on the FCA's Application and Notification Guide published on 13 January 2017 and sets out the procedural requirements for sending notifications relating to trading venues.

To read the update in full, please click here.

ESMA launches key MiFiD II and MAR financial instrument reference database

16 October 2017

ESMA has developed a database, the Financial Instrument Reference Database ("FIRDS"), which enables market participants to identify instruments subject to reporting requirements under MiFID II/MiFIR and the Market Abuse Regulation ("MAR").

Under Article 27 of MiFIR and Article 4 of MAR, trading venues and systematic internalisers are required to submit reference data for financial instruments traded on their platform to their NCA on a daily basis, which in the UK's case is the FCA. The NCA will then provide this data to ESMA who will publish the information via FIRDS.

ESMA launched the first phase of FIRDS in July 2017 by gathering financial instrument reference data from reporting entities. In October 2017, it launched the second phase of FIRDS which provides access to the database itself.

The publication of this data will allow market participants to identify instruments subject to reference data reporting requirements.

The rationale behind FIRDS is to provide certainty to firms on their obligations under MiFID II/MiFIR and MAR. The data is presented in a consistent format, allowing NCAs to more effectively undertake market monitoring by validating the reports they receive and identifying any errors. The reference data includes the characteristics of the financial instrument and will also be used to calculate transparency and liquidity thresholds. The database feeds between ESMA, the NCAs and trading venues in the EU, thereby providing a centralised infrastructure where data can be read in a standardised format.

To access the data, users input specified information into the 'search' criteria of the database, such as the instrument's identification code, the trading venue and the instrument's classification. Search results allow users to access further information in relation to the financial instrument by clicking 'more info'.

ESMA made available an extensive guidance document that provides instructions on reporting, accessing data and downloading files. This guidance can be found here.

ESMA highlights importance of LEI for MiFiDII/MiFiR compliance

9 October 2017

ESMA published a briefing on the Legal Entity Identifier (LEI) code to raise awareness of this important aspect of MiFID II. LEIs are unique codes that serve as unique identifiers of all legal entities, including those participating in financial transactions. Under MiFIR, the requirement to obtain an LEI has been expanded and new entities will now be obligated to obtain an LEI.

Until now, a number of existing EU and worldwide regulations required the use of LEIs (e.g. under EMIR, MAR and CFTC rules) and by the end of January 2017 487,000 LEIs had been registered. However, the previous regulations generally only required regulated entities themselves to obtain an LEI, whereas MiFID II will require most clients of regulated entities to also be in possession of a valid LEI.

This will include clients of investment firms, brokers, CCPs and various other intermediaries and beneficiaries. Additionally, even if these parties are a non-EU entity or are themselves the "non-reporting" counterparty, and until now were not under any obligation to have an LEI, MiFID II now requires them to do so if they wish to carry on trading with MiFID II authorised entities.

The regulation goes on to specify that each legal entity will need to have their own LEI, to the extent that each fund and subsidiary will not be able to rely on or share LEIs with their original fund or parent company.

ESMA's briefing goes onto highlight the role of LEIs in market surveillance and the promotion of transparency. The Global LEI Foundation (GLEIF) website allows users free access to check whether an entity has an LEI, as well as the reference data associated with each entity.

Finally, ESMA has not published or hinted at any exemptions and thus it would be prudent for investment firms to start incorporating LEIs into the client-onboarding processes as well as KYC procedures. Firms should also ensure that all necessary group entities and fund structures have obtained an LEI in order to continue trading.

To view the press release, please click here.

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Compliance Consulting

Ian Manson
Managing Director, Compliance Consulting
ian.manson@duffandphelps.com

Jane Stoakes
Director, Compliance Consulting
jane.stoakes@duffandphelps.com