DUFF & PHELPS

REGULATORY FOCUS

A synopsis of the Financial Conduct Authority's (FCA) latest news and publications issued in July 2016.

ISSUE 98

Markets in Financial Instruments Directive II Implementation Proposals

29 July 2016

The Markets in Financial Instruments Directive II (MiFID II) is due to take effect on 3 January 2018. In preparation for this, the FCA has published its second consultation paper, primarily to set out the proposed changes to the handbook covering the following areas:

- Commodity derivatives
- Supervision (SUP)
- Prudential rules
- Senior Management Arrangements, Systems and Controls (SYSC)
- Remuneration
- Client Assets Sourcebook (CASS)
- Complaint handling (DISP)
- Whistleblowing
- Fees Manual (FEES)

Given that many regulated firms will be affected by MiFID II and outcomes of this consultation paper, the FCA is seeking the industry's views on the proposals and would like feedback by 28 October 2016 (either by using the online response form or by writing to the FCA directly). Its aim is to publish the rules in a Policy Statement in the first half of 2017 after considering feedback received.

The FCA also plans to publish its third consultation paper on MiFID II which will cover changes to the Conduct of Business Sourcebook, product governance and to indicate additional changes to the FCA's Perimeter guidance Manual.

We will be publishing a full regulatory update on the consultation paper which will be circulated. If you would like to review the full consultation paper please click here.

OUR RECENT AWARDS*

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

UCITS FUND ADVISOR OF THE YEAR – IRELAND 2014
Acquisition International

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

Enforcement Actions

Financial Crime Reporting: Feedback on Chapter 6 of CP15/42 and Final Rules

29 July 2016

To assist the FCA in enhancing its current financial crime supervision strategy, an annual financial crime return (REP-CRIM) is to be introduced from the end of December 2016. All firms subject to Money Laundering Regulations ("MLR") will be required to complete this return, via GABRIEL. This will include designated investment firms, investment firms and full permission consumer credit firms, as well as other firms such as banks, building societies, mortgage intermediaries and retail investment intermediaries.

A proportionality rule will be applied and firms that meet the rule will not be required to complete the REP-CRIM return. As per the proportionality rule, investment firms and consumer credit firms with revenue of less than £5 million, as at the last accounting reference date, will not be required to complete the REP-CRIM. However it should be noted that revenue is defined as total revenue and therefore will include income from both regulated and unregulated business and it is not conditional on business being MLR relevant. It is anticipated that a number of our clients will be required to complete this new REP-CRIM report.

The Policy Statement (PS16/19) contains guidance notes about the contents of the REP-CRIM. For example, the return will request information on customer relationships, jurisdictions in which firms operate and whether any of these are high risk jurisdictions, as well as the number of suspicious activity reports which have been made during the period under review. The return will also request information about the systems used by the firm to conduct screening against relevant sanctions lists, as well as confirmation of the number of full time staff holding financial crime roles.

Changes to provisions in the FCA Handbook will take effect from 31 December 2016, with the first returns being for firms that have a 31 December 2016 financial year end. These returns will be due within 60 business days, i.e. by 27 March 2017. It has been proposed that firms which are part of a group may choose to complete either a single report for each regulated firm within the group or complete a group return.

Please click here for further information.

FCA Fines a Firm and Former Director for Client and Insurer Money Failings

13 July 2016

The FCA has fined an insurance firm £2,632,000 for failings in relation to its protection of client and insurer money between June 2005 and December 2013. These failures in the Firm's systems and controls led to an accumulated shortfall of £12.6 million in its client and insurer bank accounts which was undetected for a number of years. In its investigation, the FCA found that the Firm did not comply with CASS rules and Principles 3 (reasonable care to organise and control affairs reasonably and effectively with adequate risk systems) and 10 (adequate protection of client assets).

This non-compliance contributed to the following failings:

- On four separate occasions, the Firm transferred £10.5 million out of its client and insurer accounts to the account of a parent company. It is the FCA's view that the Firm did not properly consider the implications of these transactions which led to an accumulated deficit in excess of £10 million.
- The Firm did not accurately record a transfer of £2.13 million which led to the same transfer being made again fifteen months later leaving a shortfall in the client money account.
- Failure in the Firm's banking practices allowed for interest to accrue on the client money accounts. This, deemed to be the Firm's money, took place for six years and was not identified for a further two. As such, £1.45million of the Firm's own money was held in the client bank accounts.
- Furthermore the Firm breached its agreements with insurers and changed the basis upon which it received commissions from its insurer money bank account causing a deficit of £3.6 million.

The Firm first identified the shortfall in its client money and insurer money bank accounts in May 2013. It took the Firm a further five to six months to rectify the shortfall, despite the CASS rules requiring shortfalls to be made good the day the firm performed its client money calculation. The Firm also failed to notify the FCA of the shortfall. The Firm was cooperative and agreed to settle early on in the investigation; had it not been for this, the fine imposed would have been £3,760,000.

The FCA also fined a former director and client money officer at the Firm £60,000 and banned the individual from having direct responsibility for client and insurer money. On four occasions the individual instructed or approved withdrawals without following proper processes or procedures leading to the shortfall of £10.5 million mentioned above. The individual also failed to identify the risks created by his departure from the client and insurer money process and did not ensure those risks were managed. The FCA found this individual did not meet the minimum regulatory standards in terms of competence and capability and was deemed not fit and proper to conduct the role. As the individual agreed to settle early on in the investigation the fine imposed was reduced from £85,817.97 to £60,000.

For full press release please click here.

The FCA Takes Enforcement Action Against a Jersey Resident for Insider Dealing and Improper Disclosure

15 July 2016

An individual who engaged in market abuse in the form of insider dealing was fined £59,557 by the FCA. The individual has also been publically censured and ordered by the FCA to pay restitution of £2,109, inclusive of interest, to the individuals who suffered financial loss as a result of his actions.

The individual is a Non-Executive Director of an AIM listed business and holds several directorships of private companies. The market abuse took place when the individual, whilst in the possession of inside information, attempted to sell his 8% shareholding in another PLC. The inside information became known to the individual in September 2014 when the CEO of the PLC advised the individual over the telephone that the company had intentions to raise capital via a share placement. This telephone conversation was later followed by an email from the CEO, asking if the individual would be interested in purchasing shares, at what was likely to be a significant reduction on the current share price. Attached to this email was a presentation detailing the company's plans together with a clear statement that the information was likely to be considered inside information. The individual disclosed this inside information to another shareholder who was not an insider, but the other shareholder did not act on the information.

It was not until the individual received a second email from the CEO of the PLC, that he instructed his broker to sell the entire 8% shareholding 'at any price'. The CEO's second email was sent prior to when the placing occured, asking the individual to provide funding with the aim of preventing the share placing proceeding at a considerable discount to the share price.

Within the first hour of the placement being publically disclosed, the share price of the PLC fell from 20.25p to 8p. The FCA considered that it was clear that, once the disclosure was made, it would have had a significant impact on the share price.

The Broker was not able to sell all of the individual shares prior to the announcement. If he had, the individual would have avoided a loss of £242,000. The Broker was, however, able to sell 10,000 out of 1,273,500 of the individual's shares before the announcement took place, saving the individual a loss of £1,900.

Had the information known to the said individual been publically available when the individuals bought the 10,000 shares, they would have done so at lower price and therefore suffered a financial loss.

Mark Steward, Director of Enforcement and Market Oversight at the FCA said that this misconduct demonstrates the abuse of insider trading is still not well understood or appreciated, even by experienced industry professionals. He commented that the individual had done the right thing in acknowledging his wrong-doing and offering to compensate counterparties, who were entitled to be safe from trading with or in the same market as a prohibited insider.

Mr Steward further commented that prohibited insiders, especially market professionals, will be caught and be made to account to those they have misled. While the amounts are small, the principle here is an important one.

The individual received a 15% discount as he cooperated with the FCA's investigation and made admissions in the interview. The individual also received a further 30% discount by agreeing to settle at the earliest opportunity.

Full details can be found on the FCA website here.

Supervision Matters

Global Regulation in the Post-crisis Era

30 June 2016

On 30 June 2016, John Griffith-Jones, Chairman of the FCA, delivered a speech entitled 'Global Regulation in the Post-crisis Era' which addressed the roles the UK financial services industry and the FCA will need to play in light of Brexit.

After speaking of the importance of London as a financial hub, Mr Griffith-Jones emphasised that while planning for the future, focus cannot turn away from ensuring that everything continues to work well in the present. He highlighted that the FCA and the financial services industry, though having different roles to play, should work together with the objective of ensuring that markets continue to work well.

Though individual firms will likely develop their own strategic approach to dealing with Brexit, he emphasised the need for an industry led "collective" view on alternative plans that would allow the UK markets to continue to work well. He continued by saying that the UK financial services industry should be prepared to communicate to the government where the industry's major opportunities and risks lie before the negotiations on the UK's exit from the EU commence. In the meantime, the FCA will continue with its work and advised that firms must remain compliant with their obligations under UK law, including those based on EU legislation. He commented that consumers' rights and protections will remain unchanged unless the government chooses to amend the relevant legislation.

Mr Griffith-Jones commented that no one can anticipate exactly how the regulatory landscape will change. Regardless of what alternative model the country chooses to pursue, he emphasised that the FCA will keep aligned with the direction chosen.

When considering the future of the regulatory landscape, Mr Griffith-Jones stated that what has worked well in the past should not be forgotten. He noted that recent regulatory changes, such as the prudential regulations brought in to end 'too big to fail,' and the conduct regulations around anti-money laundering, were driven at an international level, which was necessary for them to be effective. He continued by saying that the FCA will continue to work with European authorities and that its membership of global bodies such and FSB and IOSCO and its bilateral agreements with other regulators would remain of high importance. He stated that the FCA has learned that there "is no monopoly to wisdom in regulation", which is a view that will likely not change.

Mr Griffith-Jones went on to say that the FCA recognises that the reform agenda will be substantial, but there is a need for "better regulation" rather than "bulkier regulation". Careful thought will be needed to see "how it all fits together". In regards to current FCA rules, he said that there may be cases where there will be a need to review these rules and the current EU pipeline. He commented that the FCA has already begun to think about how it would go about this.

He concluded by saying that there is now the "need for some exceptional teamwork between Government, the industry and the regulators to create a wholesale marketplace for the future that continues to meet the needs of both domestic and global users." For this to work, firms and their leaders will need to ensure that their culture is instilled with the ambition to keep London the premier capital market in the world, which will, without question, mean that the culture must put customers first.

The speech is available here.

Finalised Guidance - FG 16/5 - Outsourcing to the 'Cloud' and Other Third-Party IT Services

7 July 2016

The FCA has finalised its guidance for firms outsourcing to the 'cloud' and other third-party IT services. It considers that the guidance will not only be of interest to firms and service providers but also to:

(a) Third-party IT providers seeking to provide services to financial services firms;

(b) Trade associations and consumer groups;

(c) Law firms and other advisers; and

(d) Auditors of financial services firms.

The guidance is aimed at assisting firms and service providers to understand the FCA's expectations when firms are using, or considering using, the 'cloud' or other third party IT services. The guidance itself is not binding and should not be read in isolation but is intended to illustrate ways in which firms and service providers can comply with the relevant rules under the regulatory system. The FCA suggests that complying with the guidance will generally 'indicate compliance with the FCA outsourcing requirements'. If a firm is however, subject to the rules of the Prudential Regulation Authority ("PRA") then the guidance may be different and firms should confirm their approach with the PRA.

The FCA recognises that innovation can promote effective competition and understands that cloud services are continually evolving. The Regulator aims to support this innovation through regulation as opposed to blocking the benefits and imposing inappropriate barriers to stakeholder's ability to outsource, while at the same time, ensuring that the risks are suitably identified and managed. Through Project Innovate, which was launched in October 2014, the FCA identified areas where the regulatory framework can adapt in order to further innovation.

There is confusion and uncertainty with regards to how the rules apply when outsourcing to the cloud, which the FCA considers may be acting as a barrier to firms and services providers using the cloud.

It recognises that whilst the cloud can provide greater flexibility to firms, it can also introduce further risks that primarily affect the 'degree of control' exercised by the stakeholders. The risks themselves must be 'identified, monitored and mitigated' to enable firms and services providers to achieve the benefits of the cloud.

The FCA makes it clear that where a third party delivers a service on behalf of a regulated firm, such as a cloud provider, this would be considered outsourcing and a firm would therefore need to comply with the relevant regulatory obligations. The requirements that apply to firms will be dependent upon the type of firm together with the type of function that is being outsourced.

Useful checklists are included in the guidance as to what firms should be considering with respect to cloud services.

The FCA differentiates between those functions considered to be 'critical or important', whether the function can be considered 'material outsourcing'. The FCA emphasises that regulated firms cannot delegate any part of their responsibility for the discharging of their regulatory obligations to a third party. The regulated firm retains full responsibility and accountability.

Please click here to read the full guidance.

Guidance on Fund Suspensions

8 July 2016

As a result of the EU referendum, the FCA noted that a number of asset managers were receiving high levels of redemption requests from investors in their funds. Due to this increased demand for redemptions, the FCA published new guidance on fund suspensions.

The guidance covers the following areas:

- Fund managers must act in the best interest of all clients and use all relevant tools available. The types of tools available will depend on the terms of the fund's prospectus and instrument of incorporation;
- Fund managers must ensure that all assets are valued accurately;
- If a fund has to liquidate assets due to redemptions, the fund manager should ensure that the investors who remain in the fund or are to join the fund are not disadvantaged;
- If dealing needs to be suspended the FCA should be notified in advance and care should be taken about when to resume dealing;
- If the fund invests in illiquid or hard-to-value assets then other factors should be considered when determining whether to suspend dealing in the fund.

All fund managers should review this guidance issued by the FCA and bear in mind the points raised by the FCA if it is receiving high levels of redemption requests.

Please click here for the FCA article.

FCA Publishes Annual Report 2015/2016 and Report of its Competition Activities since 2013

12 July 2016

The annual report is a qualitative reflection on the work carried out by the FCA over the course of the past year. It monitors how the FCA is fulfilling its objectives of protecting consumers, enhancing integrity and promoting competition, as well as its overall strategic objective of ensuring the markets work well.

Notable highlights are:

1. The introduction of the Senior Managers and Certification Regime with the aim of strengthening individual accountability;
2. Direction of FCA resources towards influencing policy and technical standards through bodies such as the European Securities and Markets Authority (ESMA) and engaging with regulators globally;
3. Significant progress was made on the implementation of the Market Abuse Regulation (now in force) and MiFID II scheduled to enter into force 3 January 2018;
4. Project Innovate demonstrates FCA's willingness to engage with a wider audience to evolve its approach to financial regulation;
5. The FCA has successfully integrated over 25,000 consumer credit firms into its regulatory remit, bringing the total number of firms regulated to over 56,000;
6. Enforcement has been an area of focus and over the past year:
   a. Fines totalling £884.6m have been imposed on firms and individuals;
   b. 24 individuals were banned from practice; and
   c. Jail sentences totalling 32 years and nine months were handed down to individuals who were prosecuted.

This tough action demonstrates that the FCA protects consumers and polices its rules.

The FCA also published The Competition Report, the first to be published since the FCA gained its competition objective in 2013. Asset managers and wealth managers were included in market studies or calls for input to analyse competition in these sectors. Other areas of focus were pensions and credit cards.

The Chairman of the FCA, John Griffith-Jones, concluded that despite the challenging environment "on the whole, UK markets have worked well" and that "there are some indicators of a positive direction of travel" in relation to issues addressed and progress made by the FCA during the course of the year.

Click here to access the report.

Getting Culture and Conduct Right: the Role of the Regulator

13 July 2016

The Director of Supervision - Retail and Authorisations at the FCA, Jonathan Davidson, in a speech delivered at the 2nd Annual Culture and Conduct Forum for the Financial Services Industry, emphasised the importance of 'getting culture and conduct right' and the role which the regulator will play in achieving this goal. He provided a brief explanation of what is meant by culture, and why it is important, with reference being made to the scandals in the wholesale and retail banking sector. He stated: "If firms don't change the mindsets, then they will run a very significant risk that old habits of behaviour will repeat themselves and we will see poor outcomes for consumers, poor outcomes for firms and individuals with continuing fines and redress costs, and poor outcomes for markets and the industry with continued erosion of trust and reputation and business to overseas markets."

Mr Davidson confirmed that it is not the FCA's belief that one size fit all, stating that: "Imposing one specific model on such a broad range of companies would be a fruitless task." Therefore, firms are expected to adopt a culture and conduct framework having first given consideration to the nature of scales and complexity of its business.

In measuring and monitoring culture and conduct within firms, the FCA has placed the onus on the firm's corporate governance to ensure that an ethical culture is observed by all members of the firm. Mr Davidson detailed four factors which senior management could use to shape their firm's culture:

- The importance of 'tone from the top';
- The need for formal practices to ensure that the right people are employed and succeed;
- The key to effective communication ensuring purpose of strategy is shared;
- Capabilities of an organisation to adapt its skill set to ensure the needs of the customer are addressed.

Mr Davidson quoted a recent enforcement case where three senior executives were banned from performing SIF roles and fined because they put the fair treatment of customers at risk by encouraging a culture that prioritised sales within their firm.

Full details can be found on the FCA website here.

ESMA Advice on Third Country AIFMD Passports

18 July 2016

The European Securities and Markets Authority (ESMA) issued its advice to the European Commission on the extension of the AIFMD passport to Third Country Managers and to Third Country Funds.

The term 'Third Country' refers to jurisdictions which are not members of the EEA, which comprises the 28 EU Member States plus Norway, Liechtenstein and Iceland.

The AIFMD passport is formed of a marketing passport, which permits the marketing of Alternative Investment Funds to investors domiciled in all EEA Member States and a management passport, which permits a manager (fund operator) to manage an Alternative Investment Fund established in another jurisdiction.

ESMA is continuing with its country-by-country assessment approach and has now made a positive recommendation for Canada, Japan, Switzerland, Jersey and Guernsey to be included in the Third Country passporting regime.

A qualified but generally positive opinion has also been given with respect to Hong Kong, Singapore, Australia and the US. In each case, while the advice concludes that "no significant obstacles" exist, it does identify certain issues that are likely to need to be resolved before the Third Country passport can be fully implemented in these jurisdictions.

ESMA did not make a positive recommendation with respect to the Cayman Islands, Bermuda and the Isle of Man. In the latter case, ESMA concludes that the lack of an AIFMD-like regime in the Isle of Man is an obstacle to assessment. In relation to the Cayman Islands and Bermuda, ESMA notes that both are in the process of implementing new regimes and that assessment will not be possible until the final rules are in place. Further assessment of these jurisdictions will therefore be necessary before a positive recommendation can be given.

In terms of the wider process, this means that ESMA has now assessed 12 of the 22 jurisdictions on its official list, and there are 10 further jurisdictions left to assess. The Cayman Islands and Bermuda are also likely to require further assessment. In addition, it now appears likely that United Kingdom will need to be added to this list due to Brexit. The European Commission will now have 3 months to consider whether they do want to proceed with the Third Country passporting regime for AIFMD, and if so, to set a date for implementation.

Please click here for the full article.

DUFF & PHELPS

For more information about our global locations and expertise, visit www.duffandphelps.com

About Duff & Phelps

Duff & Phelps is the premier global valuation and corporate finance advisor with expertise in complex valuation, dispute and legal management consulting, M&A, restructuring, and compliance and regulatory consulting. The firm's more than 2,000 employees serve a diverse range of clients from offices around the world. For more information, visit www.duffandphelps.com.

M&A advisory, capital raising and secondary market advisory services in the United States are provided by Duff & Phelps Securities, LLC. Member FINRA/SIPC. Pagemill Partners is a Division of Duff & Phelps Securities, LLC. M&A advisory and capital raising advisory services are provided in a number of European countries through Duff & Phelps Securities Ltd, UK, which includes branches in Ireland and Germany. Duff & Phelps Securities Ltd, UK, is regulated by the Financial Conduct Authority.

Compliance Consulting

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

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