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In Principle

A Newsletter from Bingham's Financial Regulatory Practice

SPRING 2014

IN THIS ISSUE

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BINGHAM'S UK FINANCIAL REGULATORY PRACTICE

Our team advises UK- and US-based clients on the UK financial services regulatory framework, including investigations and enforcement proceedings, with a particular focus on retail markets. The team also has an active advisory practice. Clients include both regulated institutions and regulators.

Working in collaboration with Bingham's premier global securities practice, we also provide counselling, regulatory compliance and defence services to broker-dealers, investment advisers, investment managers, investment banks, mutual funds, hedge funds and other private investment funds, accounting firms, insurance companies, public companies, and officers and directors.

From the Financial Regulatory Practice

Welcome to the latest edition of *In Principle*, our newsletter focusing on developments in UK financial services regulation.

We are in a period of regulatory consolidation. 2013 was a year when structural change was implemented: the FSA was disbanded, and the Prudential Regulatory Authority ("**PRA**") and the Financial Conduct Authority ("**FCA**") were created. In this issue of *In Principle* we consider the extent to which the creation of the new regulatory bodies constitute real change in the way that financial regulation will be exercised. It appears that there is a real determination in the regulatory community to create a new form of regulation: acting in the interests of consumers rather than the industry; decisive; proactive; and, above all, interventionist.

However, with power comes responsibility, and the regulators will need to work hard and be both prescient and lucky to prevent future failures (be they of institutions, products or ethics) in the financial services industry.

The Financial Services (Banking Reform) Act 2013 (the "**Banking Reform Act**") brings about significant changes to the Approved Persons regime, as it strives to make senior individuals at banks accountable for failings. The Banking Reform Act also gives effect to additional reforms such as ring-fencing of retail banking activities and bail-ins. The Treasury has referred to these changes as "the biggest reforms to the UK banking sector in a generation"[1] and their effect will be monitored with interest.

We have outlined in this issue what we see as the key developments of the past year. We have seen novel approaches to redress, with firms and regulators agreeing on terms and approach rather than matters proceeding through a formal enforcement process. We have seen regulators emphasise the need for cultural change within institutions and the industry. We can expect the regulators (both the PRA and the FCA) to take robust action as there is still public appetite for the financial world to be held to account.

Moving forward, we can expect the regulators to focus on developing rules to give effect to the new legislation and their objectives. We will see the regulators take on new responsibilities (for example, on 1 April 2014 the FCA became the regulator for consumer credit). Firms need to make sure that they are meeting regulatory expectations. This will mean considering not only the existing regulatory framework, but also keeping up with other material such as speeches and enforcement cases so as to be aware of the direction of travel.

Notwithstanding our focus on the new regulatory bodies, we do not forget that the rules that they enforce are increasingly derived from European directives and regulation. Accordingly, we also look ahead to the key developments in European legislation that will mould financial services in the years ahead.

As we see details emerge about the evolving regulatory framework, firms and individuals will need practical and effective advice in dealing with the regulators. If you would like any more information about any aspect of the new regulatory structure, or in relation to any current issue, please contact us.

1 HM Treasury press release 18 December 2013.

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FCA and PRA—The New Regulatory Approach

The overarching strategic objective[1] of the FCA is to "[ensure] *that the relevant markets function well*" supported by three operational objectives:[2]

- to secure an appropriate degree of protection for consumers;
- to protect and enhance the integrity of the UK financial system; and
- to promote effective competition in the interests of consumers.

By contrast, the PRA is intended to promote "*the safety and soundness of deposit-taking firms, insurers and systemically important investment firms*".[3] The PRA is expected to pursue this objective "*primarily by seeking to avoid adverse effects on financial stability, and in particular seeking to minimise adverse effects resulting from disruption to the continuity of financial services that can be caused by the way firms run their business or upon their failure*".[4]

Martin Wheatley, the Chief Executive of the FCA, has made it clear that the FCA will tolerate lower levels of risk and step in earlier and faster when issues are identified. He has said, "*First, and foremost, we need a regulatory structure that is firmly forward looking. That anticipates and tackles issues before they become multi-billion dollar problems…*".[5] He expects the FCA to pursue this goal by scanning markets to see where the issues are, "*…increasingly using thematic reviews and market studies to signpost direction*". Mr Wheatley's view is that "*Rules and check lists are important but they do not guarantee good conduct… the first step for regulators has been to look beyond legal compliance. To exercise judgment more authoritatively*".

The objectives that have been set for the FCA and the standards that it has set itself are ambitious and difficult. The FCA has approached its new task with enthusiasm and a vigour that was sometimes missing in the Financial Services Authority ("**FSA**"). The FCA has been innovative (particularly in its use of industry agreements) and rigorous (as can be seen in its use of its enforcement powers). It appears that the creation of the FCA and the PRA has brought about more than structural change; it has ushered in a real change in the way in which the regulators pursue their responsibilities and engage with industry.

Nevertheless, the FCA faces a daunting task: it has promised to address issues before they become multi-billion pound problems. If the FCA is to do this it will need to intervene aggressively and early (as it has shown a willingness to do). However, so far it has been dealing with a cooperative (and, perhaps still, embarrassed) industry. It will be interesting to observe, as the industry regains its confidence, whether the financial services sector will continue to be cooperative or if it begins to challenge the FCA's new "*judgment-based*" approach and argue that such a large and complex industry requires greater regulatory certainty.

The FCA has made it clear it wants to do more than talk the talk: there has been a noticeable evolution in the regulator's approach to industry issues. The FCA has sought to engage in discussions and negotiations with industry to agree on the terms of "*voluntary*" agreements and redress schemes. These schemes suggest a willingness, on the part of the FCA, to require action from firms without necessarily following a formal "*Handbook-led procedure*". Indeed, the FCA itself considers that the approaches described below are evidence of a "*more proactive, more interventionist, more creative and more judgment-based approach*".[6]

Two of the most high profile recent redress programmes have been those involving interest rate hedging products and protection products sold by Card Protection Plan Limited ("**CPP**"). The position taken by the FCA in relation to these matters illustrates its new "*creative*" and "*judgment-based*" approach.

Interest Rate Hedging Products

In June 2012 the FSA announced that a review of interest rate hedging products had revealed serious failings in the sale of such products to small and medium-sized businesses. The banks involved subsequently agreed to carry out a pilot review of their sales of interest rate hedging products made to customers. The FSA published the key findings of the pilot review in January 2013 and the banks have since agreed to conduct full reviews using the approach set out in the report.

The redress element of the pilot review was criticised by commentators due to its slow start; as at 4 September 2013 the banks had paid out only £500,000 in compensation to businesses who were mis-sold swaps out of a potential bill of £2.5 billion. However, Martin Wheatley said that although the review had taken a long time to put into place, he was confident that it would be an effective scheme: "*With a process like this it was important to get things right and we have worked hard to ensure the scheme deals as fairly with people as possible*".[7]

1 p.12, *Journey to the FCA*—October 2012.

2 p.12, *Journey to the FCA*—October 2012.

3 p.1, *Journey to the FCA*—October 2012.

4 p.7, The Prudential Regulation Authority's approach to banking supervision (http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf).

5 p.7, *Journey to the FCA*—October 2012.

6 Tracey McDermott speech 9 October 2013.

7 *Telegraph*, 4 September 2013 "*FCA swap mis-selling scheme pays out just £500,000 in compensation*".

The New Regulatory Approach *continued from page 1*

The more recent figures on redress payments show significant improvement with £482 million being paid out as at February 2014.[8] It may be too early to assess whether the review can be considered a success or not but the FCA's approach does show the importance it places on achieving a fair outcome for consumers, and its expectation that industry participants will cooperate with it (outside the formal enforcement process) to achieve this.

CPP Redress

On 22 August 2013 the FCA issued a press release[9] announcing that CPP and 13 high street banks and credit card issuers had agreed to take part in a voluntary redress scheme (the "**Scheme**") of up to £1.3 billion to compensate customers who had been mis-sold CPP's Card Protection (the "**Card Protection Policy**") and Identity Protection policies (the "**Identity Protection Policy**" and together, the "**Policies**").

The Scheme came in the wake of enforcement action taken against CPP; in November 2012 the FSA had issued one of its largest retail fines of £10.5 million to CPP for mis-selling Policies. As well as CPP selling the Policies directly to customers, high street banks and credit card issuers introduced customers to CPP; as such, those banks and credit card issuers agreed to be part of the Scheme and provide the money needed to pay redress to customers as part of the efforts to "*put things right*". The Scheme involves around seven million customers, who purchased around 23 million policies and is intended to provide a simple and straightforward mechanism for customers to make a claim for redress.[10] The total redress bill could be up to £1.3 billion.

Martin Wheatley made the following comments about the Scheme:

> "*We have been encouraged that, working closely with the FCA and despite their different business needs, a large number of firms have voluntarily come together to create a redress scheme that will provide a fair outcome for customers. This kind of collaborative and responsible approach is a good example of how firms are taking more responsibility and helping — step by step — to rebuild trust. We believe that this will be a good outcome for customers who may have been mis-sold the card and identity protection policies*".[11]

Clive Adamson, Director of Supervision at the FCA, also said that "*The FCA has worked closely with CPP, the banks and card providers to set up this consumer redress scheme. This is an important example of firms voluntarily coming together to meet our expectation that consumers get a fair deal*".[12]

Conclusion

Each of the examples outlined above demonstrate a willingness on the part of the FCA to engage with industry to negotiate settlement agreements and redress schemes (against the backdrop of possible enforcement action). This does tend to indicate a more "assertive" regulator. However, to date there has been little resistance from an industry that is perhaps still a little embarrassed and less willing than before to fight its corner. It will be interesting to observe whether this cooperative attitude will persist; or will perhaps the FCA—with its new found confidence—be so assertive as to leave industry little choice but to fight back? This may be particularly the case if the FCA tries to rely on firms' past cooperation with innovative approaches as justification for seeking their engagement with future ones. Firms need to carefully consider their position in relation to innovative approaches proposed by the FCA in relation to the specific facts of the situation, and their regulatory exposure. <

8 FCA figures as at the end of February 2014.

9 http://www.fca.org.uk/news/consumer-redress-agreed-for-mis-sold-cpp-insurance.

10 The Scheme was approved by the Court on 7 October, 2013 and the first compensation payments are expected to be made from late March 2014.

11 FCA Press Release 22 August 2013.

12 FCA Press Release 3 February 2014.

Be Prepared—Thematic Reviews

The FCA is very focussed on acting pre-emptively, taking action against firms before consumers suffer widespread harm. One of the ways in which the FCA aims to meet this objective is through seeking to identify risks by carrying out thematic reviews of industry sectors.

Recent thematic reviews have included: outsourcing in the wealth management industry; anti-money laundering and anti-bribery and corruption systems and controls; transition management; and the annuities market.

The leitmotif emerging from these (and other) thematic reviews is one of a regulator that will pursue a judgment-based approach to regulation, with a specific focus on ensuring good outcomes for consumers. Martin Wheatley commented: "*I know some people think this focus on*

Thematic Reviews continued from page 2

business ethics is a regulatory 'phase'.... It is lasting change—as opposed to the firework that peters out and falls to earth".[1] We can expect to see the continued use of thematic reviews; as the FCA has said: "*Thematic reviews, market studies, and the increased use of judgment, these are regulatory features that are here to stay*".[2]

As the use of thematic reviews will only increase, firms must give consideration as to how to deal with requests for information in the context of such reviews, and the spectre of an FCA visit. Firms should put time and effort into preparing properly for thematic reviews as regulatory action can often arise out of problems identified within the industry in the course of these. Relevant staff will need to be available for any meetings that the regulator may wish to have; all information requests must be dealt with effectively and comprehensively; and the firm must make sure it fully understands the questions that are being asked by the regulator so it can provide an accurate response. A well-thought-out response to a thematic review that demonstrates and evidences a firm's compliance can establish credibility with the regulator. A hasty or ill-thought-out response that requires further clarification from the regulator is likely to result in additional regulatory scrutiny with potential enforcement action if breaches are identified.

The FCA regularly publishes its findings in relation to thematic reviews. These publications provide guidance and feedback on identified issues and are intended to educate the industry as to the regulator's expectations. Firms can use this feedback to inform themselves as to what issues are attracting regulatory focus, keeping in mind the emphasis the FCA places on conduct risk, and putting consumers at the heart of their business. Firms that ignore the feedback set out in the FCA publications do so at their peril as the FCA can be expected to come down forcefully on firms that do not adapt their behaviour where they are on notice of what the FCA requires.

Firms should take thematic reviews seriously as they form a significant part of the FCA's supervisory process. As is apparent from the above, thematic review visits can be a useful opportunity for firms to demonstrate their regulatory compliance, but time and effort has to be given to preparation. Thematic review visits have the potential to lead to serious regulatory action if the regulator identifies issues of concern or breaches. Much better to be prepared! <

1 Martin Wheatley, speaking at the ABI Biennial Conference on 9 July 2013: (http://www.fca.org.uk/news/speeches/100-days-of-the-fca).

2 Martin Wheatley, speaking at the ABI Biennial Conference on 9 July 2013: (http://www.fca.org.uk/news/speeches/100-days-of-the-fca).

Past Still Coming Back to Haunt the Regulators

The FCA has said that its two key challenges in moving forward are the "*overwhelming importance of achieving cultural transition in 2014. In other words, publicly demonstrating that there is clear blue water between the past and the future*".[1]

However, reports and investigations into events where the regulator's past approach has been questioned continue. Although the FCA and PRA may try to distance themselves by describing these events as occurring at a different time, under a different regime, they continue to overshadow the new structure.

On 6 January 2014 the FCA announced it was undertaking an enforcement investigation into events at Co-Op Bank[2] looking at the decisions and events up to June 2013. On the same day,[3] the PRA confirmed that it too was undertaking an enforcement investigation in relation to Co-Op Bank and that as part of that investigation it will consider the role of former senior managers. No further information about the investigations and their scope has been released by the regulators and it is difficult to assess how long their investigations will take. The independent review announced by the Chancellor will commence only once it is clear it will not prejudice the actions by the regulator. The FSA's supervision of Co-Op (including its approval of Paul Flowers as Chair) is likely to come under scrutiny.

We continue to await the FCA report into HBOS which will again have to review the actions of a regulator that no longer exists, or at least has evolved with different priorities.

It is difficult for the FCA and the PRA to convince the industry and the public of their new regulatory approach when they are still investigating and addressing issues that arose under the FSA. This is particularly evident when members of the FCA and/or PRA are questioned about their approach whilst in past roles at the FSA. This legacy was always anticipated, but it would be in both regulators' interests to seek to resolve these matters as soon as possible so that they can leave the past behind them and move forward. The longer the legacy issues remain, the harder it may become to establish distance between the current regulatory regime and the past one. <

1 Martin Wheatley speech "*Looking ahead to 2014*" 9 December 2013.

2 6 January 2014, FCA statement.

3 6 January 2014, PRA statement.

Statutory Reform—The Banking Reform Act

The Banking Reform Act follows the Independent Commission on Banking (“**ICB**”) recommendations and the Parliamentary Commission on Banking Standards (the “**Commission**”) inquiry into professional standards and culture within the UK banking sector. The Banking Reform Act gives new powers to the PRA, the FCA and the Bank of England, and introduces measures which address issues such as the accountability of senior management within banks, the cost of payday loans and the “*ring-fencing*” of retail deposits held by high street banks. Many of the reforms are directed towards consumer protection, and this is in line with the emphasis given to this issue by the FCA.

The Banking Reform Act is intended to:

> *“[Introduce] the biggest reforms to the banking sector in a generation: to make banks more resilient to shocks, easier to fix when they get into difficulties, and to reduce the severity of future financial crises…to make sure that when banks make losses, retail customers aren’t excessively affected and taxpayers’ money isn’t used to bail banks out”.*[1]

Although the Banking Reform Act received Royal Assent in December 2013, the majority of the changes that it introduces will not come into effect until 2015 at the earliest, and some of the more revolutionary structural changes will not be effective until 2019.

Changes to be brought about by the Banking Reform Act include:

- Ring-fencing retail deposits held by banks from wholesale and investment banking services. This is intended to protect the deposits of people and small businesses, and protect taxpayers should things go wrong. It is expected that banks will need to arrange their compliance with the ring-fencing requirements by 2019 at the latest.
- The PRA will be able to hold banks to account for the way they separate their retail and investment activities and will have the power to enforce the full separation of individual banks.
- Systemically important banks and building societies will have to hold “*loss-absorbing capacity*” as well as capital in order to meet their capital requirements. This is intended to improve the resilience of major UK banks and it is hoped that if a bank does fail, it can be resolved without recourse to taxpayer bail outs.
- Depositor preference — deposits that are eligible for protection under the Financial Services Compensation Scheme (“**FSCS**”) will be treated as preferential debts and therefore rank ahead of the claims of other unsecured creditors should a bank become insolvent. This gives depositors protection if a bank enters into insolvency.

1 https://www.gov.uk/government/policies/creating-stronger-and-safer-banks.

- A bail-in stabilisation option for the special resolution regime. This will be available in respect of failing banks and investment firms. It will also be an option available to building societies, with some amendment.
- A new Payment Systems Regulator (“**PSR**”) will be established for retail payment systems.[2] Its objectives will include: promoting competition in the markets for payment systems and services provided by payment systems; promoting innovation in payment systems; and ensuring payment systems are operated in a way that takes account of the interests of those who use the payment system services. The PSR will have the power to impose penalties (including fines) on firms in respect of compliance failures.
- A special administration regime for systemically important interbank and securities settlement systems in the event of their insolvency or threatened insolvency.
- Competition related reforms to the FCA and PRA. The FCA will have competition powers that will include use of Competition Act 1998 enforcement powers where companies are engaging in restrictive practices that distort, restrict or prevent competition, and powers to carry out market studies and make reference to the Competition and Markets Authority. The PRA will have a secondary objective relating to competition so it is required to act in a way so as to facilitate effective competition.
- A duty on the FCA to make rules restricting charges for high cost short term credit. The government’s view is that this cap is necessary to address the position of consumers in the payday loan market and end excessive costs on borrowers.
- The Claims Management Regulator (who is responsible for regulating businesses that handle certain types of claims for compensation) will have the power to impose penalties on claims management companies.
- Amendments to the regime in Part 12A of the Financial Services and Markets Act 2000 on regulators’ powers over holding companies. The PRA or the FCA will be able to impose rules on qualifying parent undertakings to make arrangements to allow or facilitate the exercise of resolution powers in relation to the qualifying parent undertaking or any of its subsidiary undertakings where all or part of the business of the parent undertaking or the subsidiary undertaking has financial difficulties.
- Creation of the Senior Persons Regime, certification regime and banking standards rules (which we write about separately in this edition).

It is apparent that the sweeping reforms created through the Banking Reform Act have the potential to make real impact on the banking industry. The “*devil lies in the detail*”

2 The FCA must establish a body corporate to exercise the functions conferred on the body that will be the Payment Systems Regulator.

The Banking Reform Act continued from page 4

however, as much of the relatively high level legislation will need to be implemented through the creation of rules, following consultation. The industry should follow the regulators' consultation papers closely to see how the regulators will seek to put these reforms into effect.

For now, whilst big changes are to come, the effect for firms and consumers remains to some degree uncertain. What is clear, however, is that this will no doubt be a significant focus for both the PRA and the FCA, and we can expect to see a great deal of output from the regulators in the coming months. <

Statutory Reform—Senior Persons Regime

In its June 2013 report "*Changing Banking for Good*", the Commission was very critical of the Approved Persons Regime. It drew a number of conclusions, including that many bankers—largely those at senior levels—operate with very little personal accountability, and with little prospect of enforcement action against them.[1] Accordingly, amongst other proposals, the Commission recommended implementing a Senior Persons Regime and "*Licensing*"[2] arrangements for bankers based on a set of conduct rules, as well as imposing tough new penalties against individuals. These recommendations have now been implemented by the Banking Reform Act.

The new regime will consist of:

- A Senior Persons Regime: This will replace the significant influence function ("**SIF**") element of the approved persons regime for senior bankers and is intended to ensure that key responsibilities within banks (i.e. those which involve, or might involve, a risk of serious consequence for the firm, for business or for other interests in the UK) are assigned to specific individuals who are made fully and unambiguously aware of those responsibilities and that they will be held to account for how they carry them out. The regime will also include:
    - requiring senior persons to formally accept a written statement of responsibilities which sets out their role;
    - reversing the burden of proof so that senior persons can be held accountable for contraventions of regulatory requirements in their areas of responsibility unless they can demonstrate they took all reasonable steps to prevent the contravention from occurring or continuing. Designing, implementing and recording these "*reasonable steps*" will become a vital part of every senior person's job; and
    - giving the regulators power to approve senior persons, subject to conditions or time limits.
- A Certification Regime:[3] This regime, which will sit alongside the Senior Persons Regime, will require banks to ensure that no employee performs a specified function unless that employee has a valid certificate issued by the bank. Such a certificate may only be issued if the bank is satisfied that the employee is fit and proper to perform that function.
- Banking Standards Rules: The new banking standards rules will apply to senior persons and certified bank staff, and the regulators will have the ability to take enforcement action against individuals who have breached the new rules or are knowingly concerned in a breach.
- The Banking Reform Act also introduces a new criminal offence for reckless misconduct in the management of a bank. The offence will only be applicable to individuals who fall within the Senior Persons Regime. Senior persons could be liable if they take a decision which leads to the failure of the bank or fail to take steps available to them to prevent such a decision being taken. The offence will only apply to behaviour that falls "*far below*" the standard that could be reasonably expected of a person in that position. The senior person would also need to have been aware that the decision may cause the failure of the bank.[4]
- The Banking Reform Act also creates a six-year time limit for taking regulatory enforcement action against senior managers, other approved persons and employees (increased from three years).

Current indications are that the regulators expect to be able to implement the new Senior Persons and Certification regimes in 2015.[5] Interestingly, despite the level of press around the introduction of the new criminal offence for reckless misconduct for bankers, the FCA appears to have accepted that it is unlikely to be a power used on a regular basis. FCA Chairman John Griffith-Jones commented as follows, "*Bad business judgment is not a criminal act and the bar will be set very high so I don't think it will catch many people. I don't think it is a nuclear weapon but it is a useful one to have*".[6]

1 Parliamentary Commission on Banking Standards report 'Changing Banking for Good'.
2 Ultimately referred to as "*certification*" in the Banking Reform Act.

3 Previously referred to as the "*Licencing Regime*".
4 HM Treasury briefing October 2013, s36 Banking Reform Act.
5 Timescale subject to change.
6 *Money Marketing* 9 July 2013.

Senior Persons Regime continued from page 5

We note that there is potential for individuals to find themselves with dual approval and being subject to two regimes (as the existing Approved Persons Regime will continue to apply to other parts of the financial services industry in parallel with the Senior Persons Regime). It seems likely that the Senior Persons and Certification Regime will be expanded to the financial industry as a whole, not least because it is unattractive for the regulator to administer two separate regimes. This of course will be subject to consultation.

Conclusion

While the aim of the Senior Persons Regime is to address and overcome the perceived failures of the Approved Persons Regime, there is scope for it to result in more of the type of confusion the Commission was trying to eliminate; or at best involve an increase in administration for both firms and individuals. Further, whilst the need for reform was apparent, how these changes will impact the readiness of prospective senior bank executives to put themselves forward for these roles will be worth noting. Tough new reforms may look good on paper, but they would surely be counterproductive if their actual effect is to deter qualified candidates from seeking and fulfilling these senior positions. With implementation expected in 2015, it will be interesting to see how the regulators plan to apply the new regime and what the outcome of the consultation will be.

Individuals who hold or intend to apply for roles that fall within the Senior Persons Regime should make themselves familiar with the regulatory expectations surrounding these roles. Being able to demonstrate that they took "*reasonable steps*" at all stages in the performance of their function will be a bank executive's first and most important line of defence. The consequences should failures emerge whilst "*on their watch*" have the potential to be severe. <

Contentious Regulatory Law 2013: Key FCA Enforcement Action

Notwithstanding the FCA's willingness to engage in innovative industry agreements and redress schemes, and its increased use of thematic reviews, it has continued to make determined use of its traditional enforcement powers in order to maintain its "*credible deterrence*".

Massive fines imposed in relation to the LIBOR investigations continue to subject behaviour by wholesale market participants to scrutiny. The LIBOR investigations have also led to greater regulatory scrutiny around other benchmarks. The international and UK investigations into manipulation of foreign exchange markets have been gearing up and are not expected to be concluded until 2015. The investigations into this multi-trillion dollar market demonstrate the developing and ongoing cooperation between overseas and local regulators. The outcome of the investigations is unknown, but it can be expected that any regulatory action is likely to result in massive fines against firms. Tracey McDermott, the Director of FCA Enforcement has said "*Firms should be in no doubt that the spotlight will remain on wholesale conduct and we will hold them to account if they fail to meet our standards*".[1]

Inadequate systems and controls within firms continues to be an ongoing issue that arises in a variety of contexts in recent cases, which include CASS breaches, and inappropriate sales incentives. The FCA has pursued a number of enforcement cases where systems and controls failures have led to significant regulatory exposure. The fine of £137,610,000 imposed on J.P.Morgan Chase Bank N.A. ("**JPM**") in relation to the London Whale issue demonstrates the willingness of the regulator to take action.

It seems apparent that the FCA will not shy away from imposing crippling fines where it deems these to be appropriate. The public wants to see financial institutions and individuals held to account where they are at fault, and the FCA appears to be making every effort to achieve this.

LIBOR

The tough enforcement action and the hefty fines issued by the FCA in relation to the LIBOR rate-fixing scandal demonstrate the FCA's commitment to changing the culture of firms by pursuing a strategy of "*credible deterrence*".[2] In doing so, the FCA has publicly reinforced its commitment to pursuing its objectives of ensuring that the relevant markets function well and promoting and enhancing the integrity of the UK's financial system.

1 FCA press release 29 October 2013.

2 Tracey McDermott, speaking at the NERA Economic Consulting seminar on 9 October 2013.

Key FCA Enforcement Action *continued from page 6*

On 25 September 2013 the FCA issued a financial penalty of £14 million[3] to ICAP Europe Ltd (**"IEL"**) for misconduct relating to LIBOR. The FCA found that IEL had breached Principles 5 and 3 of the FCA's Principles for Businesses in that a number of its employees sought to manipulate the Japanese Yen (**"JPY"**) LIBOR submissions made by various banks that contributed to the calculation of published LIBOR rates (**"Panel Banks"**). The FCA said that IEL, through its brokers, had colluded with traders at UBS AG (**"UBS"**) as part of a co-ordinated attempt to manipulate JPY LIBOR submissions made by Panel Banks. The FCA said that it had found evidence that IEL brokers were deliberately disseminating incorrect or misleading LIBOR submissions levels by emailing suggestions to some Panel Banks as to where they believed the published JPY LIBOR rate would set for the day and requesting certain Panel Banks to make specific JPY LIBOR submissions. The FCA found an instance where an IEL broker received corrupt bonus payments (of £5,000 per quarter) as a reward for his assistance in manipulating JPY LIBOR rates. As such, the FCA said that IEL brokers' misconduct risked undermining the integrity of the JPY LIBOR benchmark reference rate.

The FCA held that IEL had breached Principle 5 by failing to observe proper standards of market conduct. In addition, the FCA found that IEL breached Principle 3 by failing to have adequate risk management systems or effective controls in place to monitor and oversee its broking activity. In particular, the FCA investigation found that IEL had failed to adequately review its brokers' communications for compliance issues generally or place any compliance staff on broking floors; as such, the brokers' misconduct was exacerbated by a poor compliance culture within IEL, which was a result of its heavy focus on revenue at the expense of regulatory requirements. Furthermore, the FCA found that IEL's inadequate systems, controls, supervision and monitoring meant that the brokers' misconduct went undetected and continued for several years.

The ongoing shadow of LIBOR was further demonstrated by the action taken against Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (**"Rabobank"**), which received a fine of £105 million[4] for serious, prolonged and widespread misconduct relating to LIBOR. The FCA cited Rabobank's poor internal controls as having encouraged "*collusion between traders and LIBOR submitters and allowed systematic attempts at benchmark manipulation*".[5] In addition, an FCA press release noted that Rabobank "*did not fully address these failings until August 2012, despite assuring the FCA in March 2011 that suitable arrangements were in place*".[6] The FCA considered that Rabobank had failed to act with due care, skill and diligence; had failed to identify, manage or control the relevant risks; and had failed to meet proper standards of market conduct. The misconduct was described by the FCA as "*among the most serious we have identified on LIBOR. Traders and submitters treated LIBOR submissions as a potential way to make money, with no regard for the integrity of the market. This is unacceptable*".[7]

It might not have been unreasonable to hope that the LIBOR investigations would start to ebb, but instead these appear to have triggered enquiries into the operation of other benchmarks. On 16 October 2013, the FCA confirmed that it was conducting investigations alongside several other agencies into a number of firms relating to trading on the foreign exchange (forex) market.[8] Martin Wheatley told a parliamentary hearing on 4 February 2014 that allegations traders had colluded to rig prices in the USD 5.3 trillion spot market were "*every bit as bad as they have been with LIBOR*".[9] Mr Wheatley was reported as saying the strength of the allegations had come as a "*surprise*". The new allegations of forex rigging further undermine banks' reputations and could potentially impact on capital requirements if fines are at a similar scale to those for LIBOR. It is understood that at least 15 banks are cooperating with regulators in the UK, Europe and the US, with a number of banks suspending traders or in some cases, dismissing them.

The FCA is not expected to conclude its inquiries until around 2015. The impact of this and further regulatory inquiries into the way prices are formed in other asset classes could have a real effect on the way these markets operate. The ongoing investigations and revelations of bad behaviour within the financial industry will continue to cause public concern that the industry cannot be trusted.

Mis-selling

The retail cases brought by the FCA illustrate how seriously the regulator takes its operational objective to secure an appropriate degree of protection for consumers. The FCA has said that, "*influencing industry*

3 IEL agreed to settle at an early stage and therefore qualified for a 30% (stage 1) discount; were it not for this discount the financial penalty would have been £20 million.

4 Final Notice 29 October 2013. Rabobank agreed to settle at an early stage and therefore qualified for a 30% (stage 1) discount; were it not for this discount the financial penalty would have been £150 million. At the time of writing, this is the third highest fine ever imposed by the FCA or its predecessor, the FSA.

5 http://www.fca.org.uk/news/the-fca-fines-rabobank-105-million-for-serious-libor-related-misconduct.

6 http://www.fca.org.uk/news/the-fca-fines-rabobank-105-million-for-serious-libor-related-misconduct.

7 http://www.fca.org.uk/news/the-fca-fines-rabobank-105-million-for-serious-libor-related-misconduct.

8 16 October 2013 FCA statement on foreign exchange market investigation.

9 *Financial Times*, 4 February 2014 "*Forex claims 'as bad as Libor'*", says FCA.

Key FCA Enforcement Action *continued from page 7*

perceptions of what is acceptable is one of the regulator's key responsibilities".[10] As such, firms should pay close attention to the enforcement action taken by the regulator in the retail sphere.

In February 2014, the FCA issued its largest-ever retail fine[11] of £30,647,400 to HomeServe Membership Limited ("**Homeserve**"). Homeserve was found to have serious, systemic and long-running failings across many key aspects of its business. In particular, the FCA said that from January 2005 to October 2011 it mis-sold insurance policies, failed to investigate complaints adequately, its Board was insufficiently engaged with compliance matters and its senior management were reluctant to address risks to customers if there was a cost implication.[12] Homeserve is now contacting potentially affected customers to provide redress where appropriate. It is apparent from this case that firms continue to mis-sell, despite ongoing enforcement action and FCA statements about how seriously it views such breaches. The FCA has said in the past that "*priorities appear to have become skewed, resulting in business strategies that pursue profit with little regard for customers…influencing industry perceptions of what is acceptable is one of the regulator's key responsibilities*".[13] The industry should view the substantial fine imposed on Homeserve as a strong message from the FCA that it will not hold back when pursuing action in relation to mis-selling and complaints handling.

Care to ensure suitability of advice was emphasised in the case taken against AXA Wealth Services Ltd ("**AXA**"). AXA was fined £1,802,200[14] for its failure to ensure it gave suitable investment advice to its customers; the FCA said that this failure had put a significant number of AXA's customers at risk of buying unsuitable products.

In the Final Notice, the FCA said: "*It is of fundamental importance that firms providing investment advice take reasonable care to ensure that they give suitable advice to customers. AXA failed to do so*". AXA was deemed to have failed to put in place an adequate process for establishing the level of risk its customers were willing and able to take with their investments; the firm also failed to ensure that its sales advisers were appropriately considering customers' individual circumstances before making recommendations. The FCA said that there was an unacceptable risk of sales advisers making inappropriate investment recommendations to customers in order to qualify for bonus payments.

AXA has since agreed with the FCA to contact all customers who may have been affected by its failings and a third party will oversee a review of any issues identified as a result of the review; AXA has also agreed that any customer who has suffered loss as a result of inappropriate investment advice will be fully compensated and will be able to switch or withdraw their investment.

Customers' losses due to AXA's failings are currently low; however, the FCA has emphasised that in agreeing with AXA that it will contact customers to address any issues, it has pre-empted any future risk to customers by providing them with the opportunity to avoid potential losses during future stock market downturns. This seems an interesting demonstration of what the FCA perceives to be pre-emptive action taken in an enforcement context.

Systems and Controls

The FCA's self-proclaimed role is "*to create a culture of good conduct at every level of the industry*".[15] In order to ensure that the right kind of culture is being instilled in firms, senior managers need to understand their businesses as a whole. This requires adequate systems and controls being put in place as proper systems and controls allow senior managers to: monitor their businesses for compliance issues; assess potential areas of risk; and ensure that minor issues are nipped in the bud. Ultimately, a comprehensive framework of systems and controls allows senior managers to address poor practice before it becomes ingrained in a firm's culture.

However, it is apparent from the cases that continue to be taken against firms, that firms still struggle with these requirements, sometimes with devastating consequences.

The action taken against JPM in relation to the events dubbed "*the London Whale*" is a clear example of this. The FCA imposed a fine of £137,610,000 on JPM[16] as a result of trading issues which saw JPM's Chief Investment Office Synthetic Credit Portfolio (the "**SCP**") announce losses of USD 5.8 billion in the first six months of 2012. By the end of 2012, the trading losses in the SCP amounted to USD 6.2 billion.

The FCA alleged that JPM had breached Principles 2, 3, 5 and 11 of the FCA's Principles for Businesses and that the losses occurred as a result of JPM's trading strategy

10 Tracey McDermott, speaking at the NERA Economic Consulting seminar on 9 October 2013.

11 At the time of writing.

12 FCA press release 13 February 2013, Final Notice 13 February 2013. Homeserve agreed to settle at an early stage and therefore qualified for a 30% (stage 1) discount; were it not for this discount, the financial penalty would have been £43,782,058.

13 Tracey McDermott speech 9 October 2013.

14 Final Notice 13 September 2013. AXA agreed to settle at an early stage and therefore qualified for a 30% (stage 1) discount; were it not for this discount, the financial penalty would have been £2,574,595.

15 Tracey McDermott speaking at the NERA Economic Consulting seminar on 9 October, 2013.

16 The firm agreed to settle at an early stage and therefore qualified for a 30% (stage 1) discount; were it not for this discount, the financial penalty would have been £196,586,000. Final Notice 19 September 2013.

Key FCA Enforcement Action *continued from page 8*

combined with issues around its management of that trading and its response to information which the FCA considered should have alerted the firm to the risks present in the SCP.

Financial Incentives

The FCA has also taken action for systems and controls breaches in the context of financial incentives offered to employees. Lloyds TSB Bank and Bank of Scotland plc received a £28,038,800[17] fine for what the FCA considered to be serious failings in the firms' systems and controls governing the financial incentives that they gave sales staff. This related to staff selling protection and investment products to customers on an advised basis. Advisers' incentives at the firms included a number of higher risk features, such as variable salaries, bonus thresholds which involved disproportionate rewards for marginal sales, and an advanced payment option that could lead to bonus deficits if sales targets were not met. Although the firms had various systems and controls in place to monitor the quality of sales made by advisers, the FCA found that they failed to take steps to ensure that these controls were appropriately focused on the specific higher risk features of advisers' incentives. The failings were found to be particularly serious because: the firms are leading providers of protection and investment products to retail customers in the UK; the firms failed to identify that key changes made to advisers' incentives and related controls served to further increase the risk to customers; the FCA has for many years been warning firms of the need to manage and control risks to customers arising from financial incentives given to sales staff; and were it not for the FCA's intervention the breach would have continued for a longer period and thus exposed more customers to risk.

This case is a useful warning to firms of the FCA's approach to breaches where it considers that the industry has been on notice of potential risks and the need to control these. Firms should be pro-active in assessing their business and its practices to ensure they meet regulatory requirements and prioritise implementing appropriate controls. Inappropriate incentives for sales staff resulting in mis-selling has been a matter of regulatory focus for a number of years (for example in relation to PPI) and the FCA will come down hard on firms that continue with these as the risk of consumer detriment is high.

Treating Customers Fairly—Transition Management

The FCA conducted a thematic review into transition management in 2013, with the results published on 10 February 2014. It has also taken enforcement action in this area, imposing a fine of £22,885,000[18] for breaches relating to transition management services. The FCA said that the breaches involved a strategy by the firms to charge clients undisclosed mark-ups on certain transactions, in addition to the agreed management fee or commission. The overcharging only came to light after having been identified by a client. Those responsible then incorrectly claimed to both the client and the firms' UK compliance department that the charging was an inadvertent error and arranged for a substantial rebate to be paid. They then failed to disclose further mark-ups on other trades conducted. These breaches were considered by the FCA to be serious.

During the relevant period the firms' UK transition management business formed part of their Europe, Middle East and Africa Portfolio Solutions Group ("**EMEA PSG**"), which was run by EMEA PSG management. EMEA PSG was itself part of the Global Portfolio Solutions Group. Over the period of the allegations, the oversight of EMEA PSG (and therefore the UK transition management business) was operated according to a matrix management framework. This meant that responsibility for the transition management business was shared between global business line management and UK senior management. It is interesting to note that the FCA considered that the group's matrix management framework meant EMEA PSG management were not effectively challenged by UK senior management. Processes that were in place were easily circumvented by EMEA management and employees. It is crucial that firms arrange their business lines so that controls and control functions capture any arrangements that step outside of these. This is a key issue for firms with global operations and multi-regional reporting lines.

Transaction Reporting

The FCA continues to highlight the importance of accurate and timely reporting of transactions, which it sees as key to market surveillance. It has issued guidance on transaction reporting and has emphasised that it expects firms to "*get it right*" or face the consequences. It has demonstrated its willingness to take action on breaches in this area by fining The Royal Bank of Scotland plc ("**PLC**") and The Royal Bank of Scotland N.V. ("**RBS N.V.**") (together, "**RBS**") £5,620,300[19] for incorrectly reporting transactions it made in wholesale markets and, in some instances, failing to report transactions at all.

17 Reduced from £35,048,500 for 20% stage 2 settlement discount. Final Notice 11 December 2013.

18 State Street Bank Europe Limited and State Street Global Markets International Limited (Final Notice 31 January 2014). Fine reduced from £32,692,800 for a 30% stage 1 settlement discount.

19 Final Notice 16 July 2013.

Key FCA Enforcement Action *continued from page 9*

It seems that RBS reported some 44.8 million transactions incorrectly, and had failed altogether to report a further 804,000 transactions between 5 November 2007 and 1 February 2012 (the "**Relevant Period**"); the breach represented failures in relation to 30% of all transactions which were reportable by RBS during the Relevant Period.

Although the FCA noted that many of the systems and controls issues at RBS had arisen as a result of the takeover by PLC of ABN Amro Bank N.V. (now known as RBS N.V.), it nevertheless considered that the "*considerable resources available to RBS*" should have enabled it to overcome these challenges and ensure that adequate systems and controls were in place. Firms should note that one of the aggravating factors taken into account by the FCA was the fact it had provided significant guidance on report requirements and had also publicised a number of Enforcement actions taken against other firms in similar circumstances.

CASS

The FCA's appetite for taking action in relation to CASS breaches continues, with a fine of £900,200[20] being issued[21] for breaches of Principle 10 where a firm was found to have failed to arrange adequate protection for client money for which it was responsible. The FCA also found that the firm had breached the CASS rules, including, according to the FCA: failing on several occasions to perform its internal client money reconciliation; failing on several occasions to ensure that any shortfall or excess identified was paid into or withdrawn from the client bank account; failing to make mandatory notifications to the FCA of client money shortfalls or excesses, and failures to maintain accurate records and accounts; failing to submit accurate Client Money and Assets Returns; failing to adequately train employees; and failing to ensure that it maintained its records and accounts in a way that ensured their accuracy. Notably, no client funds were found to have been lost or misused in this case.

The FCA's enforcement action, coupled with the July 2013 CP,[22] demonstrates its continuing focus on the protection of client assets and firms need to engage with these issues. The FCA will have little tolerance for ongoing breaches when it has emphasised to the industry how important these issues are.

Market Abuse

When it comes to market abuse, the FCA has stated that it is committed to taking whatever steps necessary to protect the integrity of markets whatever the techniques used and wherever the perpetrators are located. Brokers and Direct Market Access providers are expected to ensure that their clients implement appropriate controls to monitor their clients' trading activity closely to ensure that it is not abusive, and to report suspicious transactions.

The FCA has had some highs and lows in relation to its pursuit of market abuse cases over the last year. Its success in the Court of Appeal in relation to Swift Trade constitutes a significant high, with a Final Notice being issued on 24 January 2014 imposing a fine of £8,000,000. The regulator found that Swift Trade systematically and deliberately engaged in a form of manipulative trading activity known as "*layering*". This activity gave or was likely to give a false or misleading impression as to the supply of, demand for or the price of the shares in question. This manipulative trading caused a succession of small price movements in a wide range of individual shares on the LSE from which Swift Trade was able to profit. It is a useful case for the FCA and will inform future cases that involve similar types of manipulative trading activity.

By contrast, the FCA had a disappointing outcome in relation to its financial crime case against four former company directors of iSoft, which was reported as "*abandoned by the financial regulator after a seven year investigation and two criminal trials*".[23] The FCA had alleged that the directors had created discrepancies in the company accounts to deceive investors. The first trial resulted in a hung jury in August 2012. The retrial began in April 2013, but after a legal argument was raised relating to procedural issues around cross examination by the prosecution, the jury was discharged. The FCA has confirmed that it will not pursue a third trial.

The outcome of this case was perceived as being something of a blow to the FCA's reputation as it was considered one of its biggest financial crime cases and only the second criminal case of conspiracy to mislead the markets. The FCA acknowledged it was disappointed but said, "*As with all our cases, win or lose, we will look to see what lessons can be learned for the future*".[24] Although the issues in this case arose from a particular procedural issue, it will be interesting to see if the experience causes the FCA to take a more cautious approach to similar cases in the future—we suspect it will continue to pursue a vigorous stance and firms need to be prepared for this.

Conclusion

The FCA has made it clear that it will continue to build on the strength of its enforcement approach and pursue credible deterrence with vigour. The FCA remains concerned that across the financial services sector, in both retail and wholesale

20 Reduced from £1,286,000 for 30% stage 1 settlement discount.

21 SEI Investments Europe Limited Final Notice 25 November 2013.

22 See CP13/5: Review of the Client Asset Regime for Investment Business: http://www.fca.org.uk/news/cp13-5-review-of-the-client-assets-regime-for-investment-business.

23 *Financial Times*, 22 July 2013 "*FCA abandons high profile prosecutions in iSoft case*".

24 *Guardian*, 22 July 2013 "*Regulator sees case against iSoft collapse over missing file*".

Key FCA Enforcement Action *continued from page 10*

markets, serious issues continue to emerge. It is committed to demonstrating that where firms or individuals do not abide by the regulatory requirements, robust action will follow.

For any firm or individual involved in enforcement proceedings, it is essential that they carefully assess the strengths and weaknesses of their cases so as to inform their approach as to whether to settle at an early stage or pursue the matter to the Upper Tribunal and potentially beyond. Firms must monitor enforcement cases carefully, as the FCA expects them to learn the lessons that arise out of them and ensure that they have business practices, values and cultures to address the risks in their business.

The FCA is determined to create a culture of good conduct within the industry and will continue to use enforcement proceedings to achieve this. The FCA has made it clear that there will be no let-up in this area. It has said, "*If anything our recent cases have underlined that we are more committed than ever to showing firms and individuals that they must play by the rules, because if they don't robust sanctions are a matter of course*".[25] We await to see if it will also be a regulator that takes greater risks in the enforcement cases that it brings and can withstand the possibility it might lose a few along the way. <

25 Tracey McDermott speech 9 October 2013.

European Developments

European legislation continues to drive the domestic agenda for financial services law. The harmonisation of financial services law across the EU and the ongoing move to a single European rulebook will have a significant impact on the UK's regime over the coming years. In the following section we outline the potential changes to the European market infrastructure requirements that are likely to be brought about by the revision to the European Market in Financial Instruments Directive ("**MiFID II**"). We also outline the key changes to be made to the European market abuse regime, which seeks to address the increased sophistication of the financial markets and to reflect the changes likely to be brought about by MiFID II. We conclude this edition with an update on the European Market Infrastructure Regulation ("**EMIR**"), which imposes requirements in respect of derivative transactions, and an update on the European Alternative Investment Fund Managers Directive ("**AIFMD**"), which has an impact on both EU investment managers and non-EU investment managers which intend to market funds into the EU.

REVISION OF THE EU MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE

After two years of discussion and negotiation, it was announced on 14 January 2014 that the European Commission, European Parliament and the Council of the European Union have reached informal political agreement on MiFID II,[1] the package of reforms and amendments to the Markets in Financial Instruments Directive[2] which establishes the framework for the regulation of financial markets and securities across the European Union.

It is expected that the final MiFID II text will be finalised within Q2 2014, after which, the relevant European bodies shall begin work on the level 2 legislation, bringing the necessary substance and detail to the requirements to be set out in MiFID II. We have described several of the major changes likely to be brought about by MiFID II below.

Once MiFID II is finalised, an implementation period of at least two years before MiFID II comes into effect is expected. MiFID II will therefore likely come into effect during late 2016 or 2017.

Organised Trading Facility

OTFs will be introduced as a new form of regulated trading venue for non-equity financial instruments (sitting alongside regulated markets and multilateral trading facilities ("**MTFs**")) to regulate platforms which bring together third party trading interests but which currently fall outside the characteristics of a regulated market or MTF (such as certain existing broker crossing networks and interdealer crossing systems).[3] Whilst a trading platform in which the operator may exercise an element of discretion in relation to the execution of trades cannot be categorised as a regulated market or MTF, such trading platforms will, under MiFID II, be categorised as an OTF which will be subject to similar transparency obligations as the other regulated trading venues. Operators of OTFs will be prohibited from executing client orders on the OTF against its own proprietary capital (subject, potentially, to limited exceptions to be set out in the final MiFID II text).

Investment Services Into EU by Third Country Firms

MiFID II will permit third country firms that intend to provide investment services to retail clients located in the EU to do so through an authorised branch established within the EU.[4]

1 MiFID II is accompanied by a new Markets in Financial Instruments Regulation ("**MiFIR**").

2 Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments ("**MiFID**").

3 See art.20 of the European Parliament's Report on MiFID II; see art.20 of the Council of Europe's General Approach on MiFID II.

4 See art.36 and art.41 of the European Parliament's Report on MiFID II; see art.41of the Council of Europe's General Approach on MiFID II.

Revision of the EU Markets in Financial Instruments Directive *continued from page 11*

It is also possible that third country firms will be able to obtain registration with the European Securities and Markets Authority ("**ESMA**") in order to provide cross-border investment services to eligible counterparties and professional clients across the EU under an EU services passport.

Both authorisation of an EU branch established by, and registration of, a third country firm would be contingent upon (amongst other factors) the home jurisdiction of the non-EU firm having equivalent legal and supervisory measures in the relevant financial areas.

The revision of the regime governing the provision of investment services by third country firms could potentially preclude the UK from retaining its current financial services exemption for "*overseas persons*".[5]

Trading in Clearing Eligible Derivatives and Liquid Financial Instruments

Derivatives transactions conducted between "*Financial Counterparties*" and "*Non-Financial Counterparties*" (and equivalent third country firms where the transaction has a direct, substantial and foreseeable effect within the EU) that are subject to the clearing obligation under EMIR[6] will be required to be conducted on a regulated market, MTF, OTF or an equivalent third country trading venue.[7]

Furthermore, the final MiFID II text may require firms to conduct certain transactions in financial instruments which are listed on a regulated market or traded on an MTF or OTF only over such regulated trading venues or through a systematic internaliser (subject, potentially, to limited exceptions to be set out in the final MiFID II text, such as exemptions for intra-group transactions and transactions which are large in scale) to further reduce the overall number of OTC trades being conducted within the EU.

Commodity Derivatives Position Limits/Position Reporting

Market participants of EU regulated trading venues will be subject to limits on the number of commodity derivatives contracts or positions which a participant can enter into or hold over a specified period of time.[8] These limits are to be set by the relevant financial regulators of each EU member state in accordance with methodologies to be prescribed by ESMA.

Additionally, regulated trading venue participants may be required to report to their respective trading venues in as close to real time as practicable their commodity derivative and emission allowance positions which they hold in their proprietary capacity and, separately, any positions which they hold on behalf of their clients. Trading venues will, in turn, publish aggregated data on such commodity derivative and emission allowance positions on a weekly basis and, on request, provide participant or instrument specific data to national regulators.

Algorithmic Trading

Firms which engage in algorithmic trading will be required to establish effective systems and controls to ensure the resilience of their trading systems to prevent trading which may create or contribute to a disorderly market.[9]

Where a firm is engaging in algorithmic trading in pursuit of a market making strategy, the firm may be required to continuously provide quotes for at least a minimum duration to be specified by the final MiFID II text.

Complex Financial Products/Investor Protection

MiFID II will provide new powers for ESMA and national regulators to prohibit or restrict the sale of a particular (or category of) financial instrument(s), financial activities or financial practices which, in the opinion of the relevant regulator, raise investor protection concerns or pose a threat to the orderly functioning and stability of a particular market or the financial system as a whole.[10]

Additionally, in the interests of investor protection, MiFID II will no longer permit structured UCITS, shares in non-UCITS collective investment undertakings, and instruments with an embedded derivative to be categorised as "*non-complex*" financial instruments. Consequently, even where firms are providing execution services in respect of these products, a firm will be required to assess whether its services and/or products are appropriate for its clients.[11]

Corporate Governance/Nomination Committee

MiFID II will require directors of firms to commit sufficient time to perform their duties. Accordingly, MiFID II will impose limitations on the amount of non-intragroup directorships which each director may hold (for example, an executive director of a firm may only hold up to two non-executive directorships of companies outside of that firm's group).[12]

Additionally, firms will be required to establish a nomination committee to assess and provide recommendations in regards to whether the management body possesses

5 See art.72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

6 See art.4 of Regulation (EU) 648/2012 on OTC, Derivatives, Central Counterparties and Trade Repositories.

7 See art.24 and art.2a of the European Parliament's Report on MiFIR; see art.24 and art.20c of the Council of Europe's General Approach on MiFIR.

8 See art.59 and art.60 of the European Parliament's Report on MiFID II; see art.59 and art.60 of the Council of Europe's General Approach on MiFID II.

9 See art.17 of the European Parliament's Report on MiFID II; see art.17 of the Council of Europe's General Approach on MiFID II.

10 See art.31 and art.32 of the European Parliament's Report on MiFIR; see art.31 and art.32 of the Council of Europe's General Approach on MiFIR.

11 See art.25 of the European Parliament's Report on MiFID II; see art.25 of the Council of Europe's General Approach on MiFID II.

12 See art.9 of the European Parliament's Report on MiFID II; see art.9 of the Council of Europe's General Approach on MiFID II.

Revision of the EU Markets in Financial Instruments Directive *continued from page 12*

adequate collective knowledge, skills and experience to understand the firm's activities and main risks, as well as to take account of diversity when selecting members to the management body.

Trade Reporting

MiFID II will extend the existing trade transparency regime that is currently applicable only to shares which are listed on a regulated market or traded on an MTF. Additionally, MiFID II will require (a) regulated trading venues (e.g. regulated markets, MTFs and OTFs) and systematic internalisers to publish quotes and post-trade data in respect of transactions conducted on its systems, and (b) firms to publish post-trade data in respect of transactions conducted OTC, in relation to "*equity-like*" instruments (e.g. depositary receipts, exchange traded funds and certificates) and non-equity instruments (e.g. bonds, structured products, emission allowances and derivatives) where such financial instruments are listed on a regulated market or traded on an MTF or OTF.

Approved Publication Arrangements ("APAs")/ Consolidated Tape Providers ("CTPs")

Firms will be required to fulfil their post-trade reporting obligations in respect of OTC transactions through the newly conceived APA. APAs will effectively replace the current publication function performed by existing Trade Data Monitors.

Secondary to the accurate publication of post-trade data, APAs will also be required to facilitate the transfer of post-trade data to the newly introduced CTPs. CTPs shall consolidate in one place post-trade data originating from firms and regulated trading venues to allow market participants to more effectively compare trades taking place across the EU, thereby further promoting market transparency.

REVISION OF THE MARKET ABUSE DIRECTIVE

Directive 2003/6/EC of the European Parliament and of the Council on Market Abuse ("**MAD**"), which came into force 12 April 2003, is also in the process of being revised. In order to further promote harmonisation of market abuse and insider dealing regimes across the EU, the European Commission published its legislative proposal to revise MAD in the form of a draft regulation ("**MAR**"), which shall be directly applicable in each of the European member states without the need for national implementation when it eventually comes into force. Whilst MAR remains unfinalised, the European Parliament and the Council of Europe have reached political agreement on the contents of MAR. MAR can only be finalised once MiFID II has been finalised since MAR relies upon concepts to be introduced by MiFID II.

At the same time as the European Commission published its proposal for MAR in October 2011, the European Commission also published a draft directive to complement MAR by introducing minimum rules on criminal offences and criminal sanctions for market abuse ("**CSMAD**"). The UK, however, has the right under the Treaty of Lisbon to opt into or out of any European legislative policy that relates to matters of justice and home affairs. The UK has exercised its discretion to opt out of CSMAD on the basis that the UK already has an established criminal market abuse regime.

Based upon the political agreement reached on MAR on 26 June 2013, we have described several of the major changes likely to be brought about by MAR below.

Financial Instruments Traded on an MTF or OTF

In addition to financial instruments admitted to trading on a regulated market, the market abuse regime will be extended by MAR to capture financial instruments which are traded on an MTF as well as those traded on an OTF (being a new type of regulated trading venue to be introduced by MiFID II).[13]

Like regulated markets, MTFs and OTFs will also be required by MAR to adopt adequate structural arrangements to be able to detect and potentially prevent market abusive practices.

Types of Financial Instruments Captured by MAR

MAR will extend the offence of market manipulation to capture cross market manipulation conducted in relation to (i) spot commodity contracts,[14] where the transaction, order or behaviour has or is likely or intended to have an effect on the price of financial instruments that are traded on a regulated market, MTF or OTF, (ii) other financial instruments (e.g. derivatives), where the transaction, order, bid or behaviour has or is likely to have an effect on the price of related spot commodity contracts,[15] (iii) emission allowances and other products auctioned pursuant to the Emissions Trading Regulations,[16] and (iv) financial benchmarks.[17]

Intermediate Steps

Reflecting the ruling by the European Court of Justice in the Daimler case,[18] MAR clarifies that information relating to an intermediate step, which is part of a protracted process, may be precise information and therefore can, by itself, constitute inside information provided all other criteria of inside information as set out in MAR are satisfied.

13 See art.2(1) of the political agreement on MAR (5 July 2013).
14 See art.2(3)(b) of the political agreement on MAR (5 July 2013).
15 See art.2(3)(c) of the political agreement on MAR (5 July 2013).
16 See art.2(1) of the political agreement on MAR (5 July 2013).
17 See art.2(3a) of the political agreement on MAR (5 July 2013).
18 Markus Geltl v Daimler AG, C-19/11.

Revision of The Market Abuse Directive *continued from page 13*

Significant Effect on Price/Reasonable Investor Test

MAR interprets information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments (**"Inside Information"**) to mean "*information a reasonable investor would be likely to use as part of the basis of his investment decision*".[19] This aligns with the Upper Tribunal's interpretation of "*significant effect on price*" in the UK case of *FSA v Massey*.[20]

Presumption of Use

The recitals of MAR state that a person in possession of inside information who carries out any transaction related to that inside information shall be presumed to have used that information, but this presumption may be rebutted if the person can establish that he did not use the inside information in carrying out the transaction. Whilst this presumption is not expressly set out in the main text of MAR, the main text of MAR does refer to situations where a person in possession of inside information shall not, in itself, be "*deemed*" to have engaged in insider dealing (for example, where adequate and effective Chinese walls have been established). This aligns with the ruling by the European Court of Justice in the Spector Photo case.[21]

Attempted Market Abuse

MAR will extend the insider dealing and market manipulation offences to also include attempted abusive behaviour, such as where a person attempts to commit insider dealing but the order is unsuccessful. It is, however, difficult to see how national regulators will be able to detect such attempted abusive behaviour in the absence of an actual effect to the markets.

Market Soundings

One particular behaviour that MAR recognises as not constituting an improper disclosure of inside information is the performance of market soundings. In order to gauge the interest of potential investors in a possible transaction and the conditions relating to it (such as its potential size or pricing), issuers of financial instruments, secondary offerors of a financial instrument in such quantity or value that the transaction is distinct from ordinary trading, emission allowance market participants, and third party agents acting on behalf of or on the account of such persons will be required by MAR to specifically consider whether the market sounding will involve the disclosure of inside information. The disclosing market participant will be required to make a written record of its conclusion and the reasons for that conclusion, both of which must be provided to a national regulator on request. MAR includes a presumption that a marketing sounding was made legitimately in the normal course of the exercise of a person's employment, profession or duty if, in addition to the requirements already mentioned, before making the disclosure, the disclosing market participant:

- obtains the consent of the person receiving the market sounding to receive inside information;
- informs the person receiving the market sounding that he will be prohibited from using that information, or attempting to use that information, by acquiring or disposing of, for his own account or for the account of a third party, financial instruments relating to that information;
- informs the person receiving the market sounding that he will be prohibited from using that information, or attempting to use that information, by cancelling or amending an order which has already been placed concerning a financial instrument to which the information relates;
- informs the person receiving the market sounding that by agreeing to receive the information he is also agreeing to, and must, keep the information confidential;

and, after making the disclosure, the disclosing market participant:

- makes and maintains a record of all information given to the person receiving the market sounding, including the information given in accordance with the bullet points above, and the identity of the potential investors to whom the information has been disclosed, including but not limited to the legal persons and the natural persons acting on behalf of the potential investor, and the date and time of each disclosure.

The disclosing market participant must also inform a person who has received a market sounding once the information ceases to comprise inside information and keep a record of such correspondence. Although this is a useful clarification there is some doubt as to how this might work where firms involved in an offering of securities reach a different conclusion as to whether the information to be disclosed is inside information or not. In such situations some recipients of the information may find that they have agreed to restrict themselves from trading, whereas others have not. Further details are to be provided in secondary legislation to be drafted by ESMA.

Insider Lists

Issuers of a financial instrument admitted to trading on a regulated market or traded on an MTF or OTF (with the exception of issuers whose financial instruments are admitted to trading on an SME growth market), emission

19 See art.63 of the political agreement on MAR (5 July 2013).

20 Financial Services Authority v Massey [2011] UKUT 49 (TCC).

21 Spector Photo Group NV v Commissie voor het Bank, Financie-en Assurantiewezen, C-45/08.

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allowance market participants, emission allowance auction platforms, auctioneers and auction monitors and any person acting on their behalf will be required to maintain, and keep updated, a list of employees who have access to inside information and to ensure that any person on the list acknowledges in writing the legal and regulatory duties entailed and is aware of the sanctions applicable to the misuse or improper disclosure of such information. MAR will require the list to at least include the following:

- the identity of any person having access to inside information;
- the reason for including that person in the list;
- the date and time at which such person obtained access to inside information; and
- the date at which the insider list was created.

Further details are to be provided in secondary legislation to be drafted by ESMA.

Manager's Transactions

Issuers of financial instruments admitted to trading on a regulated market or traded on an MTF or OTF, emission allowance market participants, emission allowance auction platforms, auctioneers and auction monitors will be required to maintain a list of persons discharging managerial responsibilities within their company and persons closely associated with them.

Such persons discharging managerial responsibilities will be required to notify the (i) issuer, emission allowance market participant, emission allowance auction platform, auctioneer or auction monitor, and (ii) the relevant national regulator, about the existence of every transaction (including the pledging and lending of financial instruments) conducted on their own account relating to the shares or debt instruments of that issuer, or to derivatives or other financial instruments linked to them, or in emission allowances or related derivatives within three business days after the transaction once the total amount of such transactions by a particular individual has reached EUR 5,000 within a calendar year (though national regulators have the discretion to increase this threshold to EUR 20,000). The issuer, emission allowance auction platform, auctioneer or auction monitor will, in turn, be required to make such information public (unless national regulators implement alternative arrangements to make public such information themselves).

MAR will require the notification to include the following information:

- name of the person;
- reason for notification;
- name of the relevant issuer, emission allowance auction platform, auctioneer or auction monitor;
- description and identity of the financial instrument;
- nature of the transaction(s) (e.g. acquisition or disposal);
- date and place of the transaction(s); and
- price and volume of the transaction(s) (in the case of a pledge whose terms provide for its value to change, this should be disclosed together with its value at the date of the pledge).

Investigatory and Supervisory Powers of National Regulators

MAR will require member states to designate a single regulator for the purposes of overseeing national compliance with the market abuse rules. In conformity with national law, MAR provides the relevant national regulator with wide ranging supervisory and investigatory powers, which include (but are not limited to) the powers to:

- access any document and other data (in any form);
- require or demand information from any person;
- in relation to commodity derivatives, request information from market participants on related spot markets according to standardised formats, obtain reports on transactions, and have direct access to traders' systems;
- carry out on-site inspections, or investigations at sites other than the private residences of national persons;
- enter premises of natural and legal persons in order to seize documents and other data, or require existing data traffic records from a telecommunications operator, where there is a reasonable suspicion that such documents, data or records may be relevant to prove a case of insider dealing or market manipulation;
- refer matters for criminal investigation;
- request the freezing and/or sequestration of assets;
- suspend trading of the financial instrument concerned;
- require the temporary cessation of any practice considered contrary to the market abuse rules;
- impose a temporary prohibition on the exercise of professional activity; and

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- take all necessary measures to ensure that the public is correctly informed, including the correction of false or misleading disclosed information, including by requiring an issuer or other person who has published or disseminated false or misleading information to publish a corrective statement.

Administrative Sanctions

One of the key criticisms of the existing market abuse regime has been the significant variation in sanctions seen across the EU. For the first time, MAR establishes a framework for civil sanctions for market abuse. Companies convicted of market abuse could be fined up to 15% of their annual turnover or, if greater, EUR 15 million. Individual perpetrators could face fines of up to EUR 5 million and a temporary, or in some cases permanent, ban on doing certain jobs within investment firms.

THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE

The European Union Alternative Investment Fund Managers Directive (the "**AIFMD**") regulates the hedge, private equity and alternative investment fund industry in Europe. It imposes organisational, management and systems requirements on alternative investment fund advisers that are either domiciled in the EU or that manage investment funds domiciled in the EU ("**AIFMs**"). It also imposes minimum standards of pre- and post- sale disclosure and regulatory reporting for non-EU managers that actively market their funds to EU investors (the "**Minimum AIFMD Marketing Requirements**").

The deadline for EU Member States to transpose the AIFMD into their national laws was 22 July 2013.

Whilst the large majority of EU Member States had transposed the AIFMD into their national laws by the 22 July 2013 deadline, several EU Member States (such as Finland, Italy, Norway and Spain) have yet to do so. The expectation is, however, that all EU Member States will have transposed the AIFMD into their national laws at some point during the first half of 2014.

In respect of the EU Member States which have transposed the AIFMD into their national laws, we note that there is little conformity across these jurisdictions with regards to the requirements for non-EU investment advisers to market funds which they manage into the respective EU jurisdictions. In particular, certain (but not all) EU member States have provided for a transitional period allowing eligible investment advisers (subject to certain conditions, which vary across the EU jurisdictions) to market funds that they manage into that jurisdiction subject to the national marketing regime in place prior to the implementation of the AIFMD until 22 July 2014. In the situation where a transitional period is not available or once the transitional period has expired, a number of EU Member States have also imposed marketing requirements that go beyond the Minimum AIFMD Marketing Requirements.

In regards to implementation of the AIFMD requirements in the UK, the UK has provided for a transitional period in which UK AIFMs which had been managing an AIF prior to 22 July 2013 may continue to do so without authorisation until 22 July 2014, and non-EU AIFMs which had marketed any AIF into the European Economic Area prior to 22 July 2013 may continue to market existing and new AIFs to prospective UK investors under the existing UK private placement regime. If the non-EU AIFM cannot avail itself of the UK transitional arrangements (or, after 22 July 2014), it would have to (i) comply with the Minimum AIFMD Marketing Requirements, (ii) comply with the existing UK private placement regime, and (iii) provide prior written notification to the FCA in which the Non-EU AIFM confirms that the conditions of the Minimum AIFMD Marketing Requirements have been met.

EUROPEAN MARKET AND INFRASTRUCTURE REGULATION

Regulation (EU) 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories ("**EMIR**") introduces new requirements on market participants to: (i) report all transactions in derivatives to a trade repository (including life-cycle events such as any modification and termination); (ii) clear certain derivatives through a central counterparty ("**CCP**"); and (iii) employ risk-mitigation techniques for derivatives that are not cleared through a CCP.

Whilst EMIR came into force on 16 August 2012, the timing for particular rules to come into effect has been staggered.

Certain of the EMIR risk mitigation techniques for OTC derivative contracts not cleared by a CCP came into effect during 2013, such as the requirement for timely confirmation and daily valuation (which came into effect on 15 March 2013), and requirements relating to portfolio reconciliation, portfolio compression and dispute resolution (which came into effect on 15 September 2013).

The derivatives trade reporting requirement, in respect of all types of derivatives, came into effect on 12 February 2014.

The mandatory derivatives clearing requirement is expected to come into effect during mid-2014 (provided the first authorisations of relevant CCPs under EMIR occur during Q1 2014). <

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